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IRS Provides Issuers of Tax-Advantaged Debt With New 'DIY' Tools to Fix Nonqualified Use

By Victoria N. Ozimek and Brian P. Teaff[*]

On April 11, 2018, the IRS released Revenue Procedure 2018-26, which provides an expansion of the remedial actions available to issuers of tax-advantaged bonds. Specifically Rev. Proc. 2018-26 provides:

- Additional options for issuers seeking to remediate private business use associated with eligible long-term leases; and
- Options for remediating ''build America bonds'' and qualified tax credit bonds, such as qualified school construction bonds.

REMEDIAL ACTIONS

A remedial action is a ''do-it-yourself'' option for issuers whose plans have changed and find themselves facing an unexpected change of use of bond-financed property. By taking an authorized remedial action, an issuer is able to cure otherwise impermissible use of the bond-financed property without having to negotiate with the Internal Revenue Service, as would be the case under the Voluntary Closing Agreement Program or pursuant to a Private Letter Ruling request. Rev. Proc. 2018-26 expands the toolkit available to issuers to cure unexpected changes in use that might otherwise disrupt the tax-advantaged status of their bonds.

Threshold Requirements for Remedial Actions

Generally, Reg. §1.141-12 provides that the taking of an action that creates excess private business (a ''deliberate act'') will not adversely affect the tax-exempt status of the bonds if certain threshold requirements have been met and the issuer (1) redeems or defeases bonds that the regulations identify as being related to the excess private use (the ''nonqualified bonds''); (2) uses the entire amount of the proceeds from the deliberate act (the ''deliberate act proceeds'') for a governmental purpose within two years of the deliberate act; or (3) provides for an alternative use of the property for a qualifying purpose.[1]

In order to be eligible to take a remedial action, an issuer must meet certain threshold requirements with respect to the bonds and the deliberate act:

1. *Reasonable expectations test*. On the original issue date of the bonds, an issuer cannot have reasonably anticipated that it would engage in a deliberate act creating excess private business.
2. *Maturity not unreasonably long*. The term of the bonds must not be longer than is reasonably necessary for the purposes of the issue. Generally, this requirement is met if the weighted average maturity of the bonds is not greater than 120% of the average reasonably expected economic life of the financed property.
3. *Fair market value consideration*. The deliberate act must be for fair market value, taking into ac-

[*] Victoria N. Ozimek is a partner in Bracewell LLP's public finance practice in Austin, Texas. She offers legal advice to clients regarding all aspects of tax advantaged obligations, from vetting the tax issues on proposed financing structures to assisting issuers with post- issuance compliance matters such as remedial actions and private business use analyses.

Brian P. Teaff, a partner in Bracewell's Houston office, has a multifaceted tax practice, advising clients in connection with tax-exempt financings and other business transactions in the public finance area, as well as counseling public charities, private foundations and high-net worth individuals on a wide range of tax planning and compliance matters.

[1] All section references are to the Internal Revenue Code of 1986, as amended (Code), and the regulations thereunder, unless otherwise specified.

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count any bona fide restrictions imposed on the property by the issuer (e.g. that it must be used for a specific types of development), and the agreement relating to the deliberate act must have been made at arm's length.

4. *Treatment of Deliberate Act Proceeds*. The issuer must treat any deliberate act proceeds as ''gross proceeds'' for arbitrage purposes. This generally means that the deliberate act proceeds cannot be invested at a yield that is materially higher than the yield on the bonds.

5. *Proceeds expended*. The bond proceeds affected by the deliberate act must have been expended on a qualified purpose (e.g., property intended for governmental use) before the date of the deliberate act. This requirement does not apply if the remedial action will be the redemption or defeasance of nonqualified bonds.

Types of Remedial Actions

If the threshold requirements are met, the issuer may take remedial action to ''cure'' the deliberate act. Depending on the facts of the deliberate act, remedial actions available to the issuer are the following:

Redemption or Defeasance of Nonqualified Bonds

If the deliberate act proceeds are exclusively cash, the cash may be used to redeem the nonqualified bonds on the earliest call date after the deliberate act. If the bonds are not callable within 90 days of the date of the deliberate act, the issuer may establish a defeasance escrow within 90 days of the deliberate act, but only if the nonqualified bonds are callable within 10 ½ years of the issue date of the bonds and the issuer provides the internal revenue service (IRS) with notice that the defeasance escrow has been established.

Nonqualified bonds are a portion of the outstanding bonds in an amount that, if the remaining bonds were issued on the date of deliberate act, the remaining bonds would not meet the private business use test. Thus, an issuer need only remediate for the private business use over and above the permitted threshold. However, for this purpose, the amount of private business use is the greatest percentage of private business use in any one-year measurement period occurring after the deliberate act. (Note: This is different from the general measurement rules, which in most cases provide that the amount of private business use is the average percentage of private business use over the entire measurement period, which allows one-year periods of little or no use to bring down the overall percentage of private business use.)

Importantly, an issuer cannot ''pick and choose'' the bonds that it would be most beneficial for an issuer to redeem (e.g. the maturities with the highest coupons). Rather, the allocation of nonqualified bonds must be made either (1) on a pro rata basis, or (2) in a manner that would not extend the weighted average maturity of the bond issue, determined as of the date of redemption or defeasance. As such, both the issuer and its financial advisor must understand these limitations, as they may affect the overall cost-benefit analysis.

Finally, one important timing consideration of which issuers should be aware is that a deliberate act occurs on the date an issuer and the private party enter into a binding contract that is not subject to material contingencies. This can sometimes cause unexpected timing hiccups, as a contract for sale (which could trigger the deliberate act) may be signed well before the actual closing date when amounts that may be needed by the issuer for the redemption or defeasance will be actually received.

Alternative Use of Deliberate Act Proceeds

If the deliberate act proceeds are exclusively cash, the issuer may also use the deliberate act proceeds for capital expenditures related to an alternative governmental purpose. An issuer must reasonably expect to expend the deliberate act proceeds within two years of the date of the deliberate act in a manner that does not cause excess private business. If an issuer does not use all of the deliberate act proceeds for capital expenditures related to an alternative governmental use within the two year period, an issuer must use the remaining deliberate act proceeds to redeem or defease nonqualified bonds.

An issuer should note that the IRS has taken the position that this remedial action requires that all of the deliberate act proceeds be used for capital expenditures related to an alternative governmental purpose within the prescribed two-year period. This is true even if the amount of the deliberate act proceeds is in excess of the amount of bond proceeds used for the financed property. For example, if an issuer sells bond-financed property for a large profit, the issuer should carefully consider whether this remedial action is in its best interest. An issuer should also make sure that the alternative expenditure meets state law requirements regarding use of bond proceeds.

Alternative Use of Facility

If the deliberate act results in the property being used for a qualifying purpose for another type of tax-exempt bond (e.g. an exempt facility bond), the nonqualified bonds may be treated as reissued as of the date of the deliberate act, provided that the new user does not use proceeds of another issue of tax-exempt obligations to finance their interest in the property. The issuer must use deliberate act proceeds to pay

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debt service on the reissued bonds on the next available payment date or to establish a yield-restricted escrow to pay debt service.

Anticipatory Remedial Actions

For many years, an issuer had to wait until after it had taken a deliberate act to remediate bonds. This was seemingly contrary to the policy objective of taking bonds off the market as soon as possible. In 2015,[2] the IRS rectified this incongruence by providing an issuer with the ability to redeem or defease nonqualified bonds in anticipation of a deliberate act if the following requirements are met:

1. *Declaration of Intent*. Prior to taking the anticipatory remedial action, an issuer must declare an official intent (a ''declaration of intent'') to redeem or defease all bonds that would become nonqualified bonds if a subsequent deliberate act is taken. The declaration of indent must describe the anticipated deliberate act and identify the financed property or loan that will be affected.

2. *Redemption of Nonqualified Bonds*. An issuer must in fact redeem or defease the nonqualified bonds prior to the date of the deliberate act. As with a ''normal'' remediation that involves a defeasance, the nonqualified bonds must be callable within 10 ½ years of the date the obligations were issued and an issuer must provide the IRS with notice that the defeasance escrow has been established.

Anticipatory remedial actions are only an option if an issuer plans to redeem or defease bonds, as both other remedial action options require that deliberate act Proceeds already be received. If an issuer has enough cash on hand to redeem or defease nonqualified bonds, however, an anticipatory remedial action can be an attractive option for issuers wishing to take care of remediating bonds prior to a deliberate act.

REMEDIATION OF LONG-TERM LEASES

Prior to the release of Rev. Proc. 2018-26, the only option to remediate ''bad'' use created by a long-term lease to a private business user was to redeem or defease the related bonds. Rev. Proc. 2018-26 provides an additional option by allowing issuers to remediate private use resulting from eligible long-term leases by recycling an amount equal to the present value of the payments to be received under the lease (the ''disposition proceeds'') into ''good'' use within two years of entering into the lease.

This new remedial action provides issuers with more flexibility to remediate private use associated with a bad lease, thus allowing these issuers to avoid, for example, the negative arbitrage that might be associated with establishing a defeasance escrow for debt that is not currently callable. We note, however, that an issuer must actually have access to amounts equal to the disposition proceeds to avail itself of this option, which could present a challenge since the issuer presumably will receive payments from the lessee over the term of the lease. Nonetheless, it never hurts to have options, especially as more governmental entities consider entering into ''public-private partnerships.''

REMEDIAL ACTIONS FOR TAX CREDIT BONDS

Prior to the release of Rev. Proc. 2018-26, there were no specific remedial actions for qualified tax credit bonds, such as ''build America bonds'' and qualified school construction bonds. The provisions of Rev. Proc. 2018-26 attempt to fill this gap by providing issuers with the remedial action options described below.

Adjustment of Federal Subsidy Payment for Direct Pay Tax Credit Bonds

''Direct pay'' tax credit bonds are issued as taxable bonds that entitle the issuer to receive a subsidy payment from the federal government in an amount equal to all or a portion of the interest paid on the bonds. Rev. Proc. 2018-26 provides a new remediation option for issuers of direct pay tax credit bonds that have nonqualified use relating to their outstanding direct pay bonds. Specifically, this option allows an issuer to make a downward adjustment to the associated federal subsidy payment in an amount related to the nonqualified use, all in connection with the process the issuer would already otherwise be undertaking to receive the federal payment (i.e., the filing of Form 8038-CP).

Application of General Remedial Actions to Tax Credit Bonds

Rev. Proc. 2018-26 allows tax credit bonds (whether issued as direct pay or holder tax credit) to be remediated either through the redemption or defeasance of nonqualified bonds or the alternative ''good'' use of any disposition proceeds within a two-year period. To avail itself of these remedial actions, an issuer must meet the requirements set forth in Rev. Proc. 2018-26, including yield restriction of amounts, payment of rebate, and timing requirements.

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[2] 80 Fed. Reg. 65,637-65646 (Oct. 27, 2015).

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CONCLUSION

As with almost any release of this nature, there are interpretive items that will require additional consideration by tax counsel and/or clarification from the IRS. Generally, however, the release of Rev. Proc. 2018-26 is a favorable development for issuers who might find themselves considering tweaking their original plans regarding bond-financed projects.

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