**REPORT # 588**

**TAX SECTION**

# New York State Bar Association

Report on IRS Advance Notice 87-69

by

The Committee on Tax Exempt Bonds

August 12, 1988

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# TAX SECTION
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August 12, 1988

The Honorable O. Donaldson Chapoton
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The Honorable Lawrence B. Gibbs
Commissioner of Internal Revenue
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

IRS Advance Notice 87-69

Dear Sirs:

Enclosed is a report (i) commenting upon the guidelines set forth in IRS Advance Notice 87-69 (the "Guidelines") concerning the private business tests of Section 141(b) of the Internal Revenue Code of 1986 (the "Code") and (ii) making recommendations with respect to the forthcoming Treasury Regulations which we presently anticipate will incorporate the Guidelines at least in part. This report was prepared by the Committee on Tax Exempt Bonds of the Tax Section of the New York State Bar Association and approved by the Tax Section Executive Committee. The report was drafted by Steven P. Waterman, co-chair of the committee, with assistance from Henry S. Klaiman, co-chair of the committee, and Dale S. Collinson.

Part I of the report provides an overview of the new statutory provisions set forth in the Tax Reform Act of 1986 which govern the determination as to whether tax-exempt obligations of a State or local government constitute “private activity bonds” for purposes of the Code.

In Part II of the report, the committee recommends that the forthcoming Treasury Regulations (i) clarify the definition of “debt service” set forth in the Guidelines by including original issue discount paid to the holders of tax-exempt obligations and (ii) explicitly adopt the reasonable Expectations standard as of the date of issuance of tax-exempt obligations, for purposes of applying the private business tests of Section 141(b) of the Code.

In Part III of the report, the committee recommends that the forthcoming Treasury Regulations provide a safe harbor for purposes of computing issue price and yield (for variable rate obligations) in the context of the present value method prescribed by the Guidelines for purposes of computing private purpose payments and debt service with respect to an issue. The committee also recommends in this Part of the report that the Treasury Regulations (i) clarify application of the present value method prescribed by the Guidelines in the context of (a) the 5-percent and 10-percent limits of Section 14l(b)(3) of the Code and Section 141(b), paragraphs (1) and (2) of the Code, respectively, (b) qualified 501(c)(3) bonds issued pursuant to Section 145 of the Code and (c) issuer elections with respect to qualified 501(c)(3) bonds in accordance with Section 141(b)(9) of the Code and (ii) include examples illustrating application of the aforementioned 5-percent and 10-percent limits in the context of related, unrelated and related but disproportionate private business use of bond proceeds.

The committee recommends various changes and refinements to the Guidelines in Parts IV through VIII of the report for purposes of the forthcoming Treasury Regulations. Part IV sets forth a facts and circumstances approach for issuers to follow in determining when private purpose payments with respect to a refunding issue should be taken into account for purposes of a refunded issue. Part The committee recommends various changes and refinements to the Guidelines in Parts IV through VIII of the report for purposes of the forthcoming Treasury Regulations. Part IV sets V sets forth a facts and circumstances approach for issuers to follow in determining when private purpose payments should not be taken into account under the regulations because such payments are not part of an “underlying arrangement” with respect to the security for a bond issue.

In Part VI of the report, the committee recommends that (i) the requirements for possession and control set forth in the incidental use test of the Guidelines be clarified by examples in the forthcoming Treasury Regulations and (ii) the pro rata allocation of bond proceeds for incidental private business use to other nonincidental uses of a bond-financed facility be deleted in the regulations. In Part VII, the committee recommends that the 10-percent standard based upon “fair market value” in the context of a “qualified improvement” under the Guidelines be changed in the regulations to a more workable standard based upon “replacement cost”. In Part VIII of the report, the committee recommends the addition of certain examples in the regulations for purposes of clarifying the calculation of the “nonqualifying amount” in the context of multi-project bond issues for purposes of applying the special rules of Sections 141(b)(4) and 141(b)(5) of the Code.

The Tax Section of the New York State Bar Association is hopeful that this report will be useful to you in the process of preparing regulations on this subject.

Very truly yours,

Herbert L. Camp
Chair

Enclosure
Copies with enclosures to Dennis E. Ross, Esq.
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Report # 588

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

# Report on IRS Advance Notice 87-69

by

The Committee on Tax Exempt Bonds

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NEW YORK STATE BAR ASSOCIATION[*]

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## INTRODUCTION

On October 2, 1987, the Internal Revenue Service released Advance Notice 87-69[1] (the "Notice"), which sets forth guidelines (the "Guidelines") to be used by issuers of state and local obligations and their counsel in applying the private activity tests of Section 141(b) of the Internal Revenue Code of 1986.[2] The Notice states that issuers may rely on the Guidelines set forth therein until regulations under Section 141(b) are published in the Federal Register. This report addresses certain issues which the committee believes should be clarified in the forthcoming regulations.

## I. THE STATUTORY FRAMEWORK

Section 103(a) provides an exclusion from gross income

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[*] This report was drafted by Steven P. Waterman, co-chair of the committee, with assistance from Henry S. Klaiman, co-chair of the committee, and Dale S. Collinson. Helpful comments were received from Jackson B. Browning, Jr., Richard Chirls, Douglas E. Goodfriend and James M. Peaslee. Some of the contributors to this report communicated with Treasury officials with respect to the subject matter contained in IRS Advance Notice 87-69 prior to its release on October 2, 1987.

[1] 1987-43 I.R.B. 20.

[2] Except as otherwise noted, all section references set forth herein refer to the Internal Revenue Code of 1986.

for interest payable with respect to any state or local bond,[3] except as provided in subsection (b). Section 103(b)(1) provides that the exclusion from gross income set forth in Section 103(a) shall not apply to any private activity bond which is not a qualified bond within the meaning of Section 141.

Section 141(a)(1) defines a “private activity bond” as any bond issued as part of an issue which meets both the private business use test and the private security or payment test. Section 141(b)(1) states that, except as otherwise provided in subsection (b), a bond issue meets the private business use test if more than 10 percent of the proceeds of the bond issue are to be used for any private business use (hereinafter referred to as the “Private Business Use Test”).[4]

Section 141(b)(2) states that, except as otherwise provided in subsection (b), a bond issue meets the private security or payment test if the payment of the principal of, or interest on, more than 10 percent of the proceeds of the issue is (under the terms of the issue or any underlying arrangement) directly or indirectly (A) secured by any interest in property

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[3] Section 103(c) (1) defines “state or local bond” as an obligation of a state or political subdivision thereof. Section 103 (c) (2) provides that the term "State" includes the District of Columbia and any possession of the United States.

[4] Section 141 (b) (6) (A) defines “private business use” as use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit. This Section also excludes use By the general public from private business use. Section 141(b)(6)(B) defines the tern “trade or business” as any activity carried on by a person other than a governmental unit.

used or to be used for a private business use (or by any interest in payments in respect of such property) (the “Private Security Test”) or (B) to be derived from payments (whether or not to the issuer) in respect of property, or borrowed money, used or to be used for a private business use (the “Private Payment Test”) ((A) and (B), above, are hereinafter collectively referred to as the “Private Security or Payment Test”).

Section 141(b), paragraphs (3),(4),(5) and (9) contain special rules that must be taken into account in certain circumstances for purposes of applying the Private Business Use Test and the Private Security or Payment Test (hereinafter collectively referred to as the “Private Activity Tests”). Under Section 141(b)(3), the Private Activity Tests are applied by using a 5 percent limit in lieu of the 10 percent limit referred to above, in circumstances where (A) the proceeds of a bond issue are to be used for (i) any private business use which is not related to any governmental use of such proceeds or (ii) the private business use is disproportionate (although related) to the governmental use of such proceeds, and (B) there are payments, property, and borrowed money with respect to any use of the proceeds described in (A)(i) or (A)(ii), above.

Section 141(b)(4) provides a special rule for output facilities (e.g., electric energy or gas) which limits to $15,000,000 the lesser of (i) proceeds of a bond issue which are to be used for any private business use, or (ii) the proceeds of

such issue with respect to which there are payments (or property or borrowed money) taken into account for purposes of the Private Security or Payment Test ((i) and (ii) above, are hereinafter collectively referred to as the "Nonqualified Amount"). For bonds issued to finance facilities other than output facilities,[5] Section 141(b)(5) provides a special rule that applies where the Nonqualified Amount with respect to an issue exceeds $15,000,000 but is less than the amount which would meet the Private Activity Tests.[6] In that event, the issuer must allocate a portion of its state volume cap pursuant to Section 146 in an amount equal to the excess of the Nonqualified Amount over $15,000,000; otherwise the bonds will constitute private activity bonds and interest on the bonds will not be excluded from gross income.

Section 141(b)(9) applies to a situation in which the Private Activity Tests would be met with respect to a state or local government bond issue because part of the proceeds of the bond issue are to be used by, and debt service is to be secured by payments or property derived from, a Section 501(c)(3) organization.[7] Section 141(b)(9) permits an issuer to

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[5] Section 141(b) (5) does not apply to bonds issued to provide output facilities because Section 141(b)(4) limits the Nonqualified Amount to $15,000,000.

[6] Section 141(b) (5) only applies to bond issues with an issue price above $150,000,000, unless the 5 percent limit of Section 141(b)(3) applies, in which case the issue price must exceed $300,000,000.

[7] Unlike prior law under the Internal Revenue Code of 1954, Section 501 (c) (3) organizations are treated as "nonexempt persons" under the Internal Revenue Code of 1986 and the use of bond proceeds by Section 501(c)(3) organizations is treated as private business use.

elect to treat that portion of a bond issue which benefits the Section 501(c)(3) organization as a separate qualified 501(c)(3) bond pursuant to Section 145 provided the requirements set forth therein are met. The procedure for making this separate election is set forth in Temporary Regulations Section 5h.5(a).

## II. CLARIFICATION OF THE STANDARD

For purposes of determining whether more than 10 percent of the debt service payable with respect to a bond issue is derived from private business use “payments” in applying the Private payment Test under Section 141(b)(2)(B), paragraph (a)(2)(i) of the Notice provides that the present value of the payments taken into account under paragraph (a)(3) of the Notice is compared to the present value of the debt service to be paid over the term of the issue.

Under the Internal Revenue Code of 1954, as amended (hereinafter referred to as "Prior Law"), Section 103(b)(2)(B) provided that the security interest test was to be applied by comparing the source of security or the payments from a private business use of bond proceeds to the "payment of principal of, or the interest on” the bond issue. This statutory language literally required an issuer to apply the security interest test by first comparing the private security or payments to the principal on the bonds and then separately comparing the private security or payments to the interest on the bonds. In several private letter rulings, however, the Internal Revenue Service (the “Service”) applied the security interest test by using a

variety of different standards which made compliance difficult under Prior Law.[8]

As under Prior law, Section 141(b)(2) contains the same troublesome language, requiring the Private Security or Payment Test to be applied by comparing the source of security or payments from private business use of bond proceeds to the "payment of principal of, or interest on" the bond issue. Paragraph (a)(2) of the Notice clarifies that the Private Payment Test of Section 141(b)(2)(B) is applied by comparing the private payments to "debt service" on the bonds as defined in paragraph (a)(2)(ii) of the Notice. For purposes of computing the interest payments that are taken into account in applying the Private Security or Payment Test, the definition of "debt service" should be clarified in the case of obligations that are sold with original issue discount – the interest should be included when it is actually paid under the terms of the instrument as opposed to when the interest accrues pursuant to Section 1288.[9] The forthcoming Treasury Regulations should similarly clarify that for purposes of determining whether a private source of security under Section 141(b)(2)(A) will cause the Private Security Test to be met, such security is compared to the "debt service"

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[8] Some of the earlier private letter rulings referred to the "principal or interest" standard of the statute (LTRS 8243114 and 8243126); some referred to debt service over the term of the bonds (LTRS 8348035 and 7952077); and some referred to annual debt service on the bonds (LTRS 8125042 and 8108143).

[9] This interpretation is consistent with paragraph (a) (2) (1) of the Notice, which takes into account the present value of the debt service "to be paid" over the term of the issue.

on the bonds as such term is defined for purposes of Section 141(b)(2)(B).

In order for issuers to be able to comply with the Private Activity Tests, these tests must be applied based upon the issuer's reasonable expectations as of the date of original issuance of the bonds. For purposes of the “substantially all” test (Treas. Reg. Section 1.103-8(a)) applicable to industrial development bonds, the Service has developed a specific set of guidelines designed to protect issuers and bondholders from the adverse consequences of events that are not reasonably foreseeable at the date of original issuance.[10] Even under circumstances where these use of proceeds guidelines have not been met due to unforeseeable changes in facts and circumstances that would otherwise result in a loss of tax-exemption, the Service has consistently held that the issuer's reasonable expectations are protected.[11]

The Notice implies that this reasonable expectations standard is to be used in applying the Private Payment Test by providing a method based on present value to be used by issuers on the date of original issuance of the bonds. The committee recommends that the reasonable expectations standard be made explicit in the forthcoming Treasury Regulations. Moreover, issuers will need additional guidance in the forthcoming

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[10] See Rev. Proc. 79-5, 1979-1 C.B. 485.

[11] See Rev. Rul. 77-416, 1977-2 C.B. 34 (city sold bond-financed electric utility system to private utility company); LTR 8544048 (city industrial park sold to for-profit entity); LTRS 8509094, 8313016, 8236047 and 8152099 (sale or lease of hospital facilities to for-profit entities).

regulations concerning the application of the present value method in the case of variable rate bond issues. This problem is discussed in detail, below.

## III. THE PRESENT VALUE METHOD

Paragraph (a)(2)(iii) of the Notice provides that the present value of the private payments and debt service on the bonds is determined by using the yield on the bond issue as the discount rate and by discounting all such amounts to the date of issue. For this purpose, paragraph (a)(2)(iii) of the Notice states that "yield" is determined in the same manner as in Section 148. Section 148(h) provides that for purposes of Section 148, the yield on a bond issue shall be determined on the basis of the issue price (within the meaning of sections 1273 and 1274).

(a) Issue Price. The "issue price" for publicly offered debt instruments means the initial offering price to the public (excluding bond houses and brokers) at which price a "substantial Amount" of the debt instruments are sold. Section 1273(b)(1) and Treasury Regulations Section 1.1273-2(b)(1)(i). The public finance community (i) interprets the term "substantial amount" to mean at least 10 percent and (ii) applies this standard to each maturity within each bond issue. This standard is very difficult to apply in the context of bond issues with several maturities where the underwriter is not able to obtain confirmations for the sale of at least 10 percent of all the maturities of the bond issue at or before the date of closing and delivery of the bond issue.

The Joint Conference Committee explanation of the Tax Reform Act of 1986 (the “Conference Report”) permits an issuer to rely upon reasonable expectations for purposes of determining the “underwriter's spread”[12] with respect to a bond issue in the context of the two percent costs of issuance limit under Section 147(g). The Conference Report explanation of the underwriter's spread that is required to be taken into account for purposes of the two percent costs of issuance limit states that the spread should be included “whether realized directly or derived through purchase of the bonds at a discount below the price at which they are expected to be sold to the public.”[13] This reasonable expectations standard for purposes of the costs of issuance limit was added to the Conference Report to enable issuers to ensure compliance with the two percent restriction, regardless of the actual price at which the bonds are sold to the public. For purposes of determining the "issue price” in calculating the yield that is used as the discount rate in applying the present value test prescribed by paragraph (a)(2)(ii) of the Notice, the committee recommends that the “issue price” be based on the price at which the bonds "are reasonably expected to be sold to the public." This standard will provide the necessary certainty as of the date of issuance of a bond issue in applying the Private Payment Test.[14]

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12 The term “underwriter’s spread” refers to the dollar amount of compensation received by the underwriter from the public offering of the bonds, equal to the difference between the purchase price paid by the underwriter for the bonds and the price paid by the general public for the bonds to the underwriter.

13 H.R. Rep. No 99-841, 99th Cong. 2d Sess. 729 (1986).

14 Unlike the rebate requirement under Section 148(f), the determination of the bond yield based on the “issue price” for purposes of the Private Payment Test must be calculated as of the date of the closing and delivery of the bond issue.

(b) Yield. Issuers and bond counsel compute bond yield under Section 148(h) based upon the actuarial method of yield prescribed by Treasury Regulations Section 1.103-13(c)(1)(ii). For fixed rate bond issues, the actuarial yield method of Treasury Regulations Section 1.103-13(c)(1)(ii) provides certainty for issuers in applying the reasonable expectations standard because the bond yield is computed at the date of original issuance of the bonds and does not change thereafter.[15] However, many tax-exempt state and local government obligations have been issued recently with a variable rate of interest. For variable rate bond issues, the actuarial yield is not able to be finally determined until the obligation is retired or redeemed.[16] The discount rate which is the basis for the present value to be used in determining whether private payments cause the Private Payment Test to be met should not change after the date of original issuance of a bond issue. Otherwise, the determination of whether the Private Payment Test is met may change depending upon market conditions during the period the bonds are outstanding.

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[15] This regulation defines “yield” as that discount rate which when used in computing the present worth of all payments of principal and interest to be paid on the obligation produces an amount equal to the purchase price.

[16] This is also true for purposes of the yield method used in computing rebate pursuant to Temporary Regulations Section 1.103-15AT(c)(4).

To illustrate the problem with a variable rate bond issue, assume that City X issues bonds on January 1, 1988 with an issue price to the public of $10,000,000. The bonds finally mature in 20 years, but are subject to annual put options by the bondholders on each January 1 when the interest rate is readjusted pursuant to a market rate index. The initial rate of interest on the bonds for 1988 is 6.5% and interest is payable annually throughout the term of the issue. For purposes of analysis, assume that (i) all of the bond proceeds will be expended for a governmental purpose, except that 11 percent of the proceeds will be used to construct facilities leased to a private company from which City X expects to receive $90,000 annual payments attributable to this private business use while the bonds are outstanding and (ii) the bonds do not have any credit enhancement, and none of the %and proceeds have been set aside for capitalized interest or any type of reserve or replacement fund.

Under paragraph (a)(2)(i) of the Notice, City X would compare the present value of the $90,000 annual payments to the debt service on the bonds. On January 1, 1988, City X would present value these amounts at 6.5%, the interest rate on the bonds for 1988, because the City has no reason to believe the actual rate of interest will be higher or lower over the term of the bonds. The present value of the private payments is $991,665.65 and the present value of the debt service on the bonds is $10,000,000, the issue price.

The Private Payment Test is not met because the ratio of the present value of the private payments to the present value of the debt service on the bonds is 9.92%.

On January 1, 1989, assume that the rate of interest on the City X bonds readjusts to 5.5% for 1989. The yield on the bonds during the first two years is now 6.0145975% and the present value of the private payments computed from the date of original issuance of the bonds equals $1,031,070.21. However, the present value of the debt service remains constant at $10,000,000 because the yield which is used as the discount rate for purposes of the present value computation is based upon the issue price. Due to a change in market conditions, the Private Payment Test is now met because the ratio of the present value of the private payments to the present value of the debt service on the bonds is l0.31%. If the actual rate of interest over the term of the City X bonds is equal to or less than the rate for the first two years, the bonds are private activity bonds and the interest thereon is not excluded from gross income retroactively to the date of issuance of the bonds.

City X is not able to rely upon its reasonable expectations in the example, above, due to circumstances beyond its control, e.g., a change in market conditions. Bond counsel will not be able to render unqualified opinions as to the exclusion of gross income from federal income taxation under these circumstances. The necessary disclosure in the offering document for these bonds concerning the risk of taxability would render the bonds unmarketable.

In order to provide certainty in computing present values where a bond issue bears a variable rate of interest, the forthcoming Treasury Regulations should provide a "safe harbor" so that issuers will be able to ascertain whether the Private Security or Payment Test is met as of the date of original issuance of the bonds. Such "safe harbor" would permit issuers to assume a discount rate as of the date of original issuance of the bonds for purposes of computing present values, regardless of the actual yield on a variable rate bond issue throughout its term. For purposes of this "safe harbor," the discount rate could be (i) the initial interest rate from the dated date to the first interest adjustment date determined under the formula prescribed in the bond indenture on the date of issue (without regard to any fixed rate initially applicable to such obligation)[17] or (ii) a "comparable rate of interest for a fixed rate issue of similar term with a comparable credit rating, which the Service has previously permitted as an acceptable "safe harbor" interest rate for purposes of determining the proper size of reserve funds for variable rate issues.[18]

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[17] This "constant market" safe harbor method is used with respect to variable rate instruments in other areas of the Code to determine (1) imputed proceeds under Treas. Reg. Section 1.038 (a)(7)(i), (2) rebate under Temp. Treas. Reg. Section 1.103-15AT(c) (4) and (3) hypothetical adjusted issue price, yield and interest with respect to original issue discount debt instruments under Treas. Reg. Section 1.1275-5(d)(2).

[18] See LTR 8351138.

(c) Application of 5 and 10 Percent Limits. Paragraph (a)(2) of the Notice does not discuss whether the present value method should be applied to the special rule set forth in Section 141(b)(3). Section 141(b)(3) requires an issuer to substitute a 5 percent limit for the 10 percent limit in applying the Private Activity Tests when the private use is "unrelated" or "disproportionate." Presumably, the present value method set forth in paragraph (a)(2) of the Notice should be applied for purposes of Section 141(b)(3) by comparing only the present value of the payments attributable to an "unrelated" or "disproportionate" private business use of a bond-financed facility to the present value of the debt service on the bonds. The forthcoming Treasury Regulations should clarify this point.

In addition to describing the methodology for calculating the amount of private payments to be received, the forthcoming Treasury Regulations should also provide guidance for issuers as to the proper procedure to be used in applying both the 10 percent limit of Section 141(b), paragraphs (1) and (2), and the 5 percent limit of Section 141(b)(3) to the same bond issue where there are payments received from a related, unrelated and/or disproportionate private business use of bond proceeds. The examples set forth in the Conference Report, which attempt to illustrate the method to be used in applying both the 5 percent and 10 percent limits to a single bond issue,[19] have not provided sufficient guidance for issuers. The committee believes that the 10 percent limit of Section 141(b), paragraphs (1) and (2),

[19] H.R. Rep. No. 99-841, 99th Cong. 2d Sess. 691, 692 (1986).

should first be applied to all payments received from related, unrelated and disproportionate private business use of bond proceeds; and next, the 5 percent limitof Section 141(b)(3) should be separately applied only to those payments received from unrelated and disproportionate private business use of such proceeds.

The forthcoming Treasury Regulations should also provide examples clarifying (i) when a private business use of bond proceeds will be considered “unrelated” to the governmental purpose of a bond issue and (ii) the method of computation that issuers should use to determine whether a private business use is “disproportionate” in comparison to a corresponding governmental use of bond proceeds. The committee recommends that these rules be applied in the manner illustrated by the County X example, set forth below.

County X proposes to issue $100,000,000 aggregate principal amount of its tax-exempt revenue bonds at par with: (i) $2,500,000 to be used to pay all costs of issuance, including the underwriter's discount, all counsel fees, feasibility studies, rating agency fees, trustee's and paying agent fees, etc.; (ii) $10,000,000 to be deposited into a reasonably required reserve fund for the issue; (iii) $7,500,000 to be deposited into a capitalized interest fund and used to pay interest on the bonds during the construction period; (iv) $72,000,000 to be used to construct a resource recovery facility to be owned by County X; (v) $2,000,000 to be used to construct a storage facility to be owned by County X and to be built on a vacant parcel of land

owned by the County near an industrial park (the “Storage Facility”) wherein certain hazardous waste will be temporarily warehoused pending its transportation to a regional hazardous waste disposal facility outside County X; (vi) $2,000,000 to be used to construct a recycling facility at an existing County X landfill site (where wastepaper, bottles, etc. are separated) to be owned and operated by Company Y, a private corporation; and (vii) $4,000,000 to be used to build a garage facility (the “Garage") adjacent to the landfill to be owned by County X and to be leased to Company Y to store and repair the company’s trucks used to haul certain County X refuse.

Assume that Company Y dedicates its truck fleet to each of the following: (1) 75% of the fleet will be used to haul hazardous waste from certain industrial facilities to the Storage Facility and from the Storage Facility to the regional hazardous waste disposal facility outside County X; and (2) 25% of the fleet will be used to haul the wastepaper, bottles, etc. from the recycling facility to a central repository outside County X.

The 10 percent limit in the County X example is $10,000,000 for purposes of the Section 141(b)(1) Private Business Use Test (applicable to all private use, whether related, unrelated or disproportionate). The 5 percent limit is $5,000,000 for purposes of the Section 141(b)(3) special rule applicable to only unrelated, and related but disproportionate, private business use.

The first step in the County X analysis is to determine the total proceeds of the bond issue that are allocable between governmental use and private business use for purposes of the Section 141(b)(1) $10,000,000 limit. In determining the total bond proceeds allocable to both governmental and private uses, so-called "neutral costs" are required to be allocated ratably between the governmental and private uses of bond proceeds,[20] as follows:

| Governmental Use | Bond Proceeds | Allocable Neutral Costs | Total Proceeds Used |
|---|---|---|---|
| Resource Recovery Facility | $72,000,000 | $18,000,000 | $90,000,000 |
| Storage Facility | 2,000,000 | 500,000 | 2,500,000 |
| Subtotal | $74,000,000 | $18,500,000 | $92,500,000 |
| Private Business Use | | | |
| Garage | $ 4,000,000 | $ 1,000,000 | $ 5,000,000 |
| Recycling Facility | 2,000,000 | 500,000 | 2,500,000 |
| Subtotal | $ 6,000,000 | $ 1,500,000 | $ 7,500,000 |
| Total | $80,000,000 | $20,000,000 | $100,000,000 |

For purposes of Section 141(b)(1) $10,000,000 limit, the total private business use of bond proceeds is within that limit ($7,500,000). The second step in the analysis requires County X to determine that portion of the $7,500,000 private

[20] The Conference report requires an allocation of costs of issuance and amounts deposited into a reasonably required reserve or replacement fund to be allocated between the governmental and private uses of bond proceeds (so-called "neutral costs"). H.R. Rep. No. 99-841, 99th Cong. 2d Sess. 687, footnote 8 (1986). In the County X example, the capitalized interest is also allocated in this manner because it is a "neutral cost."

“nongovernmental Use” of bond proceeds referred to above which is either (i) “unrelated” to any governmental use of bond proceeds or (ii) related to a governmental use of bond proceeds, but “disproportionate” thereto. The Conference Report states that “[t]he determination of whether a private use is related to a governmental use also being financed with the bond proceeds is to be made on a case-by-case basis, emphasizing the operational relationship between the governmental-and nongovernmental uses.”[21]

The recycling facility in the County X example may not be "operationally” related to either the resource recovery facility or the Storage Facility, unless one is comfortable in arguing that the county's waste control program is one integrated facility and all parts of the program have an operational relationship.[22] As noted above, the Garage leased to Company Y uses a total of $5,000,000 of bond proceeds, allocable to the other bond-financed facilities according to the operational use of the truck fleet, as follows: (1) $3,750,000 of the bond proceeds (or 75% of the total $5,000,000) is allocable to the governmental purpose of the Storage Facility

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[21] H.R. Rep. No. 99-841, 99th Cong. 2d Sess. 691 (1986).

[22] If the landfill was financed with bond proceeds, the recycling facility would be operationally related to the landfill because the materials to be recycled are first separated from the refuse at the recycling facility before the remainder is disposed of at the landfill site. If the landfill was also used to deposit ash from the resource recovery facility, the recycling facility, landfill and and resource recovery facility would all be operationally related for purposes of Section 141(b) (3).

because 75% the truck fleet is used to haul hazardous waste to and from the Storage facility[23] and (2) $1,250,000 of the bond proceeds (or 25% of the total $5,000,000) is allocable to the private purpose of the recycling facility because 25% of the truck fleet is used to haul materials from the recycling facility to the central repository outside County X (which is a use that is operationally unrelated to any governmental purpose financed with bond proceeds).

For purposes of the “disproportionate” use test, the Conference Report states “[t]he determination of whether a private use which is related to a governmental use also being financed with the bond proceeds is disproportionate to the government use to which such private use relates is determined by comparing the amount of bond proceeds used for the related private and government uses.” Accordingly, the $3,750,000 of bond proceeds used to finance the Garage facility, which is allocable to a private use which is related to the governmental purpose of the Storage Facility, is “disproportionate” when compared to the $2,500,000 of bond proceeds used for the Storage Facility by an amount equal to $1,250,000.

Based on the foregoing, the Section 141(b)(3) analysis for purposes of the $5,000,000 limit would result in a total of $5,000,000 of bond proceeds attributable to either an unrelated, or related but disproportionate private use, as follows:

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[23] Although the Storage Facility has the same general governmental purpose as the resource recovery facility, i.e., waste management, it is not operationally related to the resource recovery facility and is therefore analyzed as a "separate” governmental purpose under Section 141(b)(3).

| | |
|---|---|
| (1) Bond proceeds used to directly finance recycling facility (unrelated) | $2,500,000 |
| (2) Cost of Garage allocable to hauling materials from recycling facility to central repository (unrelated) | 1,250,000 |
| (3) Cost of Garage allocable to hauling hazardous waste to and from the Storage Facility (“disproportionate” relative to cost of Storage Facility) | 1.250,000 |
| | $5,000,000 |

Thus, based upon the foregoing analysis, the County X bonds do not satisfy the Private Business Use Test under either Section 141(b)(1) or Section 141(b)(3).

(d) Application to 501(c)(3) Organizations. The Notice, by its terms, applies only to “state and local bonds” for purposes of applying the Private Activity Tests. Paragraph (a)(2) of the Notice does not discuss (i) whether the present value method should be applied to bonds issued for the benefit of Section 501(c)(3) organizations and (ii) the methodology to be used in the case of an issuer election under Section 141(b)(9).

The committee recommends that the Guidelines also be applied to “qualified 501(c)(3) bonds” in the forthcoming Treasury Regulations for purposes of testing compliance with the requirements of section 145(a)(2) by section 501(c)(3)

organizations.[24] Also, the Notice does not provide guidance concerning application of the present value method in the case of an issuer election under Section 141(b)(9), where the Private Activity Tests would otherwise be met by reason of the use of bond-financed facilities by a Section 501(c)(3) organization. The forthcoming Treasury Regulations should provide a procedure for issuers to follow in applying the present value method of paragraph (a)(2) of the Notice when an election is made by an issuer under Section 141(b)(9) to treat a portion of a bond issue as a separate qualified 501(c)(3) bond. Such procedure should entitle an issuer making the election to disregard (i) payments received by a Section 501(c)(3) organization and (ii) that portion of the debt service on the bonds attributable to use of bond proceeds by such organization, for purposes of applying the Private Payment Test to the entire bond issue.[25]

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[24] Section 145(a)(2) requires the 501(c)(3) organization to assume that the qualified 501(c)(3) bond would not be a private activity bond if "(A) 501(c)(3) organizations were treated as governmental units with respect to their activities which do not constitute unrelated trades or businesses, determined by applying section 513 (a), and (B) paragraphs (1) and (2) of Section 141(b) were applied by substituting '5 percent' for '10 percent' each place it appears and by substituting 'net proceeds' for 'proceeds' each place it appears."

[25] The forthcoming Treasury Regulations should also address the analogous situation in which an issuer decides to simultaneously issue tax-exempt and taxable obligations. The General Explanation of the Tax Reform Act of 1986, prepared by the Joint Committee on Taxation at page 1158 (Joint Committee Print, May 4, 1987), states that the Treasury Department will be promulgating regulations as to the rules to be applied concerning the separation of taxable and tax-exempt issues.

## IV. PRIVATE BUSINESS USE PAYMENTS

Paragraph (a)(3)(i) of the Notice sets forth the types of payments that are included for purposes of determining whether a bond issue meets the Private Payment Test. In addition to payments for private business use that are allocable to the payment of debt service on a bond issue, subparagraph (B) of paragraph (a)(3)(i) includes payments of debt service on a bond issue to the extent such payments are required to be taken into account under paragraph (a)(3)(v) of the Notice. Paragraph (a)(3)(v) of the Notice states that debt service payments for a prior issue to be made from proceeds of any other issue (the "refunding issue") are taken into account for purposes of applying the Private Payment Test to the prior issue in the same proportion that (a) the present value of the payments taken into account in applying the Private Payment Test to the refunding issue bears to (b) the present value of the debt service to be paid on the refunding issue.

By requiring the private business use payments allocable to a refunding issue to be taken into account for purposes of applying the Private Payment Test to a prior issue, paragraph (a)(3)(v) represents a significant departure from Prior Law. Under Prior Law, Proposed Treasury Regulations Section 1.103-7(e)(1) applied the security interest test separately with respect to both the prior issue and the refunding issue. This Prior Law rule recognized that the source of security or payment of debt service for one bond issue has no relationship to the source of security or payment for another issue and should not affect the tax-exempt status of interest on such other issue. This is particularly true in the refunding context where the refunding issue itself has now become the source of payment of debt service for the prior issue.

The effect of paragraph (a)(3)(v) of the Notice is to "flow through" the private purpose taint from the refunding issue to the prior issue. If the Service is concerned that issuers will abuse the Private Payment Test by issuing short-term obligations that the issuer expects to refund with obligations that meet the Private Payment Test, this concern may be addressed by a special rule in the Treasury Regulations. Under this rule, if an issuer reasonably expects to secure the pa-pent of a substantial portion (e.g., 90%) of the debt service with respect to short-term obligations (e.g., a weighted average maturity of 5 years or less) with proceeds of a subsequent refunding issue that meets the Private Payment Test, the original short-term obligations will also meet such test (as of the date of issuance). For purposes of developing a standard to be applied in this context, a similar approach is set forth in the Treasury Regulations promulgated under Section 279(b) dealing with corporate acquisition indebtedness.[26] Treasury Regulation Section

[26] If debt satisfies the requirements of "corporate acquisition indebtedness" under Section 279(b), Section 279(a) provides that no deduction is allowed for interest paid or incurred by a corporation during the taxable year with respect to its corporate acquisition indebtedness to the extent such interest exceeds $5 million, reduced by interest paid or incurred by the corporation during the year on obligations that are not corporate acquisition indebtedness but are issued after December 31, 1967, to provide consideration for acquisitions described in Section 279(b)(1).

1.279-3(b)(2) states in part that “[o]bligations are issued to provide indirect consideration for an acquisition of stock or assets within the meaning of Section 279(b)(1) where ...( ii) at the time of the acquisition the issuing corporation foresaw or reasonably should have foreseen that it would be required to issue obligations, which it would not have otherwise been required to issue if the acquisition had not occurred, in order to meet its future economic needs.” This determination is based on the facts and circumstances in each case.

In recent private letter rulings, the Service has held that convertible subordinated debentures issued to repay short-term bank loans (the proceeds of which were originally used to acquire corporate assets) will not be treated as corporate acquisition indebtedness, provided that (i) the bank loan was not a mere sham or conduit to avoid the effects of Section 279, but was obtained for a valid business purpose[27] and (ii) at the time the proceeds of the bank loan were used to acquire corporate assets, the taxpayer had no intent to issue any convertible debt to retire the bank loan; but rather, the convertible debt was required to be issued to repay the bank loan because of an unforeseeable change in economic circumstances (i.e., a large increase in the market price of taxpayer's stock and a substantial decrease in fixed interest rates).[28]

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[27] See LTR 8712059 (December 23, 1986).

[28] See LTR 8712004 (December 11, 1986).

The committee's proposal under paragraph (a)(3)(v) of the Notice would require private purpose payments with respect to a refunding issue to be taken into consideration for purposes of the original short-term issue if under the facts and circumstances at the time of issuance of the short-ten obligations the issuer (i) expected to issue refunding obligations to retire the short-term indebtedness and (ii) foresaw or reasonably should have foreseen that the source of repayment of the refunding obligations would be private purpose payments. If the short-term issue is not issued to avoid application of the Private Payment Test and the issuer is not dependent upon private purpose payments to repay any obligations issued to refund the short-term issue (absent an unforeseeable change in economic circumstances), the special rule of paragraph (a)(3)(v) of the Notice should not apply to the short-term issue. Using this standard, issuers would be protected from changes in economic circumstances after the date of issuance of the short-term obligations in the same manner that corporations are protected with respect to short-term bank loans under Section 279. This more narrowly defined rule would enable bond counsel to rely upon the reasonable expectations of the issuer as to the expected source of payment for a bond issue. Absent such a rule, many bond counsel have expressed concern that they will not be able to render an unqualified opinion in complying with paragraph (3)(a)(v) of the Notice because subsequent refunding could adversely affect the tax-exempt status of interest on obligations issued with their opinion.

Given that paragraph (a)(3)(v) of the Notice represents a departure from Prior Law, the committee recommends that the forthcoming Treasury Regulations promulgated with respect to this special rule apply to bond issues (that the issuer may refund in the future) originally issued after October 2, 1987, the date of publication of the Notice.

## V. ALLOCATIONS OF PRIVATE BUSINESS USE PAYMENTS

Under Prior Law, Section 103(b)(2)(B) required that the payment of principal or interest on a bond issue be secured by, or derived from, private business use property or payments "under the terms of such obligation or any underlying arrangement" in applying the security interest test. Section 141(b)(2) continues the requirement that issuers apply the Private Security or Payment Test by taking into consideration payments of debt service for a bond issue secured by, or derived from, private business use property or payments "under the terms of such issue or any underlying arrangement." The rules set forth in the Notice (discussed below) fail to take into consideration the statutory requirement that there be some "nexus" between the private business use payments received for use of bond proceeds and the debt service payable with respect to the bonds.

Paragraph (a)(3)(ii) of the Notice states that payments for a use of bond proceeds include payments (whether or not to the issuer) in respect of property financed (directly or indirectly) with such proceeds.[29] Paragraph (a)(3)(iv) of the

[29] This paragraph of the Notice is based upon the Conference Report explanation of the Private Security or Payment Test. H.R. Rep. No. 99-841, 99th Cong. 2d Sess. 688 (1986).

Notice provides that payments by a person for a use of bond proceeds are allocable to the payment of the debt service on the proceeds used by such person to the extent that the present value of such payments does not exceed the present value of the debt service payable on such proceeds. The rules of paragraphs (a)(3)(ii) and (a)(3)(iv) of the Notice do not provide any means for an issuer to disregard certain payments for private business use even if an issuer is able to establish that such payments are not an expected source of payment of debt service on a bond issue "under the terms of the issue or any underlying arrangement."

As an example of a situation in which the aforementioned "nexus" requirement is not present, assume that City A issues $50,000,000 aggregate principal amount of bonds for the acquisition of land within a downtown redevelopment district of the City. City A will use bond proceeds not only to acquire the land, but to clear the land of deteriorated buildings and to finance basic infrastructure improvements necessary for use of the land as a public park and recreation area and to provide public parking. The City A planning board will oversee the bond-financed redevelopment. The governmental purpose of the redevelopment is to provide an incentive for the general public to visit the downtown redevelopment district and to reverse the trend of decay in this area. The city A planning board is authorized to lease or sell a portion of the bond-financed

land to private enterprises provided their use of the land is consistent with the overall goal of the board to encourage use of the district by the general public. For example, the board might approve the construction of a restaurant on one of the bond-financed parcels of land, but it would not consider a proposal to construct an office building on that parcel.

The sole source of repayment of the City A bonds is an ad valorem tax levy upon all of the real property on the tax rolls of City A, regardless of whether such real property is benefited at all from the redevelopment. City A and its planning board have not discussed commercial redevelopment within the district with any private enterprise at the time the bonds are issued. Thus, any potential payments received by City A from the lease or sale of the bond-financed parcels of land to private enterprises are not considered to be a material source of security for the payment of debt service with respect to the bonds.

Under Prior Law, Treasury Regulations Section 1.103-7(b)(4) provided guidance in applying the security interest test. This regulation states that the nature of the security for, and the source of, payment of principal or interest on a bond issue may be determined from (i) the terms of the bond indenture applicable to an issue or (ii) on the basis of an "underlying arrangement." The regulation states that an “underlying arrangement” may result from separate agreements between the parties or may be determined on the basis of all the facts and circumstances surrounding the issuance of the bonds.

Under Prior Law, three published revenue rulings[30] set forth sufficient guidelines for issuers to apply in determining whether an "underlying arrangement" existed based on facts and circumstances surrounding the issuance of the bonds. These rulings held that an underlying arrangement will always be inferred if the present value of the payments to be made by the private business users approximately equal the present value of the debt service on the bonds. Also, an underlying arrangement would usually be inferred if (i) the identity of the private user(s) is (are) known at the time the bonds are issued and (ii) these private purpose payments from the user(s) are a "material" source of security for the payment of debt service with respect to the bonds. Based upon these Prior Law criteria, the aforementioned City A bonds would not have met the security interest test because there are no agreements with private business users, the identity of those users (if any) is not known and the receipt of payments therefrom is not a material source of

[30] Rev. Rul. 80-251, 1980-2 C.B. 40 (underlying arrangement with developers, even though bonds paid from city taxes); Rev. Rul. 80-339, 1980-2 C.B. 42 (underlying arrangement with airlines, even though toll bridge revenues pledged); Rev. Rul. 85-68, 1985-1 C.B. 37 (underlying arrangement with private users, even though total revenues from several projects pledged to secure parity issues). The private business payments taken into account for purposes of the security interest test under these Prior Law rulings consisted of the "net" payments received by the issuer after deducting operating and maintenance expenses.

security for the payment of debt service with respect to the bonds.

The statutory language of Section 141(b)(2) indicates that issuers should continue to be able to disregard private business use payments where (i) such payments are not pledged under the financing documents, (ii) there are no "side agreements" between the issuer and the private business user(s) and (iii) the aforementioned factors indicating an underlying arrangement are not present. The Conference Report explanation of the Private Security or Payment Test does not state that the law concerning the "underlying arrangement" standard has changed. The Conference Report states that when bonds are issued to acquire land that is to be sold for redevelopment to private persons, amounts paid by those persons for the land are payments for purposes of the security interest test, even though incremental tax revenues are the stated security for the bonds.[31] The Senate Finance Committee explanation of the Tax Reform Act of 1986 (the "Senate Report") also makes this statement and adds that these payments are to be considered under the "expanded" security interest test whether they are made in a lump sum or in installments.[32]

The aforementioned statements in the Conference Report and Senate Report contemplate a situation where all of the bond-financed land is expected to be sold to private persons. Also, the only stated security for the bonds is "incremental tax revenue." In these circumstances, the payments from private purchasers of the land will be a "material" source of security to any issuer because incremental tax revenues alone may be insufficient to cover debt service on bonds issued for this

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[31] H.R. Rep. No. 99-841. 99th Cong. 2d Sess. 688 (1986).

[32] S. Rep. No. 99-313, 99th Cong. 2d Sess. 831 (1986).

purpose. Example (14) of Treasury Regulations Section 1.103-7(c) establishes the existence of an underlying arrangement with facts similar to those in the Conference Report and Senate Report. In example (14), political subdivision J issues bonds a major portion of the proceeds of which are to be used to rehabilitate and construct urban area buildings to be leased or sold to nonexempt persons. Although the full faith and credit of J secured repayment of the bonds, the example concluded that an "underlying arrangement" existed because "it is apparent that J requires the revenues from the lease or sale of buildings to nonexempt persons in order to pay in full the principal and interest on the bonds in question."

The facts in the City A example are distinguishable from those in the Conference Report and the Senate Report. In the City A example, the possibility of receipt of any private purchaser payments is not a material source of security for the repayment of the bonds. Unlike example (14) of Treasury Regulations Section 1.103-7(c), City A does not require revenues from the lease or sale of buildings to private persons in order to pay debt service on the City A bonds. Accordingly, under Prior Law, and under the Private Security or Payment Test, the committee believes that issuers should not be required to infer the existence of an underlying arrangement in circumstances such as those in the example of the City A bond issue.

Based on the foregoing, the committee recommends that the forthcoming Treasury Regulations contain a special rule

that allows issuers to disregard payments for private business use provided that (i) the actual identity of the private business users is not known on the date of issuance of the bonds, and (ii) the payments are not a material source of security for the payment of debt service with respect to the bonds.

## VI. INCIDENTAL PRIVATE BUSINESS USE

Paragraph (b) of the Notice provides a de minimis rule allowing certain incidental private business use of a bond-financed facility to be disregarded for purposes of the Private Activity Tests of Section 141(b). Private business use of a facility is "incidental" if three requirements are met (1) the use does not involve the transfer to the person of possession and control over space that is separated from other areas of the facility by walls, partitions, or other physical barriers, (2) the use described in (1) is not related to any other nonincidental use of the facility by the same person and (3) all uses described in (1) and (2) in the aggregate do not exceed 2 1/2 percent of the total use of the facility (the "Incidental Use Test").

The committee recommends that paragraph (1) of the Incidental Use Test be clarified by means of examples in the forthcoming Treasury Regulations. This paragraph establishes a two-prong test requiring both possession and control. However, the circumstances in which both these requirements are met are not clear. For example, there are circumstances in which equipment such as coin-operated telephones, vending machines, etc. are separated by partitions or are placed in separate rooms

and such equipment is not under the control of the equipment provider. It is our understanding that the intent of this paragraph is to require that the equipment be physically separate and that the equipment provider also have an additional degree of control over the equipment. This “control” requirement would be met, for example, where the equipment is kept in a separately locked room and the equipment provider controls access by keeping the room key without providing any to the owner of the building or the building tenant(s) for frequent access by users of the equipment.

Concerning paragraph (2) of the Incidental Use Test (that an otherwise incidental use not be related to a nonincidental use of bond-financed facilities by the same person) we recommend that this requirement be clarified by example in the forthcoming Treasury Regulations. A private business use that is not incidental, such as the rental of office space by AT&T in a city office building, should not convert an incidental use, such as AT&T telephones in the lobby of the office building, into a use that is counted for purposes of the Private Payment Test. On the other hand, vending machines in the lobby of the city office building would not be "incidental” if the owner of the machines also leases space in the office building to operate a cafeteria for building tenants. The examples in the regulations should stress the functional relationship between an otherwise incidental use and a nonincidental use of a bond-financed facility by the same person.

The flush language at the end of paragraph (b)(2) of the Notice provides that uses of space in a bond-financed facility that meet the Incidental Use Test "would be allocated to other uses of the facility that are not incidental." The committee recommends that this allocation requirement be deleted in the forthcoming Treasury Regulations because it will be extremely burdensome in circumstances where there are multiple types of "use" in a single bond-financed facility. Any allocation of space attributable to incidental use will have a "neutral" effect in testing compliance with the Private Activity Tests because the space would be allocated pro rata between governmental and private business use of the bond-financed facility. Thus, there is no Treasury Department or Service policy to be furthered by requiring the allocation.

## VII. QUALIFIED IMPROVEMENTS

Paragraph (c) of the Notice sets forth the circumstances in which proceeds of a bond issue used for a "qualified improvement" will not be treated as proceeds to be used for a private business use. Paragraph (c)(2) of the Notice sets forth nine requirements that must be met for an improvement to constitute a "qualified improvement." Paragraph (c)(2)(vii) requires that the increase in fair market value of the facility resulting from all improvements financed with proceeds of the issue (and any other improvements made or to be made pursuant to a common plan) may not exceed 10 percent.

The use of the fair market value standard in paragraph (c)(2)(vii) of the Notice is very difficult to apply to limited

use property of state and local governments. For example, a public housing project owned by a municipality may have negligible, negative or indeterminate fair market value in the real estate market. This fair market value may or may not change as a result of any improvements. As a general rule, the "fair market value” of a property may be measured using comparable properties with similar cash flows, replacement cost or in certain limited instances, historical cost increased by any capital improvements. For purposes of applying the Private Activity Tests, the most objective standard is replacement cost (as adjusted for depreciation and obsolescence), because comparable properties generally are not available and historical cost is not an accurate method. We recommend that replacement cost (as adjusted for depreciation and obsolescence) be substituted for the fair market value standard set forth in paragraph (c)(2)(vii) for purposes of the forthcoming Treasury Regulations.

## VIII. CALCULATION OF NONQUALIFIED AMOUNT

Paragraph (e) of the Notice provides guidance to issuers in calculating the Nonqualified Amount defined in Section 141(b)(8) for purposes of applying the special rules set forth in Section 141 (b)(4) and Section 141 (b)(5). Paragraph (e) also provides that if the proceeds of any such “separate” bond issue are used to finance a particular project and this separate issue is thereby treated as a private activity bond, the entire multi-project issue is treated as a private activity bond.

The forthcoming Treasury Regulations should clarify the rules set forth in paragraph (e) of the Notice, particularly the

application of these rules to output facilities in contrast to other types of facilities. If an issuer finances more than one output facility under section 141(b)(4) with a multi-purpose issue, interest payable on the entire issue will be taxable if the Nonqualified Amount with respect to that portion of the multipurpose issue used to finance any one project exceeds $15,000,000. Although Section 141(b)(4) allows an issuer up to $15,000,000 of private business use for bonds allocable to each project, the issuer does not have the option to obtain volume cap under Section 146 in the case of output facilities where the Nonqualified Amount exceeds $15,000,000. Thus, the forthcoming Treasury Regulations should specify (i) the types of "use" that must be taken into account in applying Section 141(b)(4) (e.g., "take or pay" output contracts) and (ii) the circumstances in which output facilities will be treated as separate "projects" in applying the rules set forth in paragraph (e). For example, separate power generation units in a nuclear power facility should be treated as separate "projects" where each unit is placed in service on a separate date.

If an issuer finances more than one governmental purpose project (other than output facilities) under Section 141 (b)(5) with a multi-purpose issue, paragraph (e) of the Notice requires the issuer to separately test each portion of the bond issue used to finance each separate project under Section 141(b)(5). If the Nonqualified Amount for any such portion of the multi-purpose issue exceeds $15,000,000, but is less than the amount which would satisfy the Private Activity Tests under Section 141(b),

the issuer is required to allocate volume cap under Section 146 in an amount equal to the “excess” of the Nonqualified Amount over $15,000,000. Although each portion' of the bond issue used to finance each project is tested separately, if the issuer fails to obtain volume cap for any individual “excess” with respect to that portion of a bond issue used to finance a separate project, interest payable on the entire multi-purpose issue is taxable.

The forthcoming Treasury Regulations should clarify the application Section 141(b)(5) in circumstances where the 10 percent limit of Section 141(b), paragraphs (1) and (2), and the 5 percent limit of Section 141(b)(3) apply to the same bond issue. For example, assume State X issues $400,000,000 of bonds to finance construction and rehabilitation of State X administration buildings and the bond proceeds will be used for private business use in an amount equal to (i) $40,000,000 in the aggregate for all related, unrelated and disproportionate uses of bond proceeds and (ii) $20,000,000 for only the unrelated and disproportionate uses of such proceeds. County B should be required to allocate $25,000,000 of volume cap under Section 141(b)(5) for purposes of applying the 10 percent limit of Section paragraphs (1) and (2) to the bond issue. The regulations should clarify that State X is not required to allocate another volume cap under Section 141(b)(5) for purposes of applying the 5 percent limit of Section 141(b)(3) to the bond issue.

Furthermore, the forthcoming Treasury Regulations should remove the implication that each governmental purpose project for which a portion of a bond issue is used, and separately tested, must itself meet the Private Activity Tests for the entire multi-purpose bond issue to maintain its classification as a governmental issue the interest on which is excluded from gross income for federal income tax purposes.

As an example of the problem posed by the previous paragraph, assume that State X issues $300,000,000 of bonds for a multi-project issue for numerous governmental projects and that $20,000,000 of the bond proceeds will be used by private enterprises in their trades or businesses with payments therefrom securing repayment of the bonds. Assume also that all of this private business use is related to a governmental use, therefore, the 5 percent limit of Section 141(b)(3) does not apply. Of the $20,000,000 of bond proceeds used for these private business purposes, $16,000,000 will be used to rehabilitate a sports stadium substantially all of the use of which is set aside for a privately-owned sports team pursuant to a long-term lease. The forthcoming Treasury Regulations should clarify that the rules prescribed by paragraph (e) of the Notice require State X to allocate $1,000,000 of volume cap to the sports stadium “project”, i.e., the “excess” of the Nonqualified Amount of $16,000,000 over the $15,000,000 permissible private business use for that project. The regulations should clarify that the Private Activity Tests are not to be applied to the sports stadium “project” independently for purposes of testing compliance with this special rule, otherwise the interest payable on the entire multi-purpose issue would not be excluded from gross income for federal income tax purposes.