New York State Bar Association

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NYSBA

July 20, 1995 # 842

The Honorable Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3120 MT
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

The Honorable Margaret Richardson
Commissioner
Internal Revenue Service
Room 3000
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: **Proposed Regulations Regarding**
Private Activity Bonds

Dear Secretary Samuels and Commissioner Richardson:

Enclosed please find a report of the Committee on Tax Exempt Bonds concerning the recently proposed regulations that define private activity bonds. The report was prepared primarily by Linda L. D'Onofrio and Patti T. Wu, Co-Chairs of that Committee.

The report commends Treasury and the IRS for undertaking the significant task of revising the private activity bond regulations to take into account legal interpretations and business practices that have developed since regulations were last promulgated in this area in 1972. This is an important area, and updated guidance is needed. The report recommends, however, that the regulations should include more and clearer statements of the underlying principles upon which specific rules are based. This would better comport with the recent policy of issuing regulations that articulate broad guiding principles, rather than layers of specific rules, and would make the regulations more useful over a longer period of time.

The report concludes that the proposed regulations have fundamentally changed the basic concept of private use, and in so doing have both exceeded existing understandings of private use, and substantially eroded the qualification of legitimate financing techniques as tax-exempt. Specifically, the Committee believes that private use historically encompassed situations in which a non-exempt person had an arrangement under which it received an actual or quasi-proprietary interest in the financed project. The proposed regulations, however, adopt the premise that any actual or beneficial use of the project, with or without such an arrangement, can constitute private business use, and then provide various, often narrowly drawn exceptions to mitigate the harsh effects of this broad rule.

The Committee is concerned that this approach does not fairly address the problems of private use, will not keep pace with changes in business practices, and will, unintentionally, tend to favor certain kinds of issuers and projects over others. The report therefore recommends that the regulations return to the original definition of private use, and focus on arrangements that confer on private users some form of proprietary interest in the project.

The report also expresses concern that the formulation of the private security or payment tests under the proposed regulations is inconsistent with the legislature's intent that, in addition to private use, such tests also must be met in order to classify a financing as a private activity bond.

The report includes comments on numerous specific provisions of the proposed regulations, in some cases noting agreement with the regulations, and in others recommending technical changes. Overall, the report urges that both broad conceptual changes and more detailed revisions are needed in the regulations, and that new regulations should therefore be issued again in proposed form, for further review and comment.

The members of the Committee are most interested in working with Treasury and the Service to revise and refine the proposed regulations. We trust that the enclosed report will be helpful to you, and we are, as always, available to discuss this with you further.

Very truly yours,

Carolyn Joy Lee

Carolyn Joy Lee
Chair

NEW YORK STATE BAR ASSOCIATION
TAX SECTION

REPORT ON PROPOSED REGULATIONS: DEFINITION OF PRIVATE ACTIVITY BONDS (PROP. REG. §§ 1.141-1 through 1.141-16; 1.145-1; and 1.150-4)

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REPORT ON PROPOSED REGULATIONS: DEFINITION OF PRIVATE ACTIVITY BONDS (PROP. REG. §§ 1.141-1 through 1.141-16; 1.145-1; and 1.150-4)[1]

I. INTRODUCTION

On December 30, 1994, the Internal Revenue Service (the "IRS") published proposed regulations[2] under § 141 of the Internal Revenue Code of 1986, as amended (the "Code"), on the definition of private activity bonds (the "Proposed Regulations").[3] The Proposed Regulations are intended to provide guidance in analyzing whether obligations of a state or local government will be characterized as governmental bonds or as private activity bonds.

The Committee on Tax-Exempt Finance (the "Committee") of the New York State Bar Association Tax Section (the "Tax Section") submits this report to assist the Treasury in finalizing the Proposed Regulations. Because the regulations addressing characterization of

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[1] Primary responsibility for this report was assumed by Linda L. D'Onofrio and Patti T. Wu, Co-Chairs of the Committee on Tax-Exempt Finance. Significant contributions to the report were made by Robert L. Berman, James R. Eustis, Jr., Joe E. Forrester, James S. Kaplan, Neil J. Kaplan, John R. McQueen, Carol D. Olson, Joseph P. Rogers, Edward J. Rojas, Jeremy A. Spector, and Marcus H. Strock. Helpful comments were made by Dale S. Collinson, Stephen B. Land, and Carolyn Joy Lee.

[2] 59 Fed. Reg. 67658 *et seq.*

[3] The term "private activity bonds" was adopted by the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085 (enacted Oct. 26, 1986) (the "1986 Act"). The predecessor term defining obligations of state and local governmental units that provided more than the statutorily permitted benefit to private industry (thus causing interest on such obligations to be included in gross income) was "industrial development bonds," introduced by the Tax Reform Act of 1969, Pub. L. 91-172, 83 Stat. 487 (enacted Dec. 30, 1969) (the "1969 Act").

private activity bonds have not been materially altered since their promulgation in 1972,[4] we recognize the enormity of the task of incorporating into their framework concepts, practices, and guidance that have evolved since that time. At the outset, we commend the Treasury and IRS for their remarkable effort in attempting to balance the often competing interests of the federal and local governments in this area, as reflected in the Proposed Regulations. We offer our comments to assist in this endeavor, premised in the spirit of the recent Treasury Department policy to create simple regulations that articulate general principles that can be applied to analyze situations not otherwise addressed by specific detail or examples.

In support of this principle, this report begins with an overview of our general recommendations for the approach and philosophy that the Committee believes should be reflected in final regulations on private activity bonds. The report then presents recommendations for changing the detailed provisions of the Proposed Regulations to accomplish such goals. Our interest is to assist in the creation of flexible guidance that will remain analytically useful under changing political and business environments.

The Committee and the Tax Section have long had a close working relationship with Treasury and the IRS. As noted in our Report addressing the Temporary and Proposed Regulations (T.D. 8252), published in the Federal Register on May 15, 1989, the Committee wishes to offer its time and cooperation with Treasury in further developing simpler regulations that fashion broad-based concepts applicable to ever-changing situations in the tax-exempt marketplace. This Report represents the Committee's current thoughts, based on our collective experience with the financing needs of municipalities and a fundamental understanding of the tensions created between those needs and the desire of the Treasury to curb the potential for abuse. The Committee is prepared to assist in any further areas in which the Treasury seeks our comments and recommendations.

II. OVERVIEW OF GENERAL RECOMMENDATIONS

As noted above, the Committee applauds the extraordinary efforts reflected in these Proposed Regulations in incorporating the guidance heretofore presented in published and private

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4 T.D. 7199 (July 31, 1972). These regulations define "industrial development bonds" and were promulgated under Section 103(b) of the Internal Revenue Code of 1954, as amended (the "1954 Code"). The 1986 Act redrafted the provisions of § 103(b), moved them to Code § 141(b), and established the term "private activity bonds." *See* note 3, *supra*.

rulings regarding concepts of private use. The Proposed Regulations, however, often fail to articulate underlying principles upon which the myriad rules established are premised. Furthermore, where such principles are articulated, they appear to exceed both the statutory and legislative concepts of how private use and benefit are to be determined, as well as prior administrative guidance in the area as developed by the Treasury and IRS. As a result, the Proposed Regulations at times are contradictory, overly complex, and inadequate in providing guidance for situations not explicitly presented. The Committee recognizes that the complexity is largely an attempt to address the municipal finance community's call for guidance while preserving the Treasury's desire for administrative control; we believe, however, that regulations that articulate broad guiding principles will better serve the interests of both groups and will result in clearer regulations with greater utility and longevity.

The Committee's foremost recommendation is that the underlying analytic framework of the private activity bond tests, as presented in Prop. Reg. §§ 1.141-2 and -3,[5] be reformulated to reflect their statutory, legislative, and administrative underpinnings and application. As currently drafted, the Proposed Regulations dramatically expand concepts of private use and security to include indirect uses and security not heretofore acknowledged to fall within such areas, largely because these concepts are applied "without regard to whether a financing actually transfers benefits of tax-exempt financing to a non-governmental person."[6] As a result, rather than clarifying the distinctions between legitimate governmental or public benefit and benefit to select "non-exempt" persons, the Proposed Regulations blur the analysis and thus threaten the tax-exempt financing of traditionally governmental projects. The Committee offers the following support for its recommendations.

In 1968, Congress added rules governing industrial development bonds to § 103(b) of the 1954 Code.[7] Legislative history addressing these provisions articulated the purpose of the restrictions as an:

> . . . intent[t] to prevent states and local governments from abusing the tax exempt status of their obligations by using it as a basis for interstate competition to attract

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5 The Proposed Regulations will hereinafter be cited as "Prop. Reg. §."

6 Prop. Reg. § 1.141-2(a).

7 Revenue and Expenditure Control Act of 1968, Pub. L. 90-364, 82 Stat. 251 (enacted June 28, 1968) (the "1968 Act").

industry. The legislation was not intended as an attack on the general principles of tax exemption for state and local governments.[8]

When Code § 141 was created pursuant to the 1986 Act, Congress expressed its desire to retain " . . . present-law rules under which use by persons other than governmental units is determined for purposes of the trade or business use test."[9] Congress described relationships that rise to the level of "use" of a facility as those resulting from "(1) ownership or (2) actual or beneficial use of property pursuant to a lease, a management or incentive pay contract, or (3) any other arrangement such as a take-or-pay or other output-type contract."[10] In discussing use pursuant to certain cooperative research arrangements as potentially falling within this category, Congress established safe harbors to avoid characterizing any such arrangements as joint ventures or similar cooperative relationships.[11]

The above language suggests that Congress considered private use to occur when there is an *arrangement* pursuant to which a non-exempt person receives either an actual or quasi-proprietary interest in the bond-financed project and not simply when a non-exempt person has actual or beneficial use of the bond-financed project. Pre-existing regulatory and administrative guidance at the time of 1986 Act[12] reflects this conclusion, particularly when the "use" being considered becomes less and less direct.[13] The Proposed Regulations go beyond these parameters by expanding the definition of private business use to include any actual or beneficial use. In effect, the Proposed Regulations create a presumption of use. Because this presumption creates the potential for indirect use of a facility in the trade or business of a non-exempt person

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8 H.R. Rep. No. 91-413, 91st Cong., 1st Sess. (1969) (the "1969 Act House Report"), at 172.

9 H.R. Rep. No. 99-841, 99th Cong., 2d Sess., Vol. II (Sept. 18, 1986) (the "1986 Act Conference Report"), at II-687.

10 *Id.*, at II-687—688.

11 *Id.*, at II-689.

12 *See, e.g.*, Treas. Reg. § 1.103-7(b) (references to ownership, leases only), and G.C.M. 37641 (underlying Rev. Proc. 82-14, 1982-1 C.B. 459).

13 "[A] non-exempt person that sells a commodity or provides a service to a political subdivision may benefit from the facility in an indirect economic sense, but this does not amount to "use" within the meaning of the "trade or business" test, unless the involvement, whether direct or indirect, *amounts to a proprietary use of the facility.*" G.C.M. 37641 (emphasis added). *But see* Rev. Proc. 93-19, 1993-1 C.B. 526 ("A management or other service contract that gives a nongovernmental service provider a proprietary interest in the operation of the facility is not the only situation in which a contract may result in private business use of the facility.").

that is so encompassing, the Proposed Regulations are forced to enumerate myriad exceptions in an attempt to exclude relationships that are not intended to be covered,[14] and which, prior to the Proposed Regulations, were never considered to be included because they were perceived to be inherent in accomplishing the governmental purpose of the financing. The need for these exceptions suggests that the underlying premise is far too expansive and needs to be reformulated. While the Committee understands that the Treasury and IRS may wish to draft broad regulations to prevent indirect arrangements that are *intended* to circumvent the private business tests, the Committee believes that the treatment by the Proposed Regulations of *any* actual or beneficial use as private use is so broad that the exceptions (the major one being the definition of "general public use"),[15] will not be sufficient to protect many legitimate traditional governmental financings. The Committee recommends that the Proposed Regulations be redrafted to reverse the presumption of use and to provide general principles with anti-abuse provisions, which would grant the Proposed Regulations a longer shelf life than would the current, narrowly-drafted exceptions. As more fully described in the subsequent sections of this report, without such reformulation the Proposed Regulations will have the unintended effect, particularly with regard to the tests established for general public use, of favoring large urban areas and of eliminating tax-exempt financing of truly governmental facilities where the local governmental units hold substantially all proprietary interests in the financed facility but where services are provided to non-exempt users in ways that fail the highly technical and often quantitatively-based rules of the public use exception.[16]

The Committee's secondary recommendation is that the Treasury reexamine its tests governing private security or payment, and the interrelation of these tests with the private use tests. The rules presented in the Proposed Regulations appear to eviscerate completely the need

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14 *See* Prop. Reg. § 1.141-3(e)(6)(vi) (customary contracts for janitorial services; granting of admitting privileges by a hospital to a doctor). These examples, as drafted, appear to exhaust the possible exceptions. When analyzing beneficial use of a governmental facility in the trade business of a non-exempt person, however, the possible universe becomes limitless,--*e.g.*, one might conclude, hopefully wrongly, that any privately employed attorney in a court room or administrative hearing falls within the category.

15 Prop. Reg. § 1.141-3(e)

16 *See, e.g.*, Prop. Reg. § 1.141-3(e)(2) (definition of "intended for use by the general public" requires that 25% or more of expected direct use of facility be by persons that individually account for no more than 1% of use of facility), and Prop. Reg. § 1.141-3(e)(3) (definition of "use related to other facilities" similarly contains numeric formula).

for a finding of private security or payment (in addition to private use) in order to find private activity bond status, which is contrary to legislative intent, as noted above.

Last, the Committee recommends that the rules governing change in use--a post-issuance event--be completely reworked. As presented, the change-in-use rules lack a discrete operative provision, are confused, and do not accomplish the intended goals (which are often hard to discern) of their drafters.

While various industry groups have called for complete withdrawal of the Proposed Regulations,[17] the Committee offers the specific recommendations presented below, recognizing that, whether or not our overall recommendations will be accepted, any new set of regulations will incorporate many of the provisions of the Proposed Regulations. We ask, in conclusion, that any new regulations once again be promulgated in proposed form, given the diversity and breadth of changes that are contemplated.

III. PROP. REG. § 1.141-1: DEFINITIONS, § 1.141-2: PRIVATE ACTIVITY BOND, AND § 1.141-3: PRIVATE BUSINESS USE

A. PROP. REG. § 1.141-1(b): DEFINITION OF PROCEEDS.

1. Overview.

The Proposed Regulations are directed, in part, toward the use of proceeds. Amounts treated as "proceeds" for purposes of the private activity bond tests include proceeds derived from the sale of an issue and certain amounts received from the investment of sale proceeds or other investment proceeds. The Proposed Regulations add two new categories of "proceeds" for purposes of the private activity bond tests--"disposition proceeds" and "replaced amounts." Disposition proceeds are any amounts, including property, that are derived from the sale, exchange, or other transfer of bond-financed property. Generally, if disposition proceeds exist, any proceeds allocable to the transferred property cease to be treated as proceeds of the issue. Thus, if bond-financed property is transferred, the use of the proceeds derived from the disposition of such property, rather than the subsequent use of such property, will be determinative of whether the Private Business Use Test, as defined below, is met. Comments with respect to "disposition proceeds" are set forth under "Change in Use" in Section X, *infra*.

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17 *See* Pryde, Joan, "Dozen Issuer Groups Urge IRS to do New Private Activity Rules," *Bond Buyer*, May 3, 1995, p.1.

Prop. Reg. § 1.141-1(b) includes "replaced amounts" as proceeds for purposes of the private activity bond tests. "Replaced amounts" are replacement proceeds (as defined in Treas. Reg. § 1.148-1(c)) that are reasonably expected to be available during the period beginning on the bond issuance date and ending on the date construction, reconstruction, or acquisition of the financed project is substantially complete (the "Project Period"),[18] other than sinking funds, pledged funds, and "other replacement proceeds."[19]

2. Comments.

The concept of "replacement proceeds" is expressly provided in Code § 148(a)(2) with respect to the arbitrage provisions. In Code § 148(a)(2) and corresponding provisions of § 103 of the 1954 Code, Congress sought to restrict an issuer's ability to finance a project with an issue of tax-exempt bonds and to invest other funds that had previously been earmarked for the project in higher-yielding investments. The attempt by the Proposed Regulations to treat taxes and other revenues of an issuer that had been set aside for projects that qualify for tax-exempt financing as proceeds of an issue that finances such project is inconsistent with the statutory private activity bond tests. No reference to the concept of replacement funds appears in either Code §§ 141(b)(1) and (2) or Code § 141(c)(1) as it does in Code § 148(a)(2). Moreover, if Congress intended to prohibit issuers from using tax-exempt proceeds to replace amounts that had been earmarked for qualifying purposes but instead are directly or indirectly used to pay costs that are not eligible for tax-exempt financing, Congress could have extended the definition of "private activity bond" to include such obligations.

Further, the inclusion of "replaced amounts" as proceeds would restrict an issuer's ability to respond to changing circumstances or changing community demands. For example, if a county had set aside tax revenues to construct a new community swimming pool, but chose instead to use such funds to provide low-interest loans to private corporations to foster economic

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[18] The issuer of a multipurpose issue may elect to treat the Project Period for the entire issue as ending on either the last day of the temporary period for which spendable proceeds of the issue may be invested at an unrestricted yield (in most cases, three years for issues that finance capital projects) or the end of the fifth bond year after the issue date.

[19] Under Treas. Reg. § 1.148-1(c), amounts are "replacement proceeds" (and thereby subject to arbitrage restrictions) if such amounts have a sufficiently direct nexus to the governmental purpose of the issue to conclude that the amounts would have been used for such governmental purpose had the bonds not been issued. In addition, the arbitrage regulations treat as "replacement proceeds" sinking funds, pledged funds, and, under certain circumstances, other amounts that are expected to be available to pay debt service on the issue, which are referred to as "other replacement proceeds."

development in the county, a future bond issued to finance the community swimming pool would be treated as a private activity bond.

The Committee strongly recommends that the final regulations eliminate the concept of replacement proceeds for private activity bond purposes as beyond the scope of Code § 141. The Committee believes that issuers must have the flexibility to plan the use of tax-exempt financing in the context of evolving budgetary constraints as well as changing political funding mandates. The Committee further believes that this provision will have a disproportionately adverse impact on localities and Code § 501(c)(3) organizations that generally use pay-as-you-go financing, as well as small issuers that rarely use tax-exempt financing. Issuers that finance virtually all of their capital projects through borrowings, and sophisticated issuers that have access to tax advice on a regular basis, will generally avoid earmarking taxes and other revenues for specified projects but may also be unnecessarily adversely affected.

The definition of "replaced amounts" includes not only amounts on hand as of the bond issue date, but also amounts reasonably expected to be available during the construction, reconstruction, or acquisition period of a project. Issuers typically avoid entering into substantial construction contracts until assurances exist that funds are on hand to complete a project. Even funds appropriated by a state or the federal government may be rescinded as a result of budgetary constraints or changing political climates. Because of these factors, in the event that "replaced amounts" continue to be treated as "proceeds" for purposes of Code § 141, the Committee recommends that the term "replaced amounts" be limited to amounts actually on hand as of the earlier of the bond issue date or the date such funds are earmarked for the project.

B. PROP. REG. § 1.141-3(a): IN GENERAL.

1. Overview.

The 1986 Act provides that, with limited exceptions for specified qualified purposes, interest on any state or local bond that is a "private activity bond" is not excluded from gross income for federal income tax purposes. Tests for determining whether a bond is a private activity bond are set forth in Code § 141(a). A state or local bond will be treated as a private activity bond if (i) more than 10% of the proceeds of the issue of which the bond is a part are used for any private business use (the "Private Business Use Test"), and (ii) the payment of principal of or interest on more than 10% of the proceeds of such issue is either secured by or derived from payments with respect to property used for a private business use, as more fully described in Code § 141(b)(2) (the "Private Security or Payment Test, referred to collectively with the Private Business Use Test as the "Private Business Tests").[20] In addition, except in the case of certain tax assessment bonds, a bond will be treated as a private activity bond if more than the lesser of 5% or $5 million of the proceeds of the issue of which such bond is a part are used to make or finance loans to persons other than state or local governmental units (the "Private Loan Financing Test"). Code § 145(a)(2) provides that the Private Business Tests and the Private Loan Financing Test, with certain modifications, are also used to determine whether bonds may be treated as qualified 501(c)(3) bonds, and the Proposed Regulations are also applicable to these determinations. Prop. Reg. § 1.141-3(a)(2) provides that proceeds are treated as used in the trade or business of a nongovernmental person in situations involving "other arrangements" whereby a nongovernmental person uses property acquired with the proceeds of an issue in its trade or business. Further, Prop. Reg. § 1.141-3(a)(3) provides that, in determining whether an issue meets the Private Business Use Test, both the ultimate and intermediate uses of proceeds are taken into account.

2. Comments.

The Committee recommends that Prop. Reg. §§ 1.141-3(a)(2) and (3) be redrafted to clarify that "other arrangements" and "intermediate uses" do not include arrangements that do not confer on a non-exempt user a proprietary interest in a financed facility, such as those involving conduit nominal title holders in a financing lease transaction. Nominal title arrangements are often necessitated by state law, and are generally analyzed under general federal income tax principles as secured borrowings (with the governmental user, the party predominately standing to reap the benefits and bear the burdens of the financing and the property, being characterized as the true owner).

C. PROP. REG. § 1.141-3(b): GENERAL DEFINITION OF PRIVATE BUSINESS USE.

1. Overview.

Under Prop. Reg. § 1.141-3(b)(2), proceeds are generally treated as used for a private use if they are used in a trade or business carried on by any person other than a

20 As further described in Code § 141(b)(3), the Private Business Tests are applied by substituting 5% for 10% with regard to proceeds expended for a private business use not related to or disproportionate in amount to proceeds expended for governmental use of that same issue.

governmental person. Use of bond proceeds can occur pursuant to (i) ownership or lease[21] of financed property, (ii) receipt of a loan funded with such proceeds, or (iii) any other actual or beneficial use of bond-financed property under a management or incentive pay contract, output contract, or other arrangement, other than as a member of the general public. These use concepts are more fully presented in Prop. Reg. § 1.141-3(b)(3) through Prop. Reg. § 1.141-3(b)(9), and are discussed more fully below. Prop. Reg. § 1.141-3(b)(10), "other actual or beneficial use," is a new concept added by the Proposed Regulations.

2. Comments.

As stated above under "Overview of General Recommendations," the Committee believes that the addition of the concept of "beneficial" use that does not rise to the level of a proprietary interest in the financed facility exceeds the statutory, legislative, regulatory, and administrative authority for disqualified private use. In addition, this expanded definition of private use, by its extreme potential for overinclusiveness, undermines the utility of the guidance provided by the other enumerated standards. Legal analysis of whether a facility provides private use must now encompass consideration under Prop. Reg. § 1.141-3(b)(3) through Prop. Reg. § 1.141-3(b)(9) as well as under all other possible scenarios "without regard to whether a financing actually transfers benefits of tax-exempt financing to a nongovernmental person"[22]--an impossible inquiry, particularly where no guiding principles assist to limit its scope. As a result, many publicly-owned facilities will no longer be financed on a tax-exempt basis because a private user may derive--or have a potential to derive[23]--a benefit from the facility that differs from that conferred on the general public. The Committee therefore recommends that Prop. Reg. § 1.141-3(b)(10) be deleted. If Treasury should reject this recommendation, the Committee requests that general principles be articulated that clearly limit the scope of disqualified beneficial use to a standard slightly more expansive than "proprietary interest." The Committee,

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21 Any arrangement, such as a management contract, properly characterized as a lease under general federal income tax principles, will be treated as a lease under the Proposed Regulations.

22 Prop. Reg. § 1.141-2(a), second sentence.

23 Prop. Reg. § 1.141-2(a) is another example of the broad approach taken by the Proposed Regulations. This section provides that the private activity bond tests serve to identify arrangements that "have the potential to transfer the benefits of tax exempt financing, as well as arrangements that actually transfer these benefits." The concept of potentiality of use goes well beyond both actual use and reasonable expectations and the Proposed Regulations provide no guiding principles for determining such potentiality.

unfortunately, cannot currently offer recommendations for how this standard might be derived or crafted, and strongly urges that the current proprietary-interest standard be retained.

D. USE PURSUANT TO MANAGEMENT CONTRACTS.

1. Overview.

Prop. Reg. § 1.141-3(b)(2)(6) provides that private use includes use pursuant to a management contract that is not a qualified management contract or when such contract causes the service provider to be treated as a lessee for federal income tax purposes. Prop. Reg. § 1.141-3(c) describes qualified management contracts.

The qualified management contract rules are the outgrowth of Treasury's response to concerns of the municipal finance community that private use may occur when certain arrangements between governmental or exempt persons and private service providers grant such non-exempt users an interest in the operation and success of the financed facility. In 1982, Treasury published Rev. Proc. 82-14[24] and Rev. Proc. 82-15,[25] which established the IRS' ruling criteria and, in effect, created safe harbors for allowable management and other service contracts. In response to requests for greater and more liberal guidance, Congress instructed Treasury to relax certain restrictions contained in the Revenue Procedures,[26] but affirmatively supported the Procedures' safe-harbor approach.[27] The Treasury subsequently released Rev. Proc. 93-19,[28] which created a more expansive safe harbor pursuant to the statutory directive, and clarified additional points. Prop. Reg. § 1.141-3(6)(c) abandons the safe-harbor approach in favor of an absolute standard.

2. General Comments.

Although the standards presented in Prop. Reg. § 1.141-3(c) are consistent with historical development, they narrowly define a specific universe of qualified management contracts. The Committee recommends that Treasury designate the regime created by Prop. Reg. § 1.141-3(e) (as amended by our specific recommendations presented below) as a safe

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[24] 1982-1 C.B. 459.

[25] 1982-1 C.B. 460.

[26] Section 1301(e), 1986 Act, at I-602.

[27] 1986 Conference Report, at II-688-689.

[28] 1993-1 C.B. 313.

harbor, and provide additional general guiding principles under which contracts not meeting the specific safe harbor standards may be evaluated. Arrangements between exempt persons and private service providers are changing rapidly, particularly in the health-care industry, and providing such general guidance will greatly add to the longevity and utility of this particular regulation.

If this recommendation is not accepted, the Committee requests that the final regulations provide that the Commissioner of Internal Revenue may publish in the Internal Revenue Bulletin additional examples, upon which all taxpayers may rely, of qualified management contracts.

3. Prop. Reg. § 1.141-3(c)(6): Definitions.

The Committee offers the following specific comments regarding the definitions contained in Prop. Reg. § 1.141-3(c)(6) to assist in implementing our general recommendation.

a. <u>Prop. Reg. § 1.141-3(c)(6)(ii): Capitation Fee</u>. Prop. Reg. § 1.141-3(c)(6)(ii) defines a capitation fee as a fixed periodic amount for each person for whom the service provider or the governmental person assumes the responsibility to provide all needed services for a specified period so long as the quantity and type of services actually provided to covered persons varies substantially. A capitation fee may include a variable component of up to 20% of total compensation designed to protect a service provider against risks such as "catastrophic" loss. The term "catastrophic" implies disasters such as earthquakes, epidemics, hurricanes, *etc.*, but may not cover unforeseen or unpredicted increases in an HMO's claims experience. The Committee recommends that the variable component be clarified to cover such extraordinary increases in claims experience in order to increase its utility.

b. <u>Prop. Reg. § 1.141-3(c)(6)(iv): Per-Unit Fee</u>. Prop. Reg. § 1.141-3(b)(6)(iv) defines a "per-unit fee" as a fee based on a unit of service provided. Whether the definition includes time-based units of service such as the number of in-patient days, physical therapy hours, *etc.* is not clear. The Committee recommends that the definition of per-unit fees be clarified to provide for time-based measures of service. In addition, the Committee requests that the IRS address the treatment of separate billing arrangements between physicians and patients when the physicians are under contract to provide more than *de minimis* services to a hospital. The Committee believes that such fees should also be treated as per-unit fees.

c. <u>Prop. Reg. § 1.141-3(c)(6)(vi): Management Contract</u>. The term "management contract" is defined to mean a management, service, or incentive payment contract between a governmental person and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility. Routine and customary contracts, however, such as janitorial and computer maintenance service agreements, will have little likelihood of sharing the benefits of ownership of the financed facility. The Committee recommends that the term "management contract" be limited to management and incentive payment contracts only, and requests that the IRS clarify that *all* contracts involving the acquisition of goods with service warranties (not merely janitorial or similar services) be specifically excluded from the term "management and incentive payment contract" as long as the contract terms are reasonable and customary.

The last sentence of the definition of "management contract" excludes contracts for the operation of "mixed use" facilities if the only compensation is the reimbursement of actual and direct expenses of the service provider. If such agreements do not create private use, the Committee recommends that the exclusion extend to all facilities, not just mixed-use facilities, and that it be broadened to cover reimbursement of reasonable allocable overhead, as such reimbursement presents little opportunity for abuse.[29]

Additionally, the Committee recommends that, with respect to multiple management contracts with the same service provider, the regulations be clarified to provide that, as long as different arm's-length management contracts are entered into for different purposes and do not circumvent the purposes of Prop. Reg. § 1.141-3(c), the contracts not be treated as a single contract and should be evaluated independently for compliance with the management contract rules. For example, a 100% periodic fixed-fee arrangement for management of a sewer facility should not be integrated with a percentage-of-expense arrangement to manage the construction of the sewer facility under circumstances in which both contracts are entered into at arm's length.

4. Prop. Reg. § 1.141-3(c)(2): General Compensation Requirements.

Prop. Reg. § 1.141-3(c)(2) provides that a contract must provide for reasonable compensation for services rendered with no compensation based, in whole or in part, on a share of the net profits from the operation of the facility. The Committee recommends that the rules be clarified to provide that interest or fees paid to a service provider pursuant to a subordinated loan, other form of indebtedness, or guarantee are not treated as compensation as long as such

[29] *Cf.*, Treas. Reg. § 1.141-6 (allocation and accounting rules).

fees are usual and customary payments for the type of arrangement undertaken, and do not in substance constitute compensation based on net profits.

5. **Prop. Reg. § 1.141-3(c)(3): Permissible Arrangements.**

a. Timing of Fee Negotiation. The rules as presented presume that the fee arrangements are negotiated once at the beginning of each contract term. Where a contract provides for a fixed-cost-per-procedure (*e.g.*, MRI test) over a fixed term (*e.g.*, two years), the Committee believes that the renegotiation of such fees to take into account factors such as technology advances and concomitant cost reductions, or increased training costs of technical and professional staff, should not be viewed as undermining the fixed-fee nature of the contract. The Committee therefore recommends that the regulations be amended to permit renegotiation of contract terms in a qualified manner, from time to time upon mutual agreement, without the need to enter into an entirely new contract.

b. Prop. Reg. § 1.141-3(c)(3)(i) and -3(c)(3)(ii): Single Incentive Award. Prop. Reg. § 1.141-3(c)(3)(i) provides that a fee does not fail to qualify as a periodic fixed fee for purposes of the 100 percent periodic fixed fee arrangement and the 80 percent periodic fixed fee arrangement if there is a single incentive award provision under which compensation automatically increases when a gross revenue or expense target is reached if that award is equal to a single stated dollar amount. First, the Committee recommends that the rules be clarified to provide that single incentive awards are treated as a periodic fixed fee for purposes of the 80% periodic fixed fee provision of Prop. Reg. § 1.141-3(c)(3)(ii). Second, the Proposed Regulations refer to a single incentive award as permitted over the life of a contract. The reference to a single incentive award may be narrowly interpreted to mean that only one incentive payment may be made over the term of the contract. The Committee believes that this is an unintended result and recommends that the term "single stated dollar amount" be clarified to allow for both revenue or expense targets and reward amounts to be paid annually over the term of the contract as long as only a single stated dollar amount is paid depending on the results.

c. Prop. Reg. § 1.141-3(c)(3)(i): 50% Useful Life Limit in 100% Periodic Fixed Fee Arrangements. Under Prop. Reg. § 1.141-3(c)(3)(i), a contract may have a term equal to the lesser of 50% of the expected useful life of the related property and 15 years if 100% of the compensation for services is based on a periodic fixed fee. Under Prop. Reg. § 1.141-3(c)(3)(ii), a contract may provide for 20% of the compensation to be based on other than a periodic fixed fee if the term of the contract is limited to the lesser of 80% of the expected useful life of the related property and 10 years. Presumably, these rules demonstrate the principle that the longer the term of the contract, the higher the percentage of the compensation that must be fixed. The mathematics of the formulas under Prop. Reg. § 1.141-3(c)(3)(i) and (ii), however, may lead to disparate results. For example, if property with a 10-year expected useful life is being managed, compensation based on a 100% periodic fixed fee entitles the parties to only a 5-year term (the lesser of 15 years or 50% of useful life), whereas the parties will be entitled to an 8-year term (the lesser of 10 years or 80% of useful life) if only 80% of the compensation is based on a periodic-fixed fee. Because a different percentage is used whenever useful life is 10 years or less, the contracting parties are permitted a longer term using an 80% periodic-fixed-fee arrangement. The Committee therefore recommends that the 80% useful life limit be used consistently under both arrangements because in either case the 80% limitation would ensure that the governmental person has substantial residual value.

d. Prop. Reg. § 1.141-3(c)(3)(ii): 80% Periodic-Fixed-Fee Arrangements. As currently written, this standard requires that the 80% periodic fixed fee threshold be determined annually. For purposes of administrative convenience, the Committee recommends that the determination of whether the 80% threshold is met be permitted to be made over the entire term of the contract as long as the non-fixed-fee component of the arrangement is not significantly back-loaded or front-loaded.

e. Prop. Reg. § 1.141-3(c)(3)(iv) Per-Unit Arrangements in Certain 3-Year Contracts. Prop. Reg. § 1.141-3(c)(3)(iv) permits contracts that provide for compensation based on a per-unit fee or a combination of a per-unit fee and a periodic fixed fee. The amount of the per-unit fee must be specified in the contract or otherwise specifically limited by the governmental person or independent third party.The provision as drafted is not clear on how fee discounts are taken into account. In the competitive environment of health care, certain fees are discounted from standard fees for HMO's, preferred customers, or larger purchasers. The Proposed Regulations are unclear on whether a per-unit fee that is specified in the contract may be adjusted from time to time to reflect fee discounts because of increased competition or changes in technology. The Committee recommends that the final regulations permit adjustments in the specified per-unit fee for these types of foreseeable events.

f. Leased Employees. Prop. Reg. § 1.141-3(c)(2) provides that amounts paid to the service provider in reimbursement for actual and direct expenses paid to unrelated parties is not treated as compensation. The Committee recommends that this provision be clarified so that amounts paid to employees of a private manager who are temporarily leased to a governmental person on a cost basis pending a search for permanent governmental personnel are not treated as compensation and are consequently disregarded in determining compliance with any other fee arrangement between the manager and the governmental person. For example, the leased employees' compensation should not be treated as part of the non-fixed periodic fee component in an 80% periodic-fixed-fee arrangement.

6. Prop. Reg. § 1.141-3(c)(4): No Related Parties or Common Control.

The Proposed Regulations as drafted do not permit related parties to enter into a qualified management contract. The Committee recommends that the Proposed Regulations be amended to provide that 100% related for-profit or non-profit management organizations (*e.g.*, taxable or Code § 501(c)(3) corporations that contain executive personnel who manage an entire corporate group or chain) should be permitted to enter into qualified management contracts when the fee arrangements are purely on an expense-reimbursement basis (including allocable overhead) and when these arrangements are entered into for management-sharing or other service-sharing purposes. The Committee also recommends that the final regulations clarify that relatives of directors, officers, shareholders, and employees should be counted in determining related parties and common control in order to avoid circumvention of the rules.

7. Prop. Reg. § 1.141-3(c)(5): *De Minimis* Exception for Functionally Related Use.

Prop. Reg. §1.141-3(c)(5) provides that a facility that is used pursuant to a qualified management contract is not taken into account for purposes of the Private Business Use Test as long as such use is functionally related and subordinate to the management contract and is not a separate contractual agreement in substance. The Committee recommends that the word *de minimis* be dropped from the title of this exception. The Committee contends that *any* use of a facility by the manager pursuant to a qualifying management contract should be permitted to carry out the purposes of the management contract, as long as such use is functionally and subordinately related to the primary use and not beyond the scope of the management contract.

E. USE PURSUANT TO OUTPUT CONTRACTS.

Use pursuant to output contracts is discussed in Section VII. *infra*.

F. USE PURSUANT TO DISCHARGE OF A PRIMARY LEGAL OBLIGATION.

1. Overview.

Prop. Reg. § 1.141-3(b)(8) provides that a nongovernmental person will be treated as a user of bond-financed property if the financing of such property discharges a "primary and unconditional legal obligation" of that person," not including obligations created under a law of general application. This rule is likely to apply to instances where developers agree to finance road improvements, parking facilities, or other amenities as a condition to obtaining a permit or waiver of generally applicable land use rules in connection with large residential, commercial, or industrial developments.[30] For this purpose, the general public-use exception to private business use will not apply. The Proposed Regulations also provide that an obligation imposed on the owner of a facility is not the primary obligation of any other user of that facility, such as a lessee.

2. Comments.

The Committee recommends that Prop. Reg. § 1.141-3(b)(8) be eliminated. The analysis and application of the principle appear to be overly broad and beyond legislative intent. In addition, the practical application of the rule will virtually eliminate the tax-exempt financing of most infrastructure improvements under several states' laws and practices.

Proposed Reg. § 1.141-3(b)(8) appears to be derived from the analysis used in Rev. Rul. 85-120,[31] which was issued shortly before passage of the 1986 Act. The ruling held that obligations of a public utility district, issued in connection with construction of a hydroelectric facility to finance construction of a fish passageway and recreation facility (both of which were mandated by federal and state law), were industrial development (private activity) bonds where the underlying facility was subject to a take-or-pay contract for greater than 25% of the output of the project.[32] The rationale of the ruling appears to be that, where private use facilities (here the hydroelectric facility) cannot be built without the public facilities (the fish ladder and recreation facility), and the public facilities are closely associated with the private facilities, the public facilities will be treated as part of the private facilities and thus characterized as private

[30] *See* Prop. Reg. § 1.141-3(b)(8)(ii) for an example of the perceived private use.

[31] 1985-1 C.B. 32.

[32] Prior to the 1986 Act, the Private Business Use Test and the Private Security or Payment Test were based on 25% standards (rather than their current 10% standards).

activity bonds. Rev. Rul. 85-120 was widely viewed as aberrational under then-current law, but was subsequently followed by the IRS in private letter rulings.[33] In response to these rulings, counsel required broader-based security for bonds financing infrastructure improvements for new developments through the creation of assessment and other taxing districts that tax or assess all beneficiaries of the public financing. This requirement was premised in the notion that such improvements were for the benefit of all members of the general public, that the intermediate "use" by the developer could thus be ignored, and that the public use exception, discussed below in Section I, could be relied on. Thus, the analysis of the rulings could be distinguished.

The example presented in Prop. Reg. § 1.141-3(b)(8) extends the analysis of Rev. Rul. 85-120 to treat all development-backed or assessment-type arrangements as discharges of primary legal obligations, and thus as creating private use and benefit. The example ignores three fundamental concepts heretofore considered important: (i) that the 1986 Act affirmed Congress' intention to continue to support tax-exempt financing of traditional governmental activities (which would include legal obligations to provide streets and sidewalks imposed by governments on private developers),[34] (ii) that the ultimate beneficiaries of the financing are the general public and thus, that any transitory benefit to a developer can be ignored under "ultimate use of proceeds analysis," and (iii) that the form of the legal obligation being discharged may differ widely from a direct obligation of the landowner-developer, particularly in assessment district financings.[35] The concept that a discharge of a primary legal obligation creates private use represents another improper extension of the proprietary interest standard described above: absent transfer of control over, or economic interest in, a facility, the obligation to pay for such facility does not imply its proprietary use.[36] Application of Prop. Reg. § 1.141-3(b)(8) will

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33 *See, e.g.*, Ltr. Rul. 8704049 (as condition for approval to develop shopping center/hotel/office building complex, developer agreed to secure payment on governmental obligations issued to finance widening of local and interstate highways; bonds held taxable because (1) they constituted a loan to developer (thus satisfying Private Loan Financing Test and (2) the developer's obligation to pay for road improvements closely linked use of bond proceeds to developer's facility). The Committee notes the IRS appeared to go out of its way to apply Rev. Rul. 85-120, as satisfaction of the Private Loan Financing Test would, in and of itself, have been sufficient for a finding of taxability.

34 *See* note 9, *supra*; *see also* "General Explanation of the Tax Reform Act of 1986, Staff of the Joint Committee on Taxation (May 4, 1987) (the "Blue Book" or the "1986 Act Blue Book"), at 1151, 1152.

35 Assessment obligations under most state laws are treated as *in rem* in nature.

36 *See also* discussion under Section IV, *infra* ("Private Security or Payment Test").

undermine the ability of many states and local governments to provide both essential infrastructure improvements and additions under current state laws and in the current environment of increased public/private partnerships and governmental budget tightening, the facilities simply will not be built.[37] The Committee therefore contends that elimination of this Proposed Regulation will better assist public policy.

If our recommendation is not accepted, however, we recommend alternatively that the final regulations provide (i) that the general public use exception, discussed below in Section III. I.1, be applied in this area, (it is currently excluded), (ii) that obligations to finance traditional infrastructure facilities, such as streets and sewers, be characterized as governmental obligations, regardless of intermediary "use," and (iii) that final regulations reserve for private use characterization only bonds that finance obligations exclusively personal to such intermediaries.

G. USE PURSUANT TO RESEARCH ARRANGEMENTS.

1. Overview.

The Proposed Regulations generally follow language in the 1986 Act Conference Report regarding research sponsored by nongovernmental persons. Prop. Reg. § 1.141-3(b)(9) confirms that an agreement by a nongovernmental person to sponsor research performed by a governmental person may result in any bond-financed property related to such research being treated as used in the private business of the nongovernmental sponsor. In conformance with the 1986 Act Conference Report, Prop. Reg. § 1.141-3(d) provides that certain arrangements providing for nongovernmental sponsorship of basic research involving bond-financed property will not be taken into account for purposes of the Private Business Use Test. Since the exceptions are limited to the sponsorship of basic research, use of bond-financed facilities in the performance of applied or practical research or product development sponsored by a nongovernmental person will be taken into account.

Under Prop. Reg. § 1.141-3(d)(2), basic research performed by a governmental person pursuant to a sponsorship arrangement with a nongovernmental person will not be treated as private use only if the sponsor is required to pay a competitive price for any license or other use

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[37] *See* Seed, "Public Purpose, Bonds, and Bright-Line Rules," 11 Municipal Finance Journal 331 (Winter, 1990), at 356 ("the key point is that . . . the development will not occur unless the local government agrees to provide the necessary infrastructure to serve the project, and often the local government will not provide the public infrastructure unless the developer agrees to help pay for it. That is the reality. That is how many traditional infrastructure projects happen.").

of the resulting technology. Such price is to be determined as of the date such technology is available for use. Although the sponsor must pay a competitive price to obtain a license or other right to use the resulting technology, the Proposed Regulations provide that the governmental person owning the research may provide the sponsor with an exclusive license or other exclusive arrangement to use the results of such research.

Additional rules are provided with respect to cooperative research arrangements where multiple unrelated private sponsors agree to fund university-performed basic research. Under Prop. Reg. § 1.141-3(d)(3), such arrangements will not give rise to private use of the university's bond-financed facilities used in connection with the research if (i) the research and the manner in which it is to be performed are determined by the university, (ii) title to any patent or other product incidentally resulting from the research lies exclusively with the university, and (iii) the sponsors are entitled to no more than a non-exclusive, royalty-free license to use the product resulting from the research.

2. Comments.

Governmental and charitable colleges and universities rely heavily on research grants to support their graduate programs. In the absence of such funds, colleges and universities would be more likely to use the tax-exempt bond market to finance the immense capital costs of research laboratories. The Committee believes that the Proposed Regulations generally strike a reasonable balance between the promotion of nongovernmental funding for research activities and ensuring that tax-exempt proceeds are not used in a grantor's trade or business. The Committee recommends, however, that research in the social sciences, arts, and humanities be treated no differently from research in the physical sciences. Code § 41(e)(7)(A), which defines "basic research," provides a tax credit for certain types of basic research. Thus, the definition of "basic research" is limited to the targeted types of research for which Congress intended to provide a tax credit. The Private Business Use Test, rather than providing valuable tax credits, was intended merely to prevent governmental units and charitable organizations from passing the benefits of tax-exempt financing to persons engaged in private trades or businesses. The limitations contained in Prop. Reg. § 1.141-3(d)(2) and (3) adequately address activities performed for the benefit of nongovernmental sponsors rather than for the greater public good.

Finally, the Committee believes that the safe harbors contained in Prop. Reg. § 1.141-3(d) are narrower than those envisioned by the 1986 Act Conference Report by excluding applied research. The line between basic research and applied research is difficult to draw and any exception requiring such a distinction will be of limited utility and difficult to apply. Although compelling policy considerations exist to exclude product development, the conditions set forth in Prop. Reg. § 1.141-3(d)(2) adequately guard against private benefits emanating from corporate-sponsored applied research and the conditions set forth in Prop. Reg. § 1.141-3(d)(3) provide substantial safeguards to ensure that control of the manner of research and the product of such research is maintained by an exempt person, and that the benefits of tax-exempt financing are not passed along to non-exempt sponsors. The Committee recommends that the safe harbors outlined in the legislative history to the 1986 Act,[38] as reflected in the reasoning of private letter rulings,[39] be the appropriate standard for research arrangements.

H. OTHER ACTUAL OR BENEFICIAL USE.

See discussion under Sections II and III.C, *supra*.

I. EXCEPTIONS TO PRIVATE BUSINESS USE.

In addition to qualified management contracts, exceptions to the Private Business Use Test are provided in Prop. Reg. § 1.141-3(e) for use of bond financed property as a member of the general public, certain systems improvements, and *de minimis* private use.

1. Exception for Use as a Member of the General Public.

The exception for use as a member of the general public represents the clearest example of where the failure of the Proposed Regulations to articulate a clear standard results in inconsistent, often counter-intuitive analysis and conclusions. Because the Proposed Regulations blur the distinction between actual proprietary use and some form of benefit that may be conferred on private persons, bond-financed projects that heretofore would not have risen to the level of private use within the meaning of Code § 141(b)(6), and in fact are truly public in nature, now need an exemption from private activity bond status. Unfortunately, the conclusions presented in most of the examples provided in Prop. Reg. § 1.141-3(e)(5) are contrary to precedent, are based on analysis that is internally inconsistent, and often are logically incorrect. For example, Prop. Reg. § 1.141-3(e)(5), Example 8, attempts to distinguish use by

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38 *See* 1986 Act Conference Report at II-687-90.

39 *See, e.g.*, Ltr. Rul 8003023 (holding reflects analysis of economics of privately sponsored research; payment seen as fees for service, so sponsor treated as owner of developed technology; sponsor not treated as in possession or control of facility, nor as deriving economic benefit or loss from success or failure of facility).

a governmental person from general public use. In this example, a municipal issuer enters into an arrangement with a federal agency to house federal prisoners on a space-available, first-come-first-served basis at a bond-financed prison facility housing state prisoners. During the term of the contract, the municipality expects that federal prisoners will constitute more than 10% of the prison's population. Under this arrangement, the federal agency will be charged the same amount for each prisoner as will state and local governmental units entering into similar contracts. The example treats the agreement as an arrangement giving rise to private use even though the federal government's right to use the prison is on a space-availability basis. The Proposed Regulations conclude that governmental persons are not using the prison as members of the general public, and thus, that the federal government cannot use the prison on the same basis as members of the general public because there *is* no public use of a prison.

By contrast, in Prop. Reg. § 1.141-3(e)(5) example 3, a local sewage collection and treatment district operates a bond-financed sewage treatment facility, approximately 20% of which is used to treat sewage produced by a federal agency under an agreement pursuant to which the district would use its best efforts to charge the federal agency the same amount for such use as other customers pay. The other users of the sewage treatment plant are commercial and residential property owners within the district (rather than state or local governmental units, as in example 8). The example concludes that the general public use exception applies so that such use is not taken into account for purposes of the Private Business Use Test.

The Committee finds these, as well as most of the other examples, perplexing. A jail facility seems inherently to serve the general public, while the sewage plant, by contrast, is serving large numbers of commercial users. The Committee recommends that these examples be rethought in light of our general recommendations presented above as well as our specific comments and recommendations presented below.

a. In General. (1) Overview. Code § 141(b)(6) and the 1986 Act Conference Report provide that use of bond-financed property by a nongovernmental person in a trade or business is not taken into account for purposes of the Private Business Use Test if such use is on the same basis as that of members of the general public. The Proposed Regulations contain a similar exception for such use, but such exception is drafted much narrower than that contemplated by the legislative history to the 1986 Act, which states that the 1986 Act generally retains the then-current rules under which use is determined. Treasury Reg. § 1.103-7(b)(3) provides that "when publicly-owned facilities which are intended for general public use, such as toll roads or bridges, are constructed with the proceeds of a bond issue and used by nonexempt persons in their trades or businesses on the same basis as other members of the public, such use does not constitute a use in the trade or business of a nonexempt person for purposes of the trade or business test." Proposed Reg. § 1.141-1(e)(1)(i) provides that a nongovernmental person using bond-financed property in its trade or business will be treated as using such property as a member of the general public only if:

a) the facility is intended for use by the general public; and

b) use by the nongovernmental person is reasonably expected to be on the same basis as use by other members of the general public.

(2) Comments. The Committee believes that the exception for general public use set forth in Prop. Reg. § 1.141-3(e) is much narrower than that contemplated by Code § 141(b)(6). Arrangements providing non-exempt persons with priority or other preferential rights to bond-financed property will result in use by a nongovernmental persons on a basis other than as members of the general public. Undue emphasis is placed on an issuer's motivation for providing bond-financed property, however. For example, a public playground that is open during all daylight hours to all members of a community would be no less available for general public use if that playground were located adjacent to a privately-operated preschool whose students have no greater right to use the facility than do any other members of the general public, but under the Proposed Regulations, such facility would likely raise private use questions. The public use exception should generally apply to any bond-financed property that is available to the general public, as long as no formal arrangement exists that (i) gives priority or other preferential rights to private persons, or (ii) creates an enforceable right by a non-exempt person to require an issuer to provide such facility.

The qualified management contract rules set forth in Prop. Reg. § 1.141-3(c) confirm that contracts that permit nongovernmental persons to perform certain services in bond-financed facilities pursuant to customary contracts that do not grant special uses or privileges do not cause such nongovernmental persons to be users of such facilities. This concept is inconsistent with that set forth in example 8 of Prop. Reg. § 1.141-3(e)(5), described above, which indicates that an arrangement that merely provides a nongovernmental person with the use of a facility on a space-available basis for fees comparable to fees expected to be charged to other users of the facility is considered use for purposes of the Private Business Use Test.

The rights granted to the U. S. Marshals' Service in the example cited above are no greater than the privileges granted to staff physicians of a hospital to use the facilities and equipment of such hospital, which are elsewhere exempted from analysis.[40] The determination of whether the use of a facility gives rise to private trade or business use should focus on the *nature of the rights or benefits* granted to the nongovernmental person rather than the *nature of the property*. The Committee recommends that arrangements entitling nongovernmental persons merely to use a facility on a space-available basis for universally-charged fees not give rise to private use.

2. Intended for General Public Use.

a. Overview. Proposed Reg. § 1.141-3(e)(2)(ii) provides that the general public includes natural persons not engaged in trades or businesses and a large number of nongovernmental persons engaged in separate trades or businesses. Under the Proposed Regulations, however, the general public cannot consist predominately of a large number of nongovernmental persons engaged in the same type of trade or business. Prop. Reg. § 1.141-3(e)(2)(i) sets forth a mechanical test for such determination, *i.e.*, that a facility is not intended for general public use if less than 25% of the reasonably expected direct use of the facility is by persons that individually account for no more than 1% of the use of the facility.

b. Comments. First, the Committee recommends that the Proposed Regulations be revised to enable a large number of non-exempt persons engaged in the same trade or business to comprise the general public. Prop. Reg. § 1.141-3(e)(2)(ii), if enacted in its current form, will jeopardize the tax-exempt financing of many legitimate projects, such as court houses containing law libraries that are available to persons practicing law on the same basis and at the same times as that available to the general public. Prop. Reg. § 1.141-3(e)(2)(ii) may cause such property to be treated as used in a trade or business, and will require more stringent analysis by municipal bond professionals of property never before thought to be so used. In addition, the concept that large numbers of persons in the same trade or business are not treated as members of the general public is analytically inconsistent with Prop. Reg. § 1.141-3(c)(6)(iv), which states that, for purposes of the management contract rules, private physicians who have

[40] *See* note 14 and accompanying text.

admitting privileges at bond-financed hospitals pursuant to open medical staff arrangements will not constitute private users in the absence of more preferential rights to the facility.[41]

Second, the Committee recommends that the mechanical test for determining whether property is intended for general public use be eliminated in favor of a more principled approached that would focus on underlying arrangements between persons engaged in a trade or business and the bond-financed property. The mechanical approach would have the unintended effect of adversely affecting many traditionally governmental financings, for example, municipal auditoriums or convention facilities. Because most theater productions and trade shows involve use of facilities for four or more consecutive days, issuers of bonds financing such facilities will have difficulty meeting the annual 25%/1% standard. Under this mechanical test, an issuer could enter into arrangements with up to 91 unrelated persons each of whom would use the facility for 4 days during each annual period, and the facility would not be treated as intended for public use. In fact, under the Proposed Regulations, public use would not be found even in circumstances where over the life of the property thousands of unrelated persons are entitled to use the property for four-day periods annually on a non-priority basis. The Committee therefore recommends that the mechanical approach be abandoned.

c. Use on the Same Basis as Members of the General Public.

The Proposed Regulations provide guidance on whether a nongovernmental person is using a bond-financed facility on the same basis as that of the general public. These rules address functionally and integrally related facilities and arrangements conveying priority or preferential rights.

(1) Functionally and Integrally Related Facilities. (a) Overview. Prop. Reg. § 1.141-3(e)(3) provides that bond-financed facilities that are functionally and integrally related to other facilities used by a nongovernmental person will not be treated as used on the same basis as that of the general public if significant economic benefits arise from the use of the related facility that are not available to the general public. If more than 75 percent of the use of the related facility is by the general public and not use in connection with the nongovernmental user's facility, the benefits to the nongovernmental person are considered

[41] Prior to Proposed Regulations, such physicians were treated by municipal bond professionals as using such hospital facilities on the same basis as that of the general public because most, if not all, governmental and charitable hospitals permit any member of the general public with suitable training and experience to become a member of their medical staff.

insignificant. Bond financed property will only be treated as functionally and integrally related to a nongovernmental person's facility if the bond-financed property is a necessary component of the nongovernmental person's facility. Two examples illustrating this concept are noteworthy.

In Prop. Reg. § 1.141-3(e)(5), example 6, a bond-financed runway at a governmentally-owned and operated airport is to be used in part by any aircraft operator desiring to use the airport. Portions of the airport's terminal are leased to commercial air carriers. The example concludes that the commercial air carriers that lease space in the terminal are not treated as using the runway on the same basis as that of the general public because their use of the terminal, which is treated as functionally and integrally related to the runway, enables such airlines to realize economic benefits from the use of the runway that are not available to other aircraft operators who are entitled to use the runway.

In addition, example 7 in Prop. Reg. § 1.141-3(e)(5) finds that a parking lot, which is used by employees of an airport, the airlines, and other private terminal businesses, and by departing air travelers, is not used on the same basis as that of the general public because the parking lot is functionally and integrally related to the nongovernmentally-used space in the terminals, thus providing benefits to such private users that are not available to members of the general public.

(b) Comments. The Committee believes that the functionally and integrally related facility exception to general public use is broader than necessary to ensure that the benefits of tax-exempt financing are not passed along to non-exempt enterprises, and could substantially increase the cost of needed public infrastructure projects that clearly are public facilities, such as airports. While the Committee agrees that under certain circumstances a project may be so integrally and functionally related to a private enterprise as to cause bond proceeds to be used for the private enterprise (for example, the construction of a twenty-mile road through an uninhabited area to a mine operated by a private entity should be treated as used in such private person's trade or business, even though any member of the public may drive on such road), such project would be excluded from general use under the concept underlying Prop. Reg. § 1.141-3(e)(2), *i.e.*, as not intended for public use. In its current form, however, Prop. Reg. § 1.141-3(e)(3) will impede the ability of governmental units to update airports and bus and train terminals. In addition, publicly-owned and operated convention centers that are surrounded by a number of business hotels may be treated as functionally and integrally related to such hotels.

Prop. Reg. § 1.141-3(e)(5), example 7, contradicts the conclusion in Ltr. Rul. 8926043, which held that a public parking lot at an airport was not used in the trades or businesses of air carriers renting space in the terminals, but rather by members of the traveling public using the airport. The letter ruling recognizes that the actual users of airports and bus terminals are members of the general public. This view is consistent with the position taken in Prop. Reg. § 1.141-3(c)(6)(vi) discussed above, involving membership on the medical staff of a hospital. The Committee therefore recommends that the example be deleted.

(2) Arrangements Conveying Priority or Preferential Rights. (a) Overview. Prop. Reg. § 1.141-3(e)(3)(ii) provides that arrangements that convey priority rights or other preferential benefits to nongovernmental persons will generally cause such person's use of bond-financed property not to be treated as general public use. Arrangements for a term of more than one month will be deemed to provide sufficient priority rights to cause use by a nongovernmental person to be treated as different from that of the general public. Prop. Reg. § 1.141-3(e)(3)(ii) clarifies instances in which arrangements that convey some priority or preferential rights to nongovernmental users will nevertheless be treated as general public use, *e.g.*, an arrangement permitting private use at rates that are generally applicable and universally applied generally will not be treated as conferring priority or preferential rights even if (i) different rates, which are customary and reasonable, are applied to different classes of users (*e.g.* volume purchasers), and (ii) users are permitted to reserve short-term or incidental uses in advance.

In addition, the granting to existing users (each of which must use less than 1% of the facility) of rights of first refusal to renew their use at generally applicable fair market value rates in effect as of the date of such renewal will not in itself cause an arrangement to be treated as providing priority or other preferential benefits. This rule is likely to affect financings for parking facilities of more than 100 spaces, in which portions of the parking facilities are expected to be leased to members of the general public for monthly periods that are renewable at rates generally applicable on the renewal date. In the event that federal law prohibits a user from paying generally applicable rates for the use of bond-financed property, specially negotiated fee arrangements containing terms that are as comparable as possible to generally applicable rates will not by itself cause an arrangement to be treated as granting priority or preferential rights. Prop. Reg. § 1.141-3(e)(3), example 3, provides that an arrangement by which the federal government is to be charged a negotiated fee for use of a sewage treatment facility will not, in effect, be treated as granting preferential treatment since the sewage district is obligated to use its best efforts to charge the federal government as closely as possible the same amount for its use of the facility as other users are charged. An arrangement providing for a nongovernmental person to use bond-financed property at a specially negotiated discount, however, would be giving priority rights to such nongovernmental person.

(b) Comments. The Committee finds that the rules set forth in Prop. Reg. § 1.141-3(e)(3)(ii) generally are helpful, and are consistent with the proprietary-interest analysis presented above. The Committee notes, however, that managed care health plans such as health maintenance organizations, as well as more traditional insurers, negotiate for their subscribers to receive health care services at bond-financed hospitals at discounted rates. The Committee is concerned that if such discounting arrangements are treated as conveying priority rights or preferential benefits, an issuer may not treat the nongovernmental person's use of the facility as use on the same basis as that of the general public. The Committee therefore recommends that final regulations provide that, where bond-financed property is made available at discounted rates on a space-available basis, and the exempt person has a right to cancel such discounting arrangement upon reasonable notice, such discounting arrangement will not be treated as private use.

d. Treatment of Certain Systems Improvements. (1) Overview. Prop. Reg. § 1.141-3(e)(4) provides a special rule for determining whether improvements to existing public utility or infrastructure systems, such as roads and sewers, qualify for the general public use exception. While this provision applies to system improvements such as sewer lines and expressway interchanges, specific structures such as parking garages and buildings housing restaurants along highway rest areas are not eligible. Use of the system as a whole, rather than use of the specific property financed, determines whether such facility is intended for general public use and whether it is being used on the same basis as that of the general public if the system improvement is insubstantial. Moreover, use of portions of the system that are functionally and integrally related to other privately-use facilities is disregarded, even if such nongovernmental persons, as a result of their use of such functionally and integrally related facilities, derive significant economic benefits from the system improvements that are not available to the general public. An improvement is treated as insubstantial if either the aggregate cost or scope of the bond-financed improvements is insubstantial when compared to the system as a whole within the jurisdiction of the issuer. A system improvement, other than road improvements, will be treated as insubstantial under the Proposed Regulations if the cost of the improvement is less than 5% of the cost of the whole system. Although no bright line tests are provided for determining whether improvements to highway systems may be treated as insubstantial, two examples are provided. Prop. Reg. § 1.141-3(e)(5), example 10, provides that a 25-mile road connecting existing roadways to a privately owned and operated port facility at a cost of $200 million dollars would not qualify as an insubstantial system improvement because the cost would not be insubstantial. Prop. Reg. § 1.141-3(e)(5), example 5, provides that road improvements undertaken in connection with the development of a privately-owned stadium are treated as incidental system improvements that qualify for this special rule. In this example, the bond-financed construction of a new exit and entrance ramp from an existing highway onto an adjacent public street fronting a newly-constructed stadium, where the exit ramp will be available for general public use and will not be limited to persons using the stadium, qualifies as an insubstantial system improvement notwithstanding that the ramps would be treated as functionally and integrally related to the stadium and at least 75% of the use of the ramp is expected to be by employees, spectators, and other users of the stadium.

(2) Comments. The Committee believes that if the "proprietary interest" approach described above is rejected, the special rules for system improvements contained in Prop. Reg. § 1.141-3(e)(4) provide useful guidance for issuers and should be included in final regulations. Final regulations should also include some principles upon which the insubstantiality of road improvements is measured, *i.e.*, whether insubstantiality may be based on the cost of the improvements regardless of the total cost of the system or on the length of the improvement compared to the scope of the system. In addition, if the 5% standard is not applicable to roads, an alternate percentage should be provided. Final regulations should also clarify example 5 so that highway improvements leading to stadiums and other privately-used facilities need not access adjacent public streets and may be connected directly to limited access property adjacent to the stadium or other facilities. Exit ramps to public streets are more likely to aggravate traffic congestion in the adjacent community than to provide convenient access to the metropolitan area's highway system, and such requirement does not alter the analysis that the highway improvement benefits the public at large.

In addition, the Committee recommends that any percentage standards established (including those now contained in the Proposed Regulations) be presented as safe harbors.

3. *De Minimis* Exceptions to Private Business Use.

Prop. Reg. § 1.141-3(f) provides that certain *de minimis* and incidental private uses of bond-financed property are not taken into account for purposes of the Private Business Use Test. *De minimis* uses include use pursuant to certain short-term non-renewable leases and similar arrangements, while examples of incidental uses include vending machines and telephone booths. In addition, a *de minimis* exception is provided for certain improvements to governmentally-owned and operated buildings in which less than 15% of any such building is used by a nongovernmental person in its trade or business.

a. De Minimis Use. (1) Overview. Prop. Reg. § 1.141-3(f)(1) sets forth a rule in which certain short-term leases or other arrangements providing for use of a bond-financed facility by a nongovernmental person will not be taken into account for purposes of the Private Business Use Test. The term of any such lease may not exceed the least of (i) one year, (ii) ten percent of the remaining economic life of the financed facility (determined as of the date the arrangement is entered into), and (iii) ten percent of the remaining term of the bonds that financed the property. Following the term of such agreement, the facility may not be used for a private business use. Thus, this rule will not apply if the term of the lease or other arrangement may be renewed or is, in fact, extended for a term in excess of the time limitations described above. Except in cases where the lease or other arrangement was entered into prior to the date the bonds were issued or contemplated, such arrangements must be arm's-length, fair-market-value agreements.

Proposed Reg. § 1.141-3(f)(2) provides that use of bond-financed property that carries out an essential governmental function, such as streets and sewer lines, by a developer during the initial development period of a project, will not be taken into account in certain circumstances for purposes of the Private Business Use Test.

(2) Comments. The Committee believes that the exception for short-term leases and other arrangements will be especially useful, even under our proprietary-interest analysis, for situations that may give rise to use under a quasi-proprietary interest theory. In addition, this exception will assist in situations where bond-financed acquisitions or improvements of existing facilities are subject to leases, or management or other arrangements

that will expire within one year after bonds are issued. The Committee recommends, however, that clause (C) of Prop. Reg. § 1.141-3(f)(1)(iii) be eliminated because it penalizes issuers that finance small portions of projects through a series of bond anticipation notes as expenditures are expected to be paid. By limiting the term of a holdover lease to ten percent of the remaining term of the bonds that finance the property, a project that includes holdover tenants will need to forego temporary short-term financing and will instead be required to be financed on a long-term basis as the earliest expenditures are paid or incurred.

The Committee also recommends that the final regulations reflect in the *de minimis* exceptions to private use a ruling position previous adopted by the IRS that a private developer under a turnkey project is not a user of bond proceeds.[42]

b. Incidental Use. (1) Overview. Proposed Reg. § 1.141-3(f)(3) provides rules under which certain incidental uses of bond-financed property, such as pay telephones, vending machines, and advertising posters, will not be treated as private use. This rule applies only to non-possessory use. Non-possessory use is one that does not involve possession or control over space that is separated from other areas of the facility by physical barriers. Such use may not be functionally related to any possessory use by the same person of a portion of the same facility (*e.g.*, vending machines in a courthouse that are owned by the same nongovernmental person that manages a cafeteria in the courthouse). In addition, not more than 2.5% of the use of the financed facility may involve such non-possessory use, and not more than 2.5% of the proceeds may be used to finance such incidental non-possessory uses.

(2) Comments. The Committee recommends that the *de minimis* exception for incidental uses be expanded to include certain small spaces that may be separated from other areas of a public facility by a partition or nightgate, including kiosks in buildings, as well as parks and plazas housing newsstands, snack bars, and automatic teller machines. To ensure that such uses are merely incidental to the primary use of the public facility, the Committee suggests that reasonable standard would be that no single use could exceed more than 100 square feet and that the aggregate of such use could not exceed 3% of the total square footage of the financed facility.

c. Qualified Building Improvements. (1) Overview. Prop. Reg. § 1.141-3(f)(4) provides that nongovernmental use of governmentally-owned buildings will not be taken into

[42] Ltr. Rul. 8841028 as modified by Ltr. Rul. 8847005.

account in connection with the financing of certain governmentally owned building improvements. This rule is likely to cover systems upgrades to buildings, such as new roofs and elevators, electrical system improvements, and upgrades to a building's heating, ventilation and air conditioning systems, that generally house governmental functions and contain ancillary private users. Enlargements to a building or improvements to interior space used exclusively by a nongovernmental person will not qualify for this exception, and such improvements may not increase the value of a facility by more than 5%. For this purpose, improvements to common areas that are not made as part of a substantial rehabilitation of the building are not taken into account. Similarly, such improvements may not begin earlier than on the first anniversary of the placed-in-service date of the building. In addition, this rule applies only to buildings that have no more than 15% private use. Finally, the rule is not available if any portion of the improved building or payments in respect of such building are taken into account under the Private Security or Payment Test (thus precluding use by most revenue bond issues).

(2) Comments. The Committee believes that these rules are more workable than similar rules contained in Notice 87-69,[43] but recommends that the 10% standard of the Notice be substituted for 5% in the provisions addressing increase in fair market value of common areas. The Committee contends that this provision would continue to be unavailable if a building is being substantially rehabilitated. In addition, final regulations should clarify that common areas include improvements to the exterior of a building, including window replacement and improvements to a building's shell.

J. MEASUREMENT OF PRIVATE BUSINESS USE.

1. Overview.

Prop. Reg. § 1.141-3(i)(1) provides that private use of proceeds allocated to a facility is determined according to use of that facility during each one-year period.

2. Comments.

Measuring private business use of bond-financed property on an annual basis will impose substantial monitoring and recordkeeping burdens on issuers for decades following the date bonds financing such property are issued. In addition to the administrative burden imposed by an annual test, the draconian consequence of taxability looms if the private use limitation is satisfied in any one-year period. Even with the most assiduous monitoring, an issuer may

[43] 1987-2 C.B. 378.

inadvertently enter into a nonqualifying management contract. Such activity would constitute a deliberate act insofar as it is intentional, but not in the sense that the issuer is intentionally conveying the benefits of tax-exempt financing to a nongovernmental person. Assuming that the nonqualifying management contract is detected after one year, it would nonetheless be too late to save the tax-exemption of the bonds: the annual test would be violated, and the change-in-use rules of Prop. Reg. § 1.141-13 would be unavailable, as any remedial action would have had to have been taken no later than 90 days after the contract was effected. The Committee therefore recommends that the Private Business Use Test be applied on a cumulative basis, based on the average amount of use over the term of the bonds. This approach would protect issuers from inadvertent, short-term violations of the test that may jeopardize the tax exemption of an entire issue. Because under the Proposed Regulations an issuer must reasonably expect that it will not satisfy the Private Business Use Test, the IRS should not be concerned that this recommended methodology would permit an issuer to "frontload" private use without an appropriate period of governmental use. In addition, since a deliberate act would cause bonds to become taxable, under the recommended methodology, the failure of an issuer actually to have sufficient governmental use would also trigger taxability. Therefore, the possibility of abuse is remote.

IV. PROP. REG. § 1.141-4: PRIVATE SECURITY OR PAYMENT TEST

Until these Proposed Regulations were released, the main guidance regarding the definition of private security or private payment was contained in Notice 87-69, which, although helpful, left many unanswered questions. The Proposed Regulations provide clarifying guidance for a number of uncertainties, although in some instances have the practical effect of blurring the distinction between private use and private payment or security.

A. PROP. REG. § 1.141-4(a): GENERAL RULE.

1. Private security or payment.

a. Overview. Proposed Reg. § 1.141-4(a)(1) essentially restates the statutory rule of Code § 141(b)(2). Prop. Reg. § 1.148-4(g), example 2, in applying the subsection, provides that more than 10% of the bond financed property will be sold or leased to private business users. The private users will pay, either as purchase money or lease payments, for the property. None of these payments are pledged to repay the bonds, and these revenues do not appear to be the only revenues of the issuer. Nevertheless, the example treats the payments as "indirect" private payments, thereby causing the bonds to become private activity bonds.

b. Comments. The regulation provides little guidance regarding a standard by which payments will be treated as indirect. The example cited appears to imply that if the private use test is met and if the private user makes *any* payments, even if those payments are not to be used to pay or secure the debt service on the bonds, the two part private business test is met. This result appears directly contrary to the statute as it was adopted in 1986.[44]

2. Aggregation of private payments and security.

a. Overview. Prop. Reg. § 1.141-4(a)(2) makes clear that, while a payment will not be taken into account as both a "payment" of debt service and as security for the payment of debt service, different payments, one that clearly is a "payment" and the other that clearly is "security," will be aggregated in determining whether more than 10% of the debt service is paid or secured by payments from a private user or property used in a private business use. Prop. Reg. § 1.148-4(g), example 1, illustrates this concept.

b. Comments. While the example is clear in providing how to aggregate private payments, the Committee recommends that it be changed to reflect an example of how to aggregate private payments and private security for this purpose. Such an example would be considerably more useful.

B. PROP. REG. § 1.141-4(b): MEASUREMENT OF PRIVATE PAYMENTS AND SECURITY.

1. General Rule and Present Value Measurement.

a. Overview. Prop. Reg. § 1.141-4(b)(3) provides rules for the present value measurement of private payments and security when compared to debt service on the relevant bonds. These rules appear to be derived from Notice 87-69, and imply that, in order to meet the rules, property securing bonds must be marked to market as of the first date that such property becomes security.

In addition, variable yield issues are to use their initial interest rate in making such determination, unless the bond issuer takes a "deliberate action" with respect to the facilities or the security. Prop. Reg. § 1.141-4(g), example 9, illustrates how the provision is intended to operate.

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[44] *See* 1986 Act Senate Report at 831.

b. Comments.

The Committee recommends that these rules be amended to clarify that, (i) once security has been marked to market, the resulting amount is incorporated into the present value calculation on the same basis as are private payments, and (ii) where property is expected to be pledged to an issue at a future date, the reasonably expected future value of such property is taken into account as of the bond issuance date.

C. PROP. REG. § 1.141-4(c): PRIVATE PAYMENTS.

1. Overview.

This paragraph is substantially similar to the provisions of Notice 87-69, where the IRS established "private payments" for purposes of Code §§ 141(a)(1)(B) and (b)(2). As under Notice 87-69, the Proposed Regulations establish that the amount of any private payment is determined by comparing the present value of payments to be received to the present value of debt service to be paid (excluding any payments to be made with bond proceeds). Also as provided in Notice 87-69, the Proposed Regulations state that the amount of payments from a private user treated as being made with respect to the bonds cannot exceed the percentage of proceeds that such user is deemed to be using (*i.e.*, if the private user is using 7% of the proceeds, its payments cannot be deemed to exceed 7% of the debt service). Thus, if the private user is paying rent equal to 10% of the debt service, only the amount equal to 7% of the debt service will be treated as a "private payment," while if it is paying rent equal to only 5% of the debt service, only that amount will be treated as a "private payment." Prop. Reg. § 1.141-4(g), examples 5 and 7, illustrate the application of this provision.

2. Comments.

The Committee generally supports the methodology presented in Prop. Reg. § 1.141-4(c)(2).[45] The Committee notes, however, that not all payments should be treated as made with respect to private use of a facility, and requests that final regulations clarify when private payments are made "in respect of property financed with the proceeds" even when not made by the issuer and not made by the private user. Prop. Reg. § 1.141-4(g), example 5, is particularly troublesome in this regard. In the example, a municipally-owned hospital managed by a private

[45] The Committee notes, however, that other sections of the Proposed Regulations do not necessarily follow this approach. *See* Prop. Reg. § 1.141-7(e), example 2, which flatly contradicts this approach.

user under a management contract that does not satisfy the qualified management contract rules uses the hospital's revenues, after paying the "non-qualifying" management fee, to pay debt service. The example holds that the hospital's revenues, which are derived from patient fees, will be treated as "private payments" because they are payments made in respect of property used for a private business use. The Committee contends that payment made under these circumstances are compensation for the services performed and only marginally payment for the use of the facility. We therefore recommend that final regulations provide a more principled approach to the determination of whether, how, and when payments made by an "excluded" user of the facility (*e.g.*, a patient) are to be imputed to a private (ostensible) user.

Additionally, the Committee recommends that the measurement of the limitation on private payments comport with our recommendation, *supra*, the use be measured cumulatively rather than on an annual basis. The Committee further recommends that the results of Prop. Reg. § 1.141-4(g), Example 7,[46] be amended to reflect this change.

Last, the Committee applauds the clarification made by the Proposed Regulations that payments made by a private user can first be allocated to any equity (non-debt financed) investment of the issuer in the facilities. Thus, none of the payments received from a private user should be treated as "private payments" to the extent that the total payments received from such user do not exceed an issuer's equity investment. The Committee recommends, however, that final regulations clarify whether an issuer is allowed to charge the private user for the use of such equity in the facility, or whether any such profit would be deemed to be a private payment.

D. PROP. REG. § 1.148-4(d): PRIVATE SECURITY.

1. Overview.

Pursuant to Prop. Reg. § 1.141-4(d), any property that is used by a private user and pledged as security for bonds is treated as private security. Unexpended funds that otherwise qualify for temporary periods, and bond proceeds in a reserve or replacement fund, will not be treated as "security" until those proceeds are treated as expended or "loaned" to a private party.

46 Example 7 currently provides that where a private user has a 5-year lease for 11% of the bond-financed facility pays rent equal to 20% of the debt service for those five years, *all* of the payments are taken into account *up to 11% of the debt service over the life of the bonds*, not just over the period that the lease is outstanding. The measurement of use and measurement of payments should be done using the same standard.

The phrase "any interest in" is to be interpreted very broadly, provided that the interest secures payment on the bonds. Example 6 of Prop. Reg. § 1.141-4(g) provides an example of the limitations of this interpretation. In part (i) of the example, the Private Business Use Test has been satisfied for the bond-financed facility, and the security for the bonds is a "lease" on other property of the issuer more than 10% of which is used by private users and in which the bond trustee has a right to take "possession" of the property and lease it at fair market value. The example states that this right is an "interest" in property used in a private business use and the private security of payment test is satisfied. In part (ii) of the example, the trustee has only the right to sue to receive the lease payments directly. The example holds that the right to receive lease payments is not an "interest" in the property, and that the right does not provide private security. Additionally, payments "in respect of" property used in a private business, regardless of whether the private user makes any payments, are counted, as well as pledged general public payments made with respect to privately used property. Last, the security for parity bonds is to be allocated on a "reasonable" basis.

2. Comments.

The Committee generally finds this much needed guidance useful.

E. PROP. REG. § 1.148-4(e): GENERALLY APPLICABLE TAXES.

1. Overview.

Proposed Reg. § 1.141-4(e) excepts generally applicable taxes from being treated as payments from "nongovernmental" persons and not being made in respect of property used in a private business use. "Generally applicable taxes" are defined as "enforced" contributions exacted pursuant to legislative authority in the exercise of the entity's taxing power. Presumably, a tax that is not collected from all similarly situated taxpayers or potential taxpayers is thus not a generally applicable tax. The subsection also requires that a uniform tax rate be applied to all persons of the "same classification," and that a generally applicable manner of determination and collection exist. Presumably this requirement means that different rates for different classes of taxes can exist, as well as tax abatements, so long as they are applied uniformly. The Committee recommends that regulations make that point explicit.

Prop. Reg. § 1.141-4(g), Example 10, describes two types of "ticket" taxes to illustrate the concepts. In part (i), the ticket tax is imposed only on tickets purchased for use in the bond financed stadium, while in part (ii), the ticket tax, which also is security for the stadium, is imposed on tickets for events at a number of large entertainment facilities, some of which were not financed with bonds. The example states that the first tax is a "special charge" while the second tax is a "generally applicable tax." The Proposed Regulation specifically provides that payments for privileges or services, including special assessments relating to property improvements, are not generally applicable taxes. Although the regulation makes clear that payments in lieu of taxes may be generally applicable taxes, it requires that such amounts be equal to the amount of tax that otherwise would be imposed. Payment must be designated for a "public purpose," rather than for a privilege, service, or regulatory function. It is not clear whether payments that contemplate provision of such typical municipal services as garbage collection would thereby not be treated as generally applicable taxes. Last, the regulation distinguishes between "permissible" and impermissible" agreements with respect to taxes. For example, one may make a representation with respect to the expected value of property, but not agree on the minimum market value; one similarly may agree to insure and restore damaged property but not to provide additional security, such as personal liability or third-party guarantees.

2. Comments.

The Committee believes that nothing in the legislative history of the 1986 Act or otherwise supports the rule providing that "impermissible agreements" cause what would otherwise be taxes of general application to become special assessments, and thus, in certain circumstances, loans for purposes of the Private Loan Financing Test, discussed below. As long as such an agreement does not result in the receipt of amounts that would not otherwise be paid as taxes, such agreements should not affect the exception for taxes of general application. The agreements treated as impermissible arrangements under the Proposed Regulations are often of the type used to enhance the marketability of bonds because the project being financed is in a small area and the property subject to tax is owned by few people. The provision of third-party guarantees or other credit enhancement by a taxpayer in such situations does not alter the characterization of the amounts supporting the bonds as taxes. Because this rule will either curtail financing of tax-backed infrastructure financing in small areas or greatly increase its cost (assuming that bonds can be issued at all), the Committee recommends that the final regulations delete this provision.

The Committee also notes that, under many state laws, not all taxes of general application assess all taxpayers under the same formula. This fact should not alter the characterization of the "tax" as one of general application. The Committee recommends that the final regulation so clarify this provision.

V. PROP. REG. § 1.141-5: PRIVATE LOAN FINANCING TEST

Prop. Reg. § 1.141-5 interprets Code Section 141(c), which provides that bonds are private activity bonds if more than the lesser of 5% or $5 million of the proceeds of an issue is to be used (directly or indirectly) to make or finance loans to nongovernmental persons (the "Private Loan Financing Test"). This provision, from the perspective of many issuers (particularly large issuers), is the most restrictive and troublesome prong of the private activity bond restrictions enacted by the 1986 Act. In fact, many governmental issuers have found that this Private Loan Financing Test forces them to finance many legitimate governmental activities on a taxable basis. For this reason, the regulatory interpretation of this provision should be flexible, to avoid preventing issuers from subsidizing with the proceeds of tax-exempt bonds activities that further governmental purposes. Unfortunately, for the reasons set forth below, the Proposed Regulations in this area, which follow the IRS interpretations to date, do not fully achieve this goal.

A. INDIRECT USE OF PROCEEDS.

1. Overview.

Prop. Reg. § 1.141-5(a)(2) provides that in determining whether the proceeds of an issue are used to make or finance loans, indirect as well as direct use of the proceeds is taken into account. In addition, any use of proceeds by a governmental person that results in an expenditure of those proceeds (rather than the acquisition of investment property) such as through making a grant, is treated as an ultimate use of those proceeds.

2. Comments.

The Committee recommends that the final regulations provide at least one example of an indirect use of proceeds to make loans.

B. MEASUREMENT OF TEST.

1. Overview.

Prop. Reg. § 1.141-5(a)(3) states that in determining whether the private loan financing test is met, the amount actually loaned to a nongovernmental person is not discounted to reflect the present value of the loan payments. This proposed regulation reflects the IRS's private ruling position, which was upheld by the Tax Court in *City of New York v. Commissioner*.[47] In that case, the IRS and the Tax Court rejected the City's position that below-market interest rate loans made from bond proceeds to provide funds to developers of low-income housing involved partial grants of City funds and thus, to the extent of such grants, were not loans for purposes of the Private Loan Financing Test. The Tax Court decision has been criticized for its failure to apply time value of money principles,[48] and is currently on appeal to the Court of Appeals for the D.C. Circuit.

2. Comments.

First, the Committee wishes to state explicitly that it is not commenting on the above-cited case or on the current status of the law. Whether or not the D.C. Circuit accepts the IRS position that the tax law does not necessitate application of time value of money principles absent an explicit or implicit statutory mandate (and that Code § 141(c) and its legislative history contain no such mandate), Treasury clearly has authority to apply such principles by regulation or otherwise. Its failure to do so in this context ignores the fact that below-market loans are a frequently used method by which municipal borrowers provide subsidies to private entities to carry out governmental functions. Such interest subsidy programs are often intended to permit municipalities to obtain the expertise of private enterprise and to induce private entities to undertake socially useful projects that otherwise would be uneconomic to finance without a governmental subsidy.

The Private Loan Financing Test had its origins in the industrial development bond restrictions of Section 103(b) of the 1954 Code, and was first enacted in 1968 to limit the then-widespread practice of having industrial development bond authorities issue tax-exempt non-recourse debt and lend the proceeds to private entities that had sole economic responsibility for repayment of that debt. In 1984, restrictions on loans of bond proceeds to private individuals were expanded to eliminate the then-growing practice of using tax-exempt bond proceeds to make direct loans to private individuals at rates below conventional financing. In both such cases, the party primarily responsible for repayment of the debt was a non-exempt person, and the municipal issuer was in effect passing the benefit of tax exemption to a non-exempt person

47 103 T.C. 481 (1994).

48 *See* "Time Value of Money Principles Still Giving the Tax Court Trouble," *Tax Notes*, March 6, 1995, p. 1471-1473.

in a form of conduit financing. Thus, the Private Loan Financing Test provisions fundamentally were designed to prevent a municipal issuer from using its tax exemption solely for the benefit of a private person through a loan of bond proceeds to that person. Congress presumably was concerned that in such cases, since the municipal taxpayer's funds were not primarily at risk, the municipality would not scrutinize the issue as closely as if the funds advanced were to be repaid from taxes. The Private Loan Financing Test never purported to preclude a municipality from making a grant from tax-exempt bond proceeds: in such case, the municipal taxpayers would be primarily responsible for paying part of the debt incurred, and the municipality would scrutinize such expenditures to insure that they served a proper public purpose.

The below-market interest rate loans of the type involved in the *City of New York* case do not in fact involve a pass-through of tax exemption to a non-exempt person because the municipal issuer and its taxpayers are fully responsible for the interest subsidy portion of the debt, *i.e.* the difference between what the municipal issuer receives from the obligor on the below-market loan and the amount it must pay to bond holders. The present value of this difference is truly a subsidy or grant paid by the municipality from the bond proceeds.

Prop. Reg. § 1.141-5(b)(5) concedes that a grant made from bond proceeds is not a loan. Therefore, a municipal issuer that provides subsidies in the form of grants is not subject to the Private Loan Financing Test. A municipality that uses bond proceeds to provide subsidies substantively through the form of below-market interest rate loans is, however, denied the benefit of tax-exempt financing for the full amount of proceeds used for such purposes. In many cases, such interest subsidy programs merely follow existing practice, are accepted in the market place, or are mandated by state law or other restrictions. In *City of New York v. Commissioner*, for example, the below-market interest subsidy programs for low-income housing were, to a large extent, patterned on federal housing programs involving below-market interest rate loans to private developers that had been significantly cut back by the federal government in the early 1980's, were structured before the passage of the Private Loan Financing Test by the 1986 Act, and had wide acceptance in the development community. The IRS's refusal to recognize that these programs involved partial grants of City funds caused a major municipal borrower to curtail the tax-exempt funding of these programs. The Committee recommends that final regulations provide for time-value of money analysis in this area.

C. DEFINITION OF LOAN.

1. Overview.

Prop. Reg. § 1.141-5(b)(1) generally follows the legislative history of Code § 141(c) in stating that the determination of whether a loan is made depends on the substance of the transaction. Prop. Reg. § 1.141-5(b)(2) further states that any use of proceeds that does not, treating the user as a nongovernmental person that is not a natural person, give rise to private business use, is not a loan of proceeds.

2. Comments.

The Committee is unable to readily identify a situation that would fall within the scope of Prop. Reg. § 1.141-5(b)(2), and recommends that an example of such use be provided in the final regulations.

VI. PROP. REG. §§ 1.141-6 and 1.141-8: ALLOCATION AND ACCOUNTING RULES

Prop. Reg. § 1.141-6 sets forth rules under which bond proceeds are allocated among the different purposes for which monies are expended on a given project. When both bond proceeds and equity fund a given project, the allocation rules determine the project expenditures to which the bond proceeds may be applied to avoid a private use application. The rules allow an issuer specifically to determine the amount of bond proceeds that are applied to a permissible governmental purpose as opposed to a private use.

The allocation rules are based on the allocation rules in Treas. Reg. § 1.148-6, which discuss the manner in which bond proceeds are allocated to specific investments and treated as expended for purposes of the arbitrage rules of Code § 148. When bond proceeds are segregated into distinct funds, investment and expenditure of proceeds may be determined by specifically tracing the use of those proceeds. When funds are commingled with non-bond proceeds in existing accounts, however, the rules under Treas. Reg. § 1.148-6 generally allow an issuer to allocate bond proceeds to investments or expenditures according to any reasonable and consistently applied accounting method, such as specific tracing, gross proceeds spent first, ratable allocation, etc. The exception to this rule arises with respect to the expenditure of bond proceeds for working capital purposes, in which case proceeds are treated as expended only after all other available amounts of the issuer are expended.

A. TREATMENT OF INVESTMENT PROCEEDS WHEN COMMINGLED.

1. Overview.

Prop. Reg. § 1.141-6(a) provides that, under §§ 1.141-1 through 1.141-16, the provisions of Treas. Reg. § 1.148-6(d), other than -6(d)(6), apply for purposes of allocating proceeds to expenditures. Treas. Reg. § 1.148-6(d)(6) provides that the investment proceeds of an issue of governmental bonds are treated as allocated to expenditures for a governmental purpose when the amounts are deposited into a commingled fund with substantial tax or other revenues from governmental operations of the issuer, and the amounts are reasonably expected to be spent for governmental purposes within 6 months of the date of the commingling.

2. Comments.

Treas. Reg. § 1.148-6(d)(6) was a major simplification for governmental bond issues and freed issuers from the administrative burden of tracking investment earnings for arbitrage and rebate purposes. By excluding the application of Treas. Reg. § 1.148-6(d)(6), the Proposed Regulations would require issuers to track the use of investment proceeds deposited into their general funds, thereby eviscerating a major simplification provision of the Treasury Regulations issued on June 14, 1993 (the "1993 Regulations"). Since the premise of Treas. Reg. § 1.148-6(d)(6) is that the investment earnings are reasonably expected to be used for a governmental purpose, and such funds are usually used to pay for the operating expenses of the municipality, little potential for abuse should exist if issuers were permitted to treat investment earnings as spent when commingled with other tax and general revenues of the issuer. After four versions of such regulations, the guiding principle in the drafting of the 1993 Regulations became the balancing of the need for administrative ease with the arbitrage and rebate requirements. The Committee recommends that this same principle be applied here, and that § 1.141-6(a) be amended to apply Treas. Reg. § 1.148-6(d) as a whole.

B. PROP. REG. § 141-6(b): DETERMINATION OF PRIVATE USE IN MIXED USE FACILITIES.

1. Overview.

Under Prop. Reg. § 1.141-6(b), bond proceeds can be specifically allocated only to discrete portions of mixed-use facilities for purposes of determining the use of those proceeds. Discrete portions are defined as (i) separate portions of facilities (such as floors of buildings or portions of buildings separated by walls, partitions, or other physical barriers) to which a particular use is limited, or (ii) in the case of output, sewage, water utility, or other similar utility facilities, an undivided ownership interest in such facilities. The comments herein are limited to the allocation rules relating to facilities described in (i), above.

2. Comments.

By requiring that bond proceeds be allocated only among discrete portions of similarly used mixed-use facilities, the Proposed Regulations narrow the application of a widely-accepted allocation technique known as floating equity. Under this technique, equity equal to the cost of the privately used areas of a bond-financed project is deemed applied to private business areas without specifically tracing the equity to the expenditure for areas. Prop. Reg. § 1.141-6(b)(2)(ii) allows the allocation of bond proceeds between discrete portions of a facility only if such portions applied to private use are used in the same manner as are the discrete portions applied to governmental use. Such allocations are not permitted, however, if the manner of private and governmental use differs, or if a portion of a facility has both private and governmental use (where, pursuant to the Proposed Regulations, the entire portion is treated as privately used).[49]

By limiting allocations of bond proceeds to discrete purposes, the Proposed Regulations effectively preclude an issuer from using any allocation method other than a specific tracing of bond proceeds. Because construction expenditures are usually billed and paid in monthly draws with no distinction between costs paid from bond proceeds or from equity, this requirement will substantially increase accounting burdens.

The Committee therefore recommends that the definition of "discrete portion" in Prop. Reg. § 1.141-6(b)(2)(i) be expanded to include a "project" as defined in Treas. Reg. § 1.103-8(b)(4), *i.e.*, a building, or multiple similarly constructed buildings on the same tract of land, together with any functionally related and subordinate facilities. This definition would allow issuers to allocate bond proceeds easily to qualified costs.

C. PROP. REG. § 1.141-6(c): DISPOSITION PROCEEDS ALLOCATIONS.

Allocation of disposition proceeds is discussed in Section X, *infra*.

D. PROP. REG.§ 1.141-6(d): COMMON AREAS.

1. Overview.

Prop. Reg. § 1.141-6(d) states that the allocation of proceeds to common areas may be made according to any reasonable method that properly reflects the proportionate benefit to

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49 *See* Prop. Reg. § 1.141-3(i)(2).

be derived directly or indirectly by the users of the facility. Common areas are defined as portions of a facility that are equally available to all users on the same basis for uses that are incidental to the primary use of the facility. For example, hallways and elevators generally are treated as common areas if they are used by different lessees in connection with the primary use of that facility.

2. Comments.

The Committee recommends that the types of common areas covered by this special allocation rule be expanded. For example, assume that a bond-financed building houses a Code § 501(c)(3) hospital occupying floors 2 through 10 and a private company occupying the first floor. Assume further that a bond-financed 300-space parking garage is located directly under the building. In this situation, the parking garage should be viewed as a common area of the building, and use of the parking garage should be properly allocated in the same manner as has the building--*i.e.*, based on floor usage assuming that the floors are of equal square footage and cost and that the tenants would use the garage in proportion to their respective number of floors.

E. PROP. REG. § 1.141-6(e): DETERMINING PRIVATE USE IN MULTIPURPOSE ISSUES.

1. Overview.

Prop. Reg. § 1.141-6(e) requires that any allocation of bond proceeds for private activity bond purposes be consistent with the arbitrage multipurpose issue allocation rules set forth in Treas. Reg. § 1.148-9(h). These arbitrage regulations allow the allocation of bond proceeds among its different purposes to be made in any reasonable, consistently applied manner.

2. Comments.

The Proposed Regulations require that once an allocation has been made for arbitrage purposes, the same allocation be used for private use determinations. Thus, if an issue refunds a private activity bond and a governmental purpose bond and for arbitrage purposes each refunding purpose is treated as a separate issue, then for private use purposes the refunding issue will be treated as the separate refundings of a private activity bond and a governmental bond thus precluding the possibility of financing the prior private use within a larger governmental refunding issue. Similarly, if a refunding issue is treated as a single issue for arbitrage purposes, it is also a single issue for private activity bond purposes. This latter situation poses a problem where an issue refunds two or more issues that individually were not private activity bonds but that in the aggregate are private activity bonds. For example, if an issue refunds two $100 million governmental purpose issues, each including $4 million in private loans, the aggregate refunding issue would be a private activity bond because $8 million in private loans would be attributed to it. Thus, an issuer will be penalized for not having separated the refunding issue between its purposes for arbitrage purposes even though aggregation might have been done for a legitimate governmental reason. This result will effectively preclude an issuer from treating many multipurpose issues as a single issue for arbitrage purposes because of the concurrent problems caused under the private activity bond tests.

The Committee therefore recommends that final regulations allow issuers to make different multipurpose issue allocations for arbitrage and use of proceeds purposes as long as such inconsistent allocations are not being performed for an abusive purpose, and offers the following suggested language:

> *(e) Allocation of proceeds to bonds.* Proceeds *may be* allocated to bonds in a manner consistent with the allocation rules of 1.148-9(h) *or in any other reasonable manner so long as such allocation does not constitute an abuse under § 1.141-15.*

VII. PROP. REG. §§ 1.141-7, 1.141-8, and 1.141-11: OUTPUT FACILITIES

A. PROPOSED REG. § 1.141-7(a): OVERVIEW.

While Prop. Reg. § 1.141-7(a), which contains the proposed general rule for output facilities, appears familiar, we believe it conflicts with relevant legislative and administrative underpinnings, as presented below.

1. Existing Treasury Regulations Governing Output Facilities.

Pursuant to the Treasury Regulations currently governing output facilities, an "output facility" is one that produces, transmits, or delivers "output" in the form of electric energy, gas, or water. In the simple case, a governmentally-owned output facility might be leased to, or operated by, another person, and the presence or absence of private use could be measured by conventional means, with appropriate regard for such lease or operating agreement. As likely as not, however, such facility may be operated by the governmental unit. Superficially, this might be thought to conclude the private use analysis. But since a "use" can be the direct or indirect enjoyment of a benefit that derives from the proceeds of a bond issue, and since the benefit most prominently associated with an output facility is not, *e.g.*, the occupancy of physical space as in most buildings but rather the output itself, special rules have been developed to test for private use. These rules comprise Treas. Reg. §1.103-7(b)(5), and examine whether the private use of an output facility has the effect of transferring to one or more nongovernmental persons both the benefits of ownership of the facility and the burdens of servicing the debt incurred to finance such facility.

As a general matter, the extent to which "benefits and burdens" have transferred is measured by the fixed contractual rights of a nongovernmental person in or to the so-called "subparagraph (5) output"—*i.e.*, units of production—of the output facility over a specified term of years[50] and the attendant obligations resulting therefrom. In particular, the extent of a person's use of an output facility, when expressed as a percentage, is derived from a fraction of which (i) the numerator is the units of production that such person is contractually obligated to take, or to take or pay for (a "take-or-pay contract"), and (ii) the denominator is the total units of production produced or to be produced in one year based on the facility's nameplate capacity[51] (without reduction for reserves or other unutilized capacity) *multiplied by* the number of years in the "contract term of the issue" of obligations issued to provide such facility—*i.e.*, the period commencing on the date that output is first taken pursuant to the take-or-pay contract and ending on the latest maturity of any obligation of the issue, disregarding optional redemption dates.[52] The burdens, if any, associated with any such use or "benefit" are measured by

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50 *See, by contrast*, Prop. Reg. § 1.141-3(*i*)(1) and (2), which, for other, more general purposes, calculates the amount of (nonqualifying) private use on a year-to-year basis. The difference is striking—an abnormally high percentage of private use during the first few years of operation of an output facility can be offset by declining percentages of private business use in later years—and stands as an implicit acknowledgement that output facilities, in addition to requiring long-lead construction periods, are typically designed to meet estimated loads occurring over a time horizon of number of years in order that they not be undersized or obsolete immediately upon, or shortly after, being placed in service. *Cf.* Ltr. Rul. 9247012 (August 21, 1992)("The District's load growth forecast is based on load forecasting techniques and methods which are generally accepted within the electric industry. The District's 'medium growth' load forecast has independent economic significance as the primary basis of the District's capital construction, power supply, and financial planning").

51 The Committee notes that Treas. Reg. § 1.103-7(b)(5)(ii)(*b*) authorizes the use of maximum capacity where there is no "nameplate capacity" exists. The effective consignment of the capacity from which output is derived, more than the output itself, ultimately determines the existence and extent of private use under Treas. Reg. § 1.103-7(b)(5).

52 Treas. Reg. § 1.103-7(b)(5)(ii)(*b*) provides that, if on or before the issue date of bonds financing an output facility, the issuer makes a commitment in the bond indenture or related documents to refinance the issue with one or more subsequent issues, then the contract term of the issue extends to the latest redemption date of any obligation of the last such refinancing issue. The typical case in which this situation would arise is (continued...)

comparing the payments made or to be made under the terms of the take-or-pay contract to the total amount of debt service payable with respect to the bond issue over its entire term,[53] without regard to optional redemption dates.

2. Legislative Underpinnings.

The 1986 Act affected the rules relating to bond-financed output facilities in three basic ways. First, as true for all bond-financed facilities, the amount of permissible private use was generally reduced from 25% to 10%. Second, the maximum amount of private use that can be financed on a tax-exempt basis was limited to $15 million per project, regardless of whether one or more bond issues are required to complete the project, and even if the total project cost exceeds $150 million.[54] Third, pursuant to § 1301(i) of the 1986 Act, the Secretary of the Treasury was directed to modify a special exception in Treas. Reg. §1.103-7(b)(5) under which persons whose guaranteed minimum annual payment does not exceed 3% of the average annual debt service on bonds issued to finance an output facility may be disregarded in the calculation of private use. Allowing for these statutory changes and direction, the current regulatory regime basically provides that, unless the units of production to be taken pursuant to a take-or-pay contract exceed 10% of total units of production over the contract term of an issue *and* unless the payments to be made pursuant to such take-or-pay contract exceed 10% of the total debt service payable with respect to that particular issue, no transfer of the benefits and burdens occurs.

As noted above, the 1986 Act Conference Reports states that: "The conferees intend that, to the extent not amended, all principles of present law continue to apply under the [corresponding] provisions [of the 1986 Code]."[55] Similarly, the 1986 Act Bluebook states: "To the extent not changed by the [1986] Act, the provisions of prior law are retained", and, in describing the trade or business use test: "The [1986] Act generally retains the prior-law rules

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[52](...continued)
an issue of bond anticipation notes or "BANs" that are redeemed with the proceeds of long-term bonds following completion of construction.

[53] Subject to extension as the result of a commitment to refinance. *See* note 58, *supra*.

[54] Facilities for the furnishing of water, unlike any other class of output facility, are not subject to the $15 million limitation.

[55] 1986 Act Conference Report, at II-686.

under which use by persons other than governmental units is determined for purposes of the trade or business use test."[56]

By affirming the continuing reliability of the "principles of present law," Congress appears not to have intended to abandon the current Treasury Regulations. Had Congress wished to repudiate the body of rules that is or derives from Treas. Reg. § 1.103-7(b)(5), it likely would have directed the Secretary of the Treasury, *not* simply to modify Treas. Reg. §1.103-7(b)(5) by eliminating the special 3% rule, but rather to revoke such provision in its entirety.

Additional inferences supporting the foregoing conclusion may be drawn from two footnotes in the 1986 Act Bluebook:

> Congress was aware that under Treasury Department rules, limited use of facilities by nongovernmental persons on a basis unlike that of the general public was disregarded in certain cases. See, e.g., Treas. Reg. sec. 1.103-7(c), Examples (6) and (11); Rev. Proc. 82-14, 1982-1 C.B. 459; and Rev. Proc. 82-15, 1982-1 C.B. 460. See also, Treas. Reg. sec. 1.103-7(b)(3) and Rev. Rul. 77-352, 1977-2 C.B. 34. Neither these rules nor the Treasury Department's general authority to determine what constitutes (or does not constitute) a use of bond proceeds is modified by the Act. (But see, note 60, below, regarding the modification of certain de minimis rules pertaining to output facilities.)[57]

The references to examples and revenue procedures do not relate to output facilities. Still, the reference to footnote 60, however, suggests that output facilities are embraced by the general sense of the footnote, and that the "Treasury Department rules" relating to output facilities were affected in only a relatively minor regard by the 1986 Act—the elimination of the special exception for output users paying 3% or less of average annual debt service. The other 1986 Act Bluebook footnote states:

> This special limit [the imposition of the aggregate $15 million financing cap for nonqualified uses of bond-financed output facilities] does not change the determination of when a nongovernmental person is treated as a user of bond proceeds, e.g., in the case of

[56] 1986 Act Bluebook, at 1128, 1159. Whether the Bluebook, a non-contemporaneous staff report prepared by non-elected governmental employees, can be said to be part of the legislative history of the 1986 Act is debatable. The Bluebook, however, is given significant weight by those drafting Treasury regulations, and thus, cannot be ignored.

[57] 1986 Act Bluebook at 1159-60, n.54.

facilities that are used in part by governmental utilities and in part by investor-owned utilities.[58]

Thus, the Committee believes that Congress implicitly supported the basis for determining when private use occurs for output facilities and left Treas. Reg. §1.103-7(b)(5) essentially unchanged. Letter rulings issued since enactment of the 1986 Act support this assertion.[59]

The rules comprising Treas. Reg. §1.103-7(b)(5) are fundamentally sound and work well. With its emphasis on take-or-pay contracts, Treas. Reg. §1.103-7(b)(5) recognizes that the rights of an output purchaser are only as strong as the terms of the contract (if any) that govern the transaction. For example, the longer the contract term, the fewer the "outs" possessed by the seller, and the higher the priority of service, the more such rights begin to resemble those of an owner. Conversely, whether the projected revenues from the sale of output constitute a "bankable" form of security or source of payment for bonds issued to finance the output facility hinges on the enforceability of payment obligation. A purchaser that negotiates easy terms and generous cancellation privileges—more and more the rule in an increasingly competitive energy environment—is a security risk, and its arrangement is one that cannot be relied on by the seller or bondholders for debt service support.

The 1986 Act Conference Report is less clear in describing principles governing output facility bonds: "As under *present law*, a person may be a user of bond proceeds and bond-financed property as a result of . . . any . . . arrangement such as a take-or-pay or *other* output-type contract."[60] (emphasis supplied). Unanswered and unexplainable is the precise nature of the "other output-type contracts" under "present law," largely because the *only* contract that was (and is still) thought to give rise to private use is a take-or-pay contract of the type referred to in Treas. Reg. §1.103-7(b)(5) and described above.[61]

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58 1986 Act Bluebook, at 1163 n.59.

59 Ltr. Rul: 9247012 (Aug. 21, 1992); Ltr. Rul. 9022017 (Feb. 28, 1990) ("Section 1301(i) of the 1986 Act eliminates the 3% de minimis rule for take or take or pay contracts . . . . However, by eliminating only the 3% de minimis rule in the existing regulation, *Congress made clear its intent that the remainder of that regulation . . . . should be applied in determining the 'nongovernmental' or 'private business' use of a similar facility pursuant to section 141(b) of the Code.*") (emphasis supplied).

60 1986 Act Conference Report, at II-687-688.

61 The clearest proof of this analysis is that the Internal Revenue Service has both before and after the 1986 Act ruled favorably, despite the existence of requirements contracts between a bond issuer and high-end (continued...)

Regarding the separate treatment for certain classes of transactions, the 1986 Act Conference Report provides as follows:

> The conferees wish to clarify that certain power pooling and exchange arrangements and certain spot sales of output capacity are treated as sales to the general public under the trade or business use and security interests tests. The conferees intend that the presence of a nongovernmental person acting solely as a conduit for exchange of power output among governmentally owned and operated utilities is to be disregarded in determining whether the trade or business and security interest tests are satisfied. In addition, exchange agreements that provide for "swapping" of power between governmentally owned and operated utilities and investor-owned utilities do not in any event give rise to trade or business use where (1) the "swapped" power is in approximately equivalent amounts determine over periods of 1 year or less, (2) the power is swapped pursuant to an arrangement that does not involve output-type contracts, and (3) the purpose of the agreements is to enable the respective utilities to satisfy differing peak load demands or to accommodate temporary outages.
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> The conference agreement further provides that spot-sales of excess power capacity for temporary periods, other than by virtue of output contracts with specific purchasers, are not treated as trade or business use. For purposes of this exception, a spot sale is a sale pursuant to a single agreement that is limited to no more than 30 days duration.[62]

Curiously, the quoted passage is preceded by a footnote that, except for the elimination of the special 3% rule, appears to assume the continuing force and effect of Treas. Reg. §1.103-7(b)(5)[63] and, therefore, the continuing role of take-or-pay contracts as *the* means of testing for

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[61](...continued)
users of electricity who collectively accounted for significantly more than 25% of the output from the issuer's electric generating units. *See* Ltr. Rul. 8240049 (July 6, 1982), and Ltr. Rul. 9125007 (March 15, 1991).

[62] 1986 Act Conference Report, at II-690.

[63] Note 12 on page II-689 of the 1986 Act Conference Report reads: "The conference agreement directs the Treasury Department to modify its present regulations (Treas. Reg. Sec. 1.103-7(b)(5)) for determining the portion of an output facility that is privately used to reflect the reduced limits on such use. Specifically, Treasury is directed to delete the special exception under which users of three percent or less of the output of a facility are disregarded in calculating whether the issue satisfies the trade or business use and security interest test." The Committee notes that the footnote misconstrues the exception, which, in actual text, excludes users whose guaranteed minimum annual payments are not more than 3% of average annual debt service and not (as stated) those whose use fails to exceed more than 3% of the subparagraph (5) output.

and measuring private business use. Because pooling arrangements that are implemented through (but not for the benefit of) nongovernmental persons, exchange agreements that effectively maximize the efficiency of electric generation units for all participants but which otherwise confer no palpable benefit on nongovernmental persons, and spot sales of excess power are not take-or-pay contracts, the quoted passage may fairly be read literally to provide that these situations do not involve private use and that other situations must be evaluated under the principles established by Treas. Reg. §1.103-7(b)(5). Any other construction of the quoted passage is likely to produce an irreconcilable conflict in interpretations or imply that Congress did not understand its meaning.[64]

3. Prop. Reg. § 1.141-7.

Prop. Reg. § 1.141-7(a) provides that bonds issued to finance an output facility will satisfy the Private Business Use Test and the Private Security or Payment Test where use by nongovernmental persons "has the effect of transferring to those nongovernmental persons substantial benefits of owning the facilities and substantial burdens of paying the debt service on bonds used (directly or indirectly) to finance the facilities (<u>the benefits and burdens test</u>), so as to constitute the indirect use by those persons of (and the indirect payment by those persons of debt service of) more than 10 percent of those proceeds." (emphasis in original). Apart from style and semantics, the substance of the "benefits and burdens test" is the same as the guiding principle articulated in Treas. Reg. § 1.103-7(b)(5). The remainder of Prop. Reg. § 1.141-7 reformulates well-worn concepts, partially uproots the "benefits and burdens" test, and implants disconnected special rules, all of which confuse or dismember long-standing applicable legal principles. The Committee offers the following comments.

B. PROP. REG. § 1.141-7(a): COMMENTS.

1. The Proposed Regulations introduce the concept of "available output," which is substantially identical to "subparagraph (5) output" under Treas. Reg. § 1.103-7(b)(5)(ii)(*b*). Instead of authorizing reliance on nameplate/maximum capacity, however, Prop. Reg. § 1.141-7(a)(3)(i) requires two adjustments, the first of which involves a reduction to account for scheduled maintenance. Often, a purchaser's rights to output and/or payment obligations are

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64 By supposition, the quoted passage likely was intended to assure unnamed political constituents that certain transactions in which they had engaged or on which they were about to embark were outside the trap of private use. This interpretation may explain why the passage begins: "The conferees wish to clarify . . . ," when, until then, the status of these transactions was not seriously in doubt.

suspended during periods of scheduled maintenance; thus, such a reduction will likely have no substantive impact on the relative proportions of private use and/or private payments to their respective totals. Further, the adjustment raises several questions, *e.g.*, when are scheduled maintenance adjustments to be measured? Should an expectations test or a fact test be inferred? What happens if the frequency of maintenance or the amount of time required to carry out scheduled maintenance becomes altered because of design characteristics of the facility or regulatory changes, and should it matter whether any such alterations or changes might have been anticipated? The Committee recommends that, rather than finding regulatory solutions to these questions, the proposed adjustment for scheduled maintenance be eliminated.

The consequences of the second proposed adjustment are far-reaching and potentially incalculable. Prop. Reg. § 1.141-7(a)(3)(i) provides that if the nameplate/maximum capacity standard is greater than 150% of the average expected output during the contract term, average expected output is to be used in lieu of such standard. This adjustment raises questions about *how* to calculate average expected output for a power plant, such as a peaking unit, that is seldom operated at or near maximum capacity, and *when* the relevant expectation is to be formed. Prop. Reg. § 1.141-7(a)(3)(iv), in directing that the "issuer's requirements for output from the facility [be] applied on the basis of the issuer's reasonable expectations as of the issue date", may be intended to address these questions. If so, the comparison of average expected output to nameplate capacity made when bonds are issued may be viewed as an inquiry to determine whether the output facility has been sized to meet the current and reasonably expected needs of the issuer or whether it is more than 50% larger than necessary. The Committee recommends that Prop. Reg. § 1.141-7(a)(3)(iv) be modified to clarify that this timing and comparison were intended, and to prescribe criteria for making such comparison. The Committee further requests that the final regulations also clarify that average expected output is not required to be computed over time until the final maturity of the bonds, which would require near-impossible predictions and raise serious difficulties in predicting compliance.

2. Guidance in applying the term "available output" to transmission lines is vague. Prop. Reg. § 1.141-7(a)(3)(i) states that "available output must be measured in a reasonable manner," and observes that thermal capacity for short, radial transmission lines and use of load

share ratios for a transmission network "*may be* reasonable."[65] (emphasis supplied). This guidance raises questions regarding the meaning of "reasonable" for other transmission facilities. Except for the admonition that "available output" be measured in a "reasonable manner," guidance in applying such term to cogeneration facilities is nonexistent. The operation and usage of transmission lines, transmission networks, and cogeneration facilities can be complicated. The Committee recommends that final regulations provide clearer, more expansive guidance.

3. Under Prop. Reg. § 1.141-7(a)(2)(i)(B), two or more nongovernmental persons share the "benefits and burdens" of the ownership of an output facility if such persons individually pay "an *average annual demand charge or other* guaranteed minimum payment" during the contract term of a particular issue that exceeds 1% of the average annual debt service on such issue (emphasis supplied). A demand charge may be prescribed by a rate schedule of general applicability or by contract,[66] and if by contract, may simply incorporate the terms of the applicable rate schedule.[67] A demand charge, as any other charge, may be applied to pay debt service, and/or to operation and maintenance costs, insurance costs, and renewals and replacements. A demand charge is sometimes compared to the minimum charges paid by homeowners pursuant to published rate schedules whether or not energy is actually consumed. So described, demand charges appear to be within the permissive language of Prop. Reg. § 1.141-3(e)(ii), which reads:

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[65] The reasonableness of the use of load share ratios evidently depends on whether such ratios are applied in a manner consistent with FERC requirements.

[66] "Demand Charge" has been defined as: "The specified charge to be billed on the basis of the billing demand, under an applicable rate schedule or contract." "Billing demand" has been defined as: "The demand upon which billing to a customer is based, as specified in a rate schedule or contract. It may be based on the contract year, a contract minimum, or a previous maximum and, therefore, does not necessarily coincide with the actual measured demand of the billing period." A related definition of "Rate Schedule" devolves into a discussion of the two main classes of accepted forms of rates—"Demand Rates" and "Meter Rates"—and the several types of rates within each. "Demand Rates" refers to "any method of charge for electric service which is base upon, or is a function of the rate of use, or size, of the customer's installation or maximum demand . . . during a given period of time." *Glossary of Electric Utility Terms*, prepared by the Statistical Committee of the Edison Electric Institute (undated), at 24, 67.

[67] The Committee submits that the conclusion reached in Prop. Reg. § 1.141-7(e), Example 1, and in Treas. Reg. § 1.103-7(c), Example 13 (on which the former appears to be based), should be the same regardless of whether the "numerous other private utilities [that purchase output] under a prevailing rate schedule, including demand charges", become obligated without benefit of a contract, application for service, or some other similar writing that ties the service to the particular rate schedule, or does little more than incorporate by reference the terms of the applicable rate schedule. Either way, the rights and obligations of the utilities are the same. Under Prop. Reg. § 1.141-7(a)(2)(i)(B), however, the mere existence of such a writing could cause one group of utilities to be treated more harshly than another.

> Arrangements providing for use that is available to the general public . . . on the basis of rates that are generally applicable and uniformly applied do not convey priority rights or other preferential benefits. For this purpose, rates may be treated as generally applicable and uniformly applied even if—
>
> (A) Different rates apply to different classes of users, such as volume purchasers, if the difference in rates are customary and reasonable[.]

Whether or not within such language, a demand charge is not, however, reasonably considered some "other guaranteed minimum payment" that has the effect of transferring the burdens associated with a governmentally-owned output facility to a nongovernmental person. This conclusion was presumably drawn when Prop. Reg. § 1.103-7(b)(3)(iv)(*b*) (1971), was abandoned in favor of the current rule contained in Treas. Reg. § 1.103-7(b)(5)(i)*(a)*(*1*). Prop. Treas. Reg. § 1.103-7(b)(3)(iv)(*b*) read in relevant part:

> [A governmentally owned output facility] will not be treated as used in the trades or businesses of nonexempt persons if the output of such facility is sold on a kilowatt-hour basis *without any guarantee* of minimum payment by one or more customers, or is sold to a substantial number of unrelated customers under a rate schedule (which may include demand charges) of general application, *provided that no single customer pays annually a demand charge or guaranteed minimum payment* which exceeds 2½ percent of the average annual debt service with respect to the obligations in question. (emphasis supplied).

By contrast, Treas. Reg. § 1.103-7(b)(5)(i)*(a)*(*1*) omits any reference to demand charges and instead treats the contractually committed output of certain nonexempt users as a private use only if the *guaranteed* minimum payment of each, made pursuant to a take-or-pay contract, exceeds 3% of average annual debt service.

The Committee recommends that, because Prop. Reg. § 1.141-7(a)(2)(i)(B) is distinctly contrary to Treas. Reg. § 1.103-7(b)(5)(i)*(a)*(*1*), it be rejected in favor of the old rule, except to retain the reduced 1% 3% standard. Such change would be consistent with the mandates of the 1986 Act Conference Report as noted above,[68] as well as with regulatory history and principles elsewhere embraced by the Proposed Regulations.

4. Prop. Reg. § 1.141-7(a)(2)(ii) addresses certain payments made by nongovernmental persons under contracts described in paragraph (a)(2)(i) of Prop. Reg. § 1.141-7 or "by other persons under those contracts." The Committee is not clear on the meaning of the quoted text or the circumstances under which "payments by other persons" might be expected

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[68] *See* footnote 63.

to arise, and recommends that final regulations provide textual clarification and an illustrative example.

5. The concluding sentence of Prop. Reg. § 1.141-7(a)(3)(ii), addressing contract extensions, is a *non sequitur*, and should be deleted given that the term "contract term of the issue," by definition, *begins* on the later of the issue date of bonds and the placed-in-service date of a bond-financed output facility and *ends* on the final maturity date of such issue.

6. Prop. Reg. § 1.141-7(a)(3)(iv) defines the terms "take-or-pay contract" and "take contract." The Committee offers several comments.

First, Prop. Reg. § 1.141-7(a)(2), which delineates the application of the "benefits and burdens test," speaks in terms of a "contract to take, or take or pay for . . .", a phrase apparently taken directly from Treas. Reg. § 1.103-7(b)(5)(i). Because we assume that consistency in terminology is intended, the Committee recommends that either Prop. Reg. § 1.141-7(a)(3)(iv) be revised to define "contract to take, or take or pay for . . ." or, alternatively, Prop. Reg. § 1.141-7(a)(2) be revised to refer to a contract that is a "take-or-pay contract" or a "take contract."

Second, the Committee believes that it is not correct to lump all firm transmission contracts together and, without inquiring further into the particular terms of such a contract, to conclude, *ipso facto*, that each is a take contract or a take-or-pay contract. Rather, such a determination cannot fairly be made without taking into account contract term, priority of service, the extent and basis of any payment obligation, contract outs, and alternative available transmission paths. Further, the Committee believes that it is also not correct, without first examining such factors, to conclude that a contract that provides for "transmission service comparable to the owner's" is tantamount to a take or take-or-pay contract. For example, a transmission contract of some years' duration could permit a contracting party to schedule transmission service from time to time for a maximum of only several days or hours at any time and, except for a demand charge, could require such party to pay for service only when and as given. Suppose that the transmission service, when actually rendered by owner to purchaser, is qualitatively the same as the owner's own use of bond-financed transmission lines over which service is provided. The Committee questions whether the contract should, *ipso facto*, be considered a take contract or a take-or-pay contract, given that such service is neither regular nor continuously available, and contends that it is doubtful that either the owner or the other contracting party in this example would find either such contract.

The Committee recommends that this clarification be premised in the guiding principle summarized by the phrase "dependable rights and dependable obligations," with emphasis on the word *dependable*. Thus, we recommend that final regulations reflect that the benefits and burdens associated with a bond-financed output facility have been transferred (and the Private Business Use Test and the Private Security or Payment Test satisfied) only where, by contract, capacity of the output facility has been surrendered—with the same degree of assurance as if it had been leased by a nongovernmental entity—and where, pursuant to such contract, the nongovernmental entity has relieved the owner of a fair, if not proportionate, share of the carrying costs and operating expenses attributable to such capacity—with the same degree of obligation as if the nongovernmental entity had agreed to make rental payments to the owner with respect to the hypothetical "leased" capacity.

Third, the Committee believes that Prop. Reg. § 1.141-7(a)(3)(v) misunderstands and misrepresents the significance of requirements contracts. Under the general rule of Prop. Reg. § 1.141-7(a)(3)(v)(A), a contract pursuant to which a nongovernmental person agrees to purchase all of its output requirements is *always* a take or a take-or-pay contract if the purchaser "agrees to pay a guaranteed minimum payment or if the purchaser has no substantial ability to purchase its output requirements from other sources." The Committee contends that this rule is neither helpful nor fair. No guidance is provided on how significant a guaranteed payment must be, and its emphasis on the existence of a "guaranteed minimum payment" misses the fact that private use is only found when a transfer of benefits occurs, *i.e.*, the embedded notion of dependable rights. Under a requirements contract, an output purchaser's rights are only as great as are its needs, a situation that is not very dependable. If the purchaser's needs change or are diminished, it will have no property interest or right that it can sell, assign, or liquidate. From the opposite perspective, a governmental entity will likely not be willing to construct a costly output facility relying exclusively on a *de minimis* guaranteed payment and a hope that a customer's output requirements will not decline over the term of the bonds. What clearly is absent is the dependability of obligation.

Similarly, Prop. Reg. § 1.141-7(a)(3)(v)(B) provides that a requirements contract is *always* a take contract or a take or pay contract:

> if the purchaser has priority rights to the output (or rights to control the allocation of the available output), [or] if it is reasonably expected that the purchaser will purchase at least 10 percent of the available output of the facility, or if the

purchaser under the contract is a regulated utility that is in the business of reselling output of the type purchased.

This analysis ignores the realities of purchasers and the utilities industry, which include fluctuating customer demand because of price, the success of demand-side energy conservation programs, the intrusion of independent power producers, and the likely occurrence of some form of retail wheeling.

The Committee thus recommends that Prop. Reg. § 1.141-7(a)(3)(v)(B) be rewritten to clarify its intentions and provide some supporting justification, or be completely withdrawn.

7. Prop. Reg. § 1.141-7(a)(4) provides that the benefits and burdens test "is not the exclusive means by which bonds financing output facilities may satisfy the private business use or private security or payment tests." In the single remaining sentence the Proposed Regulation provides a simple example in which an output facility is leased to a nongovernmental person and concludes that the Private Business Use Test may be satisfied.

The Committee questions why this provision was thought to be necessary, and asks whether it was inserted to state a conclusion that could hardly be in doubt, or, alternatively, to become a legal touchstone for a new, unarticulated, or yet-to-be-imagined body of rules for output facilities. In either instance, the Committee recommends that Prop. Reg. § 1.141-7(a)(4) be deleted as obvious or as an unacceptable complete and unexplained departure from many years of consistently applied precedent.

C. PROP. REG. § 1.141-7(b): OVERVIEW AND COMMENTS.

Prop. Reg. § 1.141-7(b), in separate subparagraphs, examines different types of routine transactions, many of which are reminiscent of the arrangements described in the 1986 Act Conference Report and discussed above. The Committee questions why the Proposed Regulations devote so much attention to transactions that have never been thought to involve a meaningful degree of private business use of a bond-financed output facility. Specifically:

1. Prop. Reg. § 1.141-7(b)(1) confirms that agreements providing for swapping or pooling of power by or among one or more governmental persons and one or more nongovernmental persons does not result in private business use of a governmentally owned output facility. This result is obvious. Such agreements are neither take contracts nor take-or-pay contracts. Rather, as indicated in the previous discussion of "legislative underpinnings," they are agreements entered into

for mutual benefit. These agreements present clear examples of situations that do *not* confer private business use. Prop. Reg. § 1.141-7(b)(1), however, conditions the conclusion previously reached by requiring that:

(i) a governmental person be a net importer of output, without regard to emergency consumption. This concept makes no sense in the context of public power. The stated condition subscribes to principles developed *strictly* in relation to the private activity bond exception under Code § 142(f) for the local furnishing of electric *energy* or gas and that have never applied to "public *power.*" Public power is a matter of capacity, or "power," and not of the energy, or "output," that flows from such capacity, hence the reference to "nameplate capacity" in both Treas. Reg. § 1.103-7(b)(5) and Prop. Reg. § 1.141-7(a)(3)(i). Further, the local furnishing exception is linked to a geographic limitation, *viz.*, a service territory no greater than 1 city and 1 contiguous county or 2 counties, each contiguous to the other. Energy flowing into and out of the service territory is a consideration that runs to the heart of qualification. As it evolved, the "net importer" principle enabled a utility company to avoid having to track in- and out-flows of electrons as long as the inbound flows, measured on an annual (or more frequent) basis, were not less than the outbound flow. This principle proved to be a manageable way of establishing that a "local system" was not used for "non-local" purposes. Public power is *not* subject to geographic limitation. A public power agency may have, but often does *not* have, a service area. Last, the exclusion in Prop. Reg. § 1.141-7(b)(1)(i)(A) of "emergency consumption" from the count of outflow appears to be based on the local furnishing principle that outflows of energy under "emergency circumstances" do not violate the strict geographic limitation imposed by statute. Such a principle is a good one, but is completely irrelevant in the public power arena.

(ii) under an exchange agreement between a governmental and nongovernmental owner of output facilities, swapped power from one to the other must be approximately equal in value, determined at least annually, and be accomplished under an exchange agreement that is not a take or take-or-pay contract. This condition makes too much of too little, and if needed to effectuate language in the 1986 Act Conference Report, should be converted to an example demonstrating that this arrangement is clearly not a take or take-or-pay contract. In addition, Prop. Reg. § 1.141-7(b)(1)(ii)(C) should be modified to provide that the purpose of the agreement presented is merely to provide an example of allowable purposes.

2. Prop. Reg. § 1.141-7(b)(3) addresses spot sales. Specifically, Prop. Reg. § 1.141-7(b)(3) states that "spot sales of excess power capacity for temporary periods, other than pursuant to take or take-or-pay contracts, do not result in private business use" and continues by explaining that "a spot sale is a sale pursuant to a single agreement that is limited to no more than 30 days' duration including renewal periods."

The Committee questions (i) the need for the limiting definition of "spot sale," a term of art within the power industry that is *not* limited to 30-days' duration, (ii) why spot sales contracts of *any* duration pose a problem under private use analysis, and (iii) how spot sales contracts can ever be take or take-or-pay contracts. The Committee thus recommends that this definitional phrase be deleted.

3. Prop. Reg. § 1.141-7(b)(4) addresses the use of bond-financed transmission facilities providing transportation services for nongovernmental entities. Prop. Reg. § 1.141-7(b)(4), while captioned "wheeling" activities, is drafted broadly enough to encompass almost any transmission arrangement. The apparent purpose of the regulation is to insure that certain transmission activities undertaken in response to (or to prevent the issuance of) an order of the United States to compel transmission service will not result in private use characterization. Its negative implication is that any other transmission activities involving bond-financed facilities undertaken on behalf of a nongovernmental entity will create private use. The Committee recommends that Prop. Reg. § 1.141-7(b)(4) be modified to affirmatively endorse wheeling arrangements. Such arrangements prevent the construction of redundant transmission capacity and support federal energy policy.

The Committee recommends that, to increase the relevance and longevity of regulations in this ares, modifications provide that transmissions arrangements (of which many exist) other than FERC-mandated arrangements escape private use characterization,[69] and that final regulations liberalize treatment of wheeling and transmission agreements in a way that anticipates an ever-increasing demand for access to unused transmission capacity.

D. PROP. REG. § 1.141-7(c): OVERVIEW AND COMMENTS.

Prop. Reg. § 1.141-7(c) provides that the purchase of output by a nongovernmental person pursuant to an "output contract" is not treated as private use if, among other requirements, (i) the contract term does not exceed 1 year; (ii) the contract cannot be renewed or extended beyond such 1-year term; (iii) as of the later of the bond issue date or the date of the 1-year contract, the issuer reasonably expects that once the contract has expired, the "related output" will not be used for a private use; and (iv) no subsequent deliberate actions are taken that are inconsistent with such expectation.

First, the Committee recommends that final regulations define "output contract" (and whether and how it differs from "take or take-or-pay contract) and "related output" (which would be difficult to quantify once a contract has expired), as well as clarify the intended scope of "subsequent deliberate actions." Additionally, while we recognize that the 1-year contract term limitation supports our notion that payment obligations must be "dependable" in order to be considered private use (and, clearly, for a typical 30-year bond issue, such contract is *not*, the rule is far too restrictive. Other heavily-negotiated contracts with longer terms but with many "outs" are not reliable sources of security or payment. The Committee requests that this limitation be reexamined by analogy to the management contract rules of Prop. Reg. § 1.141-3(c) (as amended by our recommendations). While the relationship of manager to bond-financed facility may be perceived as more attenuated than that between output purchaser and facility,[70]

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69 The Committee submits that only contracts providing for firm transmission capacity for a specific term rise to the level of private use. Other arrangements are too undependable to qualify.

70 Such argument might be (a) that an operator is merely performing an agent's function for agent's wages, whereas an output facility makes available for ready and independent consumption a valuable commodity, and (b) that payments with respect to bond-financed property in the former instance can be attributed to the operator only indirectly, which cannot be said of payment made for the purchase of output. Still, the purchase of output is no more than an indirect use of a bond-financed facility that may or may not benefit (continued...)

the manager is nonetheless benefitted from its use of the bond-financed facility. Although the 10- to 15-year terms sanctioned for qualified management contracts may be too expansive for contracts for the purchase of output, their vast difference from the 1-year term limitation of Prop. Reg. § 1.141-7(c) suggests that this limitation needs reexamination.

E. PROP. REG. § 1.141-7(d): OVERVIEW AND COMMENTS.

Prop. Reg. § 1.141-7(d) prescribes rules for allocating the output sold under contract to a particular facility. For this purpose, subparagraph (d)(2) states, in part: "The method of pricing output under the contract and the consistency of the contract with commercially reasonable terms are . . . significant factors," and continues with a brief discussion of the relevant terms of a hypothetical contract to provide peaking capacity. The Committee recommends that subparagraph (d)(2) be modified to clarify that no negative inference is to be drawn from the fact that the *seller* sets prices for the output made available by contract against a particular facility (typically the seller's highest priced unit). A contrary rule or inference would violate routine pricing practices. Further, in connection with electric transmission facilities, subparagraph (d)(4) states: "[T]he determination of use of an electric transmission facility may be based on the contract path specified by the parties to the contract, *if reasonable*." (emphasis supplied). The Committee requests that final regulations provide an example regarding the determination of reasonableness.

F. OTHER MATTERS UNDER PROP. REG. § 1.141-7.

Several areas of substantive concern are not addressed by Prop. Reg. § 1.141-7 or other portions of the Proposed Regulations and need clarification. The Committee offers the following comments.

1. Guidance Under § 1313 (b)(5) the 1986 Act.

Subject to certain enumerated conditions and exceptions, transitional rules under subsections (a) and (b) of § 1313 of the 1986 Act permit tax-exempt bonds issued under the 1954 Code to be currently refunded and advance refunded, respectively, as if 1954 Code law continued to apply. Thus, an outstanding issue of 1954 Code bonds, where as much as 25% of

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[70](...continued)
the purchaser, with the price paid for output being a fair price paid for the commodity received, and not for the use of the bond-financed facility.

the proceeds were used for a private use, may be refunded despite the 10% (or lower) ceiling for private use under the Code.

As a practical matter, this result is *not* true for an advance refunding of bonds more than 5% of the proceeds of which were used to finance governmentally owned electric output facilities that qualified for tax-exemption under the 1954 Code: 1986 Act § 1313(b)(5) recites that any refunding bond "shall be treated as a private activity bond for purposes of Section 146 of the 1986 Code (to the extent of the nongovernmental use of [the refunded] issue, under rules similar to the rules of Section 146(m)(2) of such Code)." 1954 Code § 146(m)(2) does not squarely address the situation presented in 1986 Act § 1313(b)(5): rather, such rule applies to *non*-transitional advance refunding issues and requires that volume cap be obtained to the same extent that volume cap was (or would have been) required for the refunded issue under Code § 141(b)(5).[71] Volume cap must therefore be secured, or the benefits of tax-exempt financing otherwise should be foregone, to the extent that nongovernmental use carried forward from refunded to refunding bonds exceeds $15 million (the "$15 Million Cap"). In effect, the $15 Million Cap diverts needed volume cap from non-output bonds that might otherwise have been issued, or, alternatively, forces issuers of 1954 Code output bonds to defease bonds from other sources.

No guidance is provided in the 1986 Act legislative history, or in any regulations (proposed or final) concerning the 1986 Act § 1313(b)(1) or 1986 Act § 1313(b)(5).[72] The Committee recommends that final regulations (or their preamble) confirm that the combined effect of these rules is to confer full transitional relief at the cost, calculated once at the time of issuance of the refunding bonds, of "crowding out" some bonds that might otherwise have been issued. So construed, such combined effect does not (a) result in greater private use than that originally permitted under the law in effect when the original bonds were issued, or (b) raise issues that conflict with or otherwise compromise any ruling or regulation, including the Proposed Regulations.

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71 This point helps explain the phrase "rules similar to," relegating the determination of what those rules should be to affected issuers and their counsel.

72 The confluence of these rules appears to be unique under Code §§ 103 and 141 through 150.

2. Modify the Definition of "Contract Term of the Issue."

The term "contract term of the issue" is not easily applied to refunding issues under either Prop. Reg. § 1.141-7(a)(3)(ii) or Treas. Reg. § 1.103-7(b)(5)(ii)(*b*). Such term is one factor in determining the denominator of a fraction used to establish the amount of private use ascribed to an output facility.[73] Simply stated, the shorter the contract term, the smaller the denominator and the greater the relative weight given to the numerator (which defines the private use).

The problem is best demonstrated by example. A "new money" issue of bonds covers a period that ends on the "final maturity date of the issue" (proposed provision) or "latest maturity date of any obligation of the issue" (current provision), "determined without regard to optional redemption dates." Here, 40-year bonds are issued to provide an electric generating unit having a 5-year construction period, an expected economic life of 35 years, and a take-or-pay contract with a nongovernmental person commencing on the first day of the 6th year. The "contract term of the issue" is thus 35 years. When a subsequent refunding issue "steps into the shoes" of these bonds, the contract term of the issue continues to be 35 years, and assuming that the final maturities of the refunded and refunding bonds are the same as the generating unit's expected economic life, perfect symmetry will exist between the refunded and refunding bonds. Inheritance by the refunding bonds of all attributes of the refunded bonds is appropriate and doubtless intended.

A problem arises, however, if the original issue was issued for a term shorter than the expected economic life of the output facility, and the maturity date of the refunding issue is extended to coincide with the last date of the facility's period of expected usefulness. In this instance, the refunding bonds inherit a "contract term of the issue" that was unnecessarily compressed when the refunded bonds were issued.

The Committee recommends the following solution to this problem,[74] which avoids the unnecessary harm that would otherwise obtain. Final regulations should permit the issuer of

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73 *See, e.g.*, the text at footnote 53, *supra*.

74 A similar problem in a "new-money" context occurs where a single, multi-year construction project is financed in several stages and each bond issue, corresponding to each stage, has a different final maturity. The unavoidable (but odd) result is that the "contract term of the issue," and, therefore the applicable nongovernmental use, for each bond issue will be different, notwithstanding that the objective and end results of each financing are identical. *See, e.g.*, Prop. Reg. § 1.141-8(c), example 2.

refunding bonds to elect to treat the contract term of the issue as ending on the last day of the period of expected economic usefulness of the output facility being refinanced instead of the final maturity date of the refunded bonds.

3. Affirmative Endorsement of Demand Side Management Programs.[75]

Rev. Rul. 95-32, 1995-16 I.R.B. 5, concludes that expenditures made by a public utility in connection with the implementation and operation of its energy conservation and load management ("DSM") programs are not capital expenditures.[76] Accordingly, for federal income tax purposes, the utility can treat such expenditures as ordinary and necessary operating expenses, notwithstanding that for financial and regulatory accounting purposes such expenditures are charged to capital account and amortized over a period of several years. Such a conclusion is beneficial for investor-owned utilities, but detrimental for governmental issuers that have financed[77] or will finance DSM expenditures on a tax-exempt basis because of arbitrage implications relating to working capital expenditures and replacement proceeds.

Whether the holding of Rev. Rul. 95-32 is permissive or mandatory is uncertain, which complicates the analysis for tax-exempt financing. The ruling indicates that "[a] public utility currently capitalizing costs associated with its DSM programs must seek the Commissioner's consent to change its method of accounting," but does not indicate whether such utility must actually *change* its accounting method, raising the question of whether capitalization remains a continuing option. The ruling examines results of the DSM expenditures having been made pursuant to a plan to build, maintain, or protect a customer base, where a conclusion

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75 For purposes of this discussion, the Committee assumes that the "conservation facilities" to which reference is made in Prop. Treas. Reg. §1.141-7(d)(5) would *not* include facilities or expenditures that are usually associated with a demand side management program, but would instead include such things as fish ladders. In this regard, clearer delineation of what is intended by "conservation facilities" would be helpful.

76 The stated purposes of the DSM expenditures were to reduce customers' electrical costs and to address environmental and societal concerns associated with the adverse environmental effects of increased electrical generation.

77 The IRS may have already ruled on DSM-type expenditures. *See* Ltr. Rul. 9438034 (June 29, 1994) ("All of the conservation measures that are a part of the Project will be installed among residential, industrial, and commercial customers . . . . As additional measures are installed, the Project will provide increasing amounts of conservation savings . . . .") The Committee notes that if DSM-type expenditures were covered by Ltr. Rul. 9438034, the character of such expenditures was apparently assumed.

favoring capitalization might have been appropriate under the rationale of *Houston Natural Gas Corporation v. Commissioner.*[78]

The Committee recommends that final regulation provide an exception to the broad reach of Rev. Rul. 95-32 that would enable demand side management expenditures to be financed on a tax-exempt basis. Such exception could be drafted into an expanded definition of "capital expenditure" under Treas. Reg. §1.150-1(b), or to increase the scope of the exceptions in Treas. Reg. §1.148-6(d)(3)(ii) to the "proceeds-spent-last" principle Treas. Reg. §1.148-6(d)(3)(i).

G. PROP. REG. § 1.141-8: OVERVIEW AND COMMENTS.

Prop. Reg. § 1.141-8 provides needed and generally useful guidance with respect to Code § 141(b)(4). The Committee offers the following comments.

1. Prop. Reg. § 1.141-8 appears to misconstrue Code § 141(b)(8), the definition of "nonqualified amount" for purposes of Code § 141(b)(4), which provides that the "nonqualified amount" of tax-exempt bonds issued in substantial part[79] to finance a governmental output facility may not exceed $15 million.[80] Under Code § 141(b)(8), and therefore Code § 141(b)(4), "nonqualified amount" means the *lesser* of the amount of proceeds used for a private use and the amount of proceeds with respect to which the Private Security or Payment Test is satisfied. With respect to an output facility that is financed with the proceeds of more than one issue, or two or more output facilities that, although part of the same project, are financed at different times, the $15 million limitation is applied on a cumulative basis and not issue-by-issue.

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78 90 F.2d 814 (4th Cir.), (*cert. denied*), 302 U.S. 722 (1937). The taxpayer in this case incurred salary and other expenses of so-called solicitors to overcome advances made by a competing gas company. The objectives of the expenditures were "to secure new [gas] customers and hold the old ones." The duties of the solicitors were "to keep informed concerning prospective new customers, to try and sell gas service to the same, cultivate and maintain the good will of old customers as well as prospective new customers, to prevent . . . consumers from switching to the competing company . . . ." In affirming the Board of Tax Appeals' disallowance of a current deduction by the taxpayer of the solicitors' salaries and expenses, the Court of Appeals for the Fourth Circuit stated, *inter alia*: "[I]n 1930 the [taxpayer] acquired (1) 5,470 new customers, and (2) good will . . . . Money expended for new customers or subscribers, and for good will, is a capital investment." *Houston Natural Gas Corporation* v. *Commissioner*, *supra*, at 816.

79 If less than 5% of the proceeds of an issue are used to finance an output facility (other than a water furnishing facility), the $15 million limitation does not apply.

80 This $15 million limitation is different from the previously discussed $15 Million Cap that applies to certain issues of transitional advance refunding bonds pursuant to 1986 Act § 1313(b)(5).

Prop. Reg. § 1.141-8(a) requires than an issuer of "output bonds" establish a separate total for *both* (1) the amount of proceeds that are to be used for private use, and (2) the amount of proceeds with respect to which the Private Security or Payment Test is met, and that such suppurate total be carried forward to subsequent issues for purposes of measuring the aggregate, on-going nonqualified amount for the same purpose or project. In the words of Prop. Reg. § 1.141-8(a)(3), the effect of this requirement is as if "the benefits and burdens test of § 1.141-7 applie[d], except that '15 million' is substituted for '10 percent.'"

The Committee contends that this result is contrary to explicit statutory language as noted above, and recommends that Prop. Reg. § 1.141-8(a)(1), (2), and (3) be amended to conform to such language.

2. In examining how much of the $15 million limitation under Code § 141(b)(4) has been utilized by a prior outstanding issue, Prop. Reg. § 1.141-8(a)(3)(ii) applies a fraction, "the numerator of which is the *greater* of the outstanding principal amount or present value of the outstanding bonds of the earlier issue . . . , and the denominator of which is the issue price of the earlier issue as of the issue date of that issue." (emphasis supplied). Why the numerator is described in terms of the greater of two values is not clear. Except in the case where all bonds of an outstanding issue were issued at par, the application of the fraction will result in an overstatement or understatement of the pre-existing nonqualified amount, depending on whether some of the prior bonds were originally issued at a discount or a premium.

The Committee submits that the correct value for the numerator should be the outstanding bonds' "principal amount," as that term is defined in Treas. Reg. § 1.148-9(b)(2) in connection with the transferred proceeds allocation rule for refunding issues. By application of that rule, the principal amount of an outstanding "plain par bond"--*i.e.*, one issued with not more than a *de minimis* amount or original issue discount--would be its stated face amount, and the principal amount of any other outstanding bond would be its present value. The Committee further submits that the correct value for the denominator should be the issue price of an issue consisting only of plain par bonds, or the "adjusted issue price," to account for accredited OID or amortized original issue premium, in any other case. The recommended reformulation of the fraction would produce a symmetry between the numerator and denominator of the fraction, in that both would relate to the face amount or present value of outstanding bonds. Under the Proposed Regulations, such symmetry is not assured in all cases.

3. The holding of Prop. Reg. § 1.141-8(c), example 2, is contrary to that of an example found in the legislative history, [81] even though the two examples are substantially the same. Both involve the issuance of multiple bond issues for the purpose of financing a $500 million electric generating unit, 10 percent of the benefits and burdens of which are to be transferred to an investor-owned utility. Therefore, only $465 million of the total cost (90% of the cost + $15 million) may be financed with tax-exempt bonds. In the 1986 Act Conference report version of the example, having explained the aggregate limit on allowable tax-exempt financing, it is irrelevant whether the tax-exempt share and the private use share are contributed on a *pro rata* basis. Under the Proposed Regulations example, however, a $150 million series of bonds, which follows an initial $100 million series, is declared to "consist of [taxable] private activity bonds," presumably because "no other amounts have been paid under the construction contract for the facility [as of the issue date of the second series]"--*i.e.*, the actual financing of the tax-exempt share has proceeded more quickly than the private use share as of such date.

The Committee contends that the IRS has never held that the construction financing provided for governmental and private use shares of a jointly-owned or used facility of *any* type must proceed on a *pro rata* (or other) basis. Instead, attention has been focused only on how those shares will appear at the placed-in-service date of the facility, thereby permitting one such share to proceed ahead of the other.

The example in the Proposed Regulations contradicts not only the legislative history, but also years of precedent and practice. The Committee recommends that Prop. Reg. § 1.141-8(c), example 2, be modified to conform to the 1986 Act Conference Report example.

H. PROP. REG. § 1.141-11: OVERVIEW AND COMMENTS.

In its entirety, Prop. Reg. § 1.141-11 states, "Section 141(d) provides a special definition of private activity bond for bonds the proceeds of which are used to acquire nongovernmental output property. The provisions of §§ 1.141-1 through 1.141-16 (except § 1.141-12) apply to section 141(d)."

Code § 141(d), although seldom used, is long, complicated, and difficult to apply, and Prop. Reg. § 1.141-11 offers little guidance. As a matter of form and presentation, the

[81] 1986 Act Conference Report, at II-690, example 2.

Committee recommends that the regulations on Code § 141(d) be "reserved," and that the two sentences of proposed text be withdrawn.

VIII. PROP. REG. § 1.141-9: UNRELATED OR DISPROPORTIONATE USE

A. OVERVIEW.

The 1986 Act reduced the amount of proceeds of a tax-exempt bond issue that may be used to finance private business activities from 25% to 10%. This 10% limit was further reduced to 5% with respect to private activities not related or disproportionate to the governmental use financed by the issue. Code § 141(b)(3) does not define private use that is not related to a governmental use of proceeds. A disproportionate related business use is defined as use of an amount of proceeds equal to the excess of the proceeds of the issue to be used for a private use over the proceeds of the issue to be used for the governmental use to which the private use relates. The only guidance in defining a private use that is not related to a governmental use is provided in the legislative history. The guidance provided by the 1986 Act Senate Report, 1986 Act Conference Report, and the 1986 Act Blue Book in defining a related governmental use is minimal.[82]

Unfortunately, Prop. Regs. § 1.141-9 largely restates the 1986 Act Senate and Conference Reports, especially on the central question of what constitutes a related private use, by providing that whether a private use is related to a governmental use is determined on a case-by-case basis, emphasizing the operational relationship between the governmental use and the private use. Substantially echoing the 1986 Act Senate and Conference Reports, the Proposed Regulations add that generally a facility used for a related private use must be located within, or adjacent to, the governmentally used facility. The Proposed Regulations use examples similar to those in

82 The 1986 Act Senate Report states that a newsstand located in a courthouse is related to the courthouse, a privately-owned cafeteria located in a school is related to the school, and a golf course is not related to a school. Other than including the newsstand and cafeteria examples and dropping the golf course example, the 1986 Act Conference Report adds two examples concluding that use of school bond proceeds to build an administrative office building for a catering company that operates cafeterias for the school system is not a related use of bond proceeds, and that office space for lawyers engaged in the private practice of law is not related to financing of a courthouse or other governmental building. The 1986 Act Blue Book contains the same examples except for the golf course example, but adds the phrase "in which the offices may be located" to the law office example, which, as modified, reads as follows: "[O]ffice space for lawyers engaged in the private practice of law is not related to financing of a courthouse or other governmental building in which the offices may be located." The conclusions reached in all of these examples, except for the courthouse examples, seem fairly obvious. The courthouse examples are unclear because the 1986 Act Conference Report and the 1986 Act Blue Book fail to explain why a privately-operated newsstand within a courthouse is related to the operation of a courthouse, while private law offices similarly located are not so related.

the 1986 Act Reports, and all reach obvious or unexplained conclusions. Consequently, they are not very helpful.

Regarding the disproportionate use test, the Proposed Regulations provide that a private use is disproportionate to a related governmental use only to the extent that the amount of proceeds used for that private use exceeds the amount of proceeds used for the related governmental use. Regarding application, the Proposed Regulations contain rules concerning the measurement of uses, the order of application of the tests, and the aggregation and allocation of uses, which generally follow the guidance provided by the 1986 Act Reports. In addition, the Proposed Regulations provide that parallel related and unrelated use will be considered related if the related use is not insignificant, and the amount of unrelated or disproportionate use of the facility is based on the maximum expected governmental use if the facility is used by the issuer for more than an insignificant period during the term of the issue. Finally, the Proposed Regulations include five examples of the application of the rules, three of which are taken substantially from the 1986 Act Conference Report.

The 1986 Act Bluebook explanation of the unrelated use restriction contains the following recommendation for solving a potential problem with respect to the rules that was not included in the Proposed Regulations:

> Congress was aware that certain governmental financings (as opposed to private activity bond financings) historically have been accomplished on a composite basis with multiple governmental facilities receiving funding from regularly scheduled issues on a "current disbursements" basis. Congress intended that, to the extent permitted by the Treasury Department, the unrelated and disproportionate use requirements may be applied in such cases on the basis of total financing for a facility rather than on an issue-by-issue basis if, for example, the total amount of financing for the facility (including both governmental and private use portions) is specified in a detailed plan adopted in advance of initial financing for the facility.[83]

B. COMMENTS.

1. Related Business Use.

As a result of limiting the guidance provided by Prop. Reg. § 1.141-9 with respect to the meaning of a related business use largely to the material contained in the 1986 Act Reports, the Proposed Regulations fail to provide any real assistance in interpreting the central definition underlying the unrelated and disproportionate use tests. The lack of guidance is

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[83] 1986 Act Bluebook, 1164 n.64.

particularly troubling in situations where the use is located within or adjacent to the governmentally used facility, such as private use of a portion of a governmental office building. The examples presented throughout the Proposed Regulations appear to be inconsistent with the interpretation of related use in the example in the 1986 Act Blue Book that concludes that office space for lawyers engaged in the private practice of law is not related to financing of a courthouse in which the offices are located.

For example, Proposed Regulations, such as Prop. Reg. §1.141-3(h), example 4, relating to the leasing of 1 floor of a 10-story office building by a private corporation, concludes that the arrangement does not, by itself, cause the Private Business Use Test to be met because not more than 10 percent of the bond proceeds used to construct the building is used directly or indirectly in the trade or business of a nongovernmental person. The example provides no indication that the private use by the corporation has any relationship to the governmental use of the building. Numerous other examples exist throughout the Proposed Regulations where the 10% related business use threshold is applied to a facility without indication that the private use is related to the governmental use. The clear inference drawn from these examples is that if space in a facility can be used by a private person, the restriction on that private use is measured by the 10% related business use limit, not the 5% unrelated business use limit. The Committee recommends that Prop. Reg. § 1.141-9 be amended to clarify that the partial use of a governmentally owned facility by a private user, such as an office building, an electric generating station, or a wastewater treatment facility, be treated as a related business use. The need for defining a related business use where private use is located within the governmentally used facility does not appear productive in light of the numerous examples throughout the Proposed Regulations where the 10% private use limitation is applied.

2. Parallel Related and Unrelated Uses and Maximum Use.

The Proposed Regulations in both the "parallel related and unrelated use" rule and the "maximum use" rule use the term "insignificant," but do not give any standard for its application. The Committee therefore recommends that the final regulations provide guidance on the measure of "insignificant."

3. Multiple Governmental Facilities.

The Proposed Regulations do not address the concern raised in the quotation cited above from the 1986 Act Blue Book. Many states and other large governmental issuers of tax-exempt bonds finance a large number of diverse facilities by the frequent issuance of bonds.

As a result of the allocation of certain facilities to a specific issue, the private business uses relating to those facilities may possibly be financed by another bond issue, thereby arbitrarily and unfairly affecting the application of the unrelated and disproportionate use tests. The Committee recommends that the suggestion contained in the 1986 Act Bluebook be incorporated into the Regulations. The ability of the issuer to combine bond issues for purposes of the unrelated and disproportionate business use tests would prevent issuers from being unduly penalized by these tests where multiple facilities are financed by multiple bond issues.

IX. PROP. REG. § 1.141-10: COORDINATION WITH VOLUME CAP

A. OVERVIEW.

Prop. Reg. § 1.141-10 provides that the provisions of §§ 1.141-1 through 1.141-16 (except § 1.141-12) apply to Code § 141(b)(5). Section 141(b)(5) provides that, if the nonqualified amount with respect to a bond issue exceeds $15,000,000 but does not otherwise exceed the amount that would cause the bonds to be private activity bonds under other applicable rules, the bonds will nonetheless be treated as private activity bonds unless the issuer obtains a volume cap allocation with respect to such issue in an amount equal to the excess of the nonqualified amount over $15,000,000.

B. COMMENTS.

Presumably, the rules of §§ 1.141-1 through 141-16 would, of necessity, apply to section 141(b)(5), even in the absence of the cross-reference in the Proposed Regulations; accordingly, the rule in the Proposed Regulation seems unobjectionable. Unfortunately, the Proposed Regulation, in its brevity, does not take advantage of the opportunity to address questions presented by Code § 141(b)(5).

By way of example, consider a $210,000,000 general obligation issue by City X, $20,000,000 of the proceeds of which will be applied to improvements at a municipally owned solid waste disposal facility, with the remaining proceeds applied to general municipal purposes not involving private business use. If the solid waste disposal facility is subject to a long-term lease to a nongovernmental entity, the nonqualified amount with respect to the issue exceeds $15,000,000, but does not exceed the 10% level that would otherwise result in private activity bond status.

In this example, Code § 141(b)(5) presumably requires that City X obtain a volume cap allocation of $5,000,000 in order to avoid private activity bond status. This result seems, as a policy matter, somewhat incongruous since, under Code § 146(h), no volume cap allocation would be required if the issue were entirely devoted to the financing of improvements to the solid waste disposal facility or if the $20,000,000 constituted a separate bond issue for purposes of Code § 141(b)(5). Nonetheless, this result seems mandated as the "price" of avoiding the additional restrictions imposed on private activity bonds and, when applicable, AMT status if the $210,000,000 in bonds are treated as a single bond issue.

The more troubling unanswered questions concern the consequences to City X if no allocation of volume cap is made under Code § 141(b)(5). In this case, it is unclear whether all $210,000,000 are treated as taxable private activity bonds because the $190,000,000 of proceeds applied to purely municipal purposes are not expended for purposes that would permit the bonds to be characterized as "qualified bonds" under Code § 141(e). Similarly unclear are whether (i) use by governmental entities can be combined with private use of exempt facilities as under prior law[84] for purposes of determining tax exemption and (ii) if so, what the status of the bonds is.

The answers to these questions should be consistent with the result that would be realized by City X if the solid waste disposal improvements were financed by a separate bond issue. To do otherwise would be to favor form over substance and force issuers to separate financings in time or otherwise take steps which, for the most part, have been rendered unnecessary by the definition of "issue" in Temp. Treas. Reg. § 1.150T-1(c).[85]

The purpose of Code § 141(b)(5) is to limit the amount of proceeds of large bond issues that can be applied to the financing of facilities subject to private use and that could not otherwise be financed with tax-exempt bonds. In situations such as the example presented above, where the facilities subject to private business use *can* otherwise be so financed, the Committee submits that the regulations should permit separate issue treatment for purposes of Code § 141(b)(5) for any portion of an issue that could independently constitute a "qualified bond."

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84 *See, e.g.*, Example 6 under Treas. Reg. § 1.103-8(i).

85 Temp. Treas. Reg. § 1.150T-1(c)(3)(i) would, in this example, permit the portion of City X's bond issue used for the solid waste disposal facility to be treated as a separate issue for most purposes. Temp. Treas. Reg. § 1.150T-1(c)(3)(ii) indicates, however, that the general rule does not apply for purposes of Code § 141(b)(5).

The suggested rule would permit issuers to undertake more efficiently financing programs without expanding the amount of tax-exempt financing for facilities subject to private use beyond the amounts that would be available through the issuance of a separate series of bonds. If the deemed separate issue would require an allocation of volume cap in order to constitute qualified bonds, an allocation of volume cap would be required. If no volume cap allocation is required under Code § 146, separate issue treatment would give effect to that primary legislative policy decision reflected in the Code § 146 rules.

Moreover, separate issue treatment would provide a clear, policy-based framework for analysis of the remainder of the issue. The remainder of the issue would be independently tested under the private activity bonds rules, including Code § 141(b)(5), as either taxable or tax-exempt, with no remaining ambiguity.

X. PROP. REG. §§ 1.141-12, 1.141-13 and 1.150-4: CHANGE IN USE

A. IN GENERAL.

1. Overview.

Prop. Reg. § 1.141-2(d)(1) provides that an issue will become private activity bonds if the issuer takes a "deliberate action" subsequent to the issuance date that causes the Private Business Tests or the Private Loan Financing Test to be met. The change-in-use rules contained in Prop. Reg. § 1.141-13 provide that an action that causes the Private Business Tests or the Private Loan Financing Test to be met is not treated as a deliberate action if the issuer takes one of the remedial actions described in Prop. Reg. § 1.141-13(b) through (e), and meets all the requirements set forth in Prop. Reg. § 1.148-13(a)(1) through (4). These requirements are similar to the requirements set forth in Rev. Proc. 93-17,[86] which currently applies to changes in the use of bond financed property.

To determine whether an action causes the Private Business Tests or the Private Loan Financing Test to be met, however, one must first determine what constitutes proceeds of the issue. The Proposed Regulations add "disposition proceeds" as a type of proceeds that must be analyzed. Generally, if disposition proceeds exist, any proceeds allocable to the transferred property cease to be treated as proceeds of the issue. Thus, if bond-financed property is transferred, the use of the proceeds derived from the disposition of such property, rather than

[86] 1993-1 C.B. 507.

the subsequent use of such property, will determine whether the Private Business Use Test is met.

2. Comments.

The provisions in the Proposed Regulations regarding the change in use rules, the definition of disposition proceeds, and the allocation of disposition proceeds are dispersed throughout the Proposed Regulations. The operative provisions appear buried in definitional sections, and cross-references often do not work to accomplish their intended results. In the current political climate, more and more governmental entities are exploring the possibilities of privatizing various governmental services to downsize government and reduce expenses that must be paid from tax dollars. These privatization efforts will involve the transfer of capital assets that were financed in good faith with tax-exempt bonds. Given the growing importance of the change-in-use rules to governmental entities throughout the United States, the Committee recommends that the change-in-use rules be rethought and presented in a more organized manner. The Committee offers the following specific recommendations under the Proposed Regulations.

B. DISPOSITION PROCEEDS.

Prop. Reg. § 1.141-1(c)(1) defines disposition proceeds as any amounts (including property) derived from the sale, exchange, or other disposition (transfer) of property (other than investments) financed with the proceeds of an issue.

1. Property.

a. Overview. The Proposed Regulations provide that disposition proceeds include property.

b. Comments. Several ambiguities inhere in this statement. First, Prop. Reg. § 1.141-6(c) provides that, if a transfer that produces disposition proceeds is made pursuant to an installment sale, or the property otherwise continues to have a nexus to the bonds, the disposition proceeds are allocated to the transferred property. Thus, an installment sale note apparently is not property for purposes of the definition of disposition proceeds. The Committee recommends that this explication be contained in the same section as the definition of disposition proceeds. Second, the regulations should contain an example of how property would otherwise continue to have a nexus to the bonds. Third, the regulations should further clarify the scope of the term "property." As now written, the definition of disposition proceeds is broad enough to include not only real and personal property, but also any consideration received in connection with the transfer of bond-financed property such as agreements to provide services to a municipality, or an agreement to undertake the improvement of property. The scope of the term "property" is crucial not only to the application of the Private Activity Bond Tests and Private Loan Financing Test but also to the exception for general obligation programs and the anti-abuse rules discussed below.

2. Investments.

a. Overview. The Proposed Regulations provide that disposition proceeds are amounts derived from the sale, exchange, or other disposition (transfer) of property (other than investments).

b. Comments. Why the sale of investments does not generate disposition proceeds is unclear. Because Prop. Reg. § 1.141-1(c)(1) provides that proceeds of an issue allocable to the transferred property cease to be treated as proceeds of the issue if disposition proceeds are produced, it is unclear if investments that are sold are still treated as proceeds of the issue that must be traced for purposes of analyzing their use. The Committee contends that this analysis should not be the result, and recommends that final regulations clarify that proceeds from the sale of investments are treated as sale proceeds.

3. Allocation of Disposition Proceeds.

a. Overview. Prop. Reg. § 1.141-6(c) provides that disposition proceeds are allocated under the rules of Prop. Reg. § 1.141-6, which focuses on the allocation of proceeds to expenditures.

b. Comments. Since property may be financed with the proceeds of more than one issue, the Committee recommends that an operating rule be provided to clarify how disposition proceeds received upon the transfer of such financed property are to be allocated, or that such allocation is to be *pro rata* among the various issues that financed the transferred property.

4. Below Market Transfers and Authority of Commissioner.

a. Overview. The Proposed Regulations grant the IRS discretion to treat as proceeds either the property financed with the proceeds of the bonds or the disposition proceeds, whichever results in a greater amount of private business use and private security or payments if (1) the property is transferred at less than fair market value, (2) the weighted average maturity of the nonqualified bonds allocable to the transferred property is more than 120% of the reasonably expected weighted average economic life of the transferred property, (3) the issuer does not spend the proceeds or deposit the money in a defeasance escrow within two years of transfer, or (4) the transfer is designed to avoid the provisions of Section 141 of the Code.

b. Comments. The Committee submits that governmental bonds are not subject to the 120% test of Code § 147(b) and should not be made subject to such rule through regulatory action. The IRS is understandably concerned that situations may exist in which bond-financed property may be sold as a way of avoiding the Private Business Tests or the Private Loan Financing Test and the Commissioner should have authority to prevent such avoidance. Rather than imposing rules that go beyond the statutory framework, however, the Committee recommends that final regulations provide a simple, anti-abuse provision that would permit the Commissioner to look to either the property or the disposition proceeds if a transfer is designed to avoid the provisions of Code § 141.

C. EXCEPTION FOR GENERAL OBLIGATION PROGRAMS.

Prop. Reg. § 1.141-1(c)(3) provides that disposition proceeds do not arise on the transfer of property financed with the proceeds of a general obligation program if certain requirements are satisfied, unless the issuer elects otherwise. This provision appears to provide a *de minimis* exception to the change-in-use rules for issuers that finance a multitude of projects with the proceeds of a single issue of bonds. The Committee applauds the IRS' effort to provide such a *de minimis* exception. We believe that it will provide welcome relief to issuers that have occasional transfers of bond-financed property because of obsolescence, which frequently occurs with any governmental issuer with a sizeable capital asset base. The Committee recommends, however, that certain technical details of the requirements be refined.

1. Definition of General Obligation Program.

a. Overview. Prop. Reg. § 1.141-1(c)(3) defines a general obligation program as an issue of general obligation bonds issued by a general purpose governmental unit that finances more than 75 discrete facilities or projects.

b. Comments. If the *de minimis* exception is intended to protect multiproject issuers from the change in use rules as a result of small casual sales of bond financed property, the Committee recommends that the threshold number of discrete facilities or projects be reduced and believes 25 would be a more reasonable number. The lower number should permit most multiproject issuers to qualify for this exception and still prevent the rule from being used by small, single-project issuers.

2. Original Cost.

a. Overview. Prop. Reg. § 1.141-1(c)(3)(i) requires that the transferred property cannot have had an original cost in excess of the greater of $3 million and 2.5% of the bond issue price.

b. Comments. The Committee recommends that final regulations clarify that the reference to original cost is to the original cost financed with the particular issue of bonds in question, as an issuer may finance a project with the proceeds of more than one issue.

3. Aggregate Amount of Disposition Proceeds.

a. Overview. Prop. Reg. § 1.141-1(c)(3)(iii) requires that the aggregate amount of disposition proceeds of the issue can not exceed 10% of the issue price.

b. Comments. The application of this provision to a series of sales of bond financed property is unclear. If an issuer were to sell several assets over time and the total proceeds received from these sales were under 10%, the Proposed Regulations do not specify whether disposition proceeds from these early sales would become subject to the private activity bond rules if the issuer were to sell another asset and receive proceeds that would cause total proceeds received to exceed 10%. The Committee recommends that this provision be clarified to provide that, in a series of sales, the sale that causes the aggregate amount of disposition proceeds to exceed 10% does not retroactively cause the prior sales to give rise to disposition proceeds.

4. Commingled Fund.

a. Overview. Prop. Reg. § 1.141-1(c)(3)(iv) requires that amounts received must be deposited into a commingled fund with substantial tax or other revenues from governmental operations of the transferor and reasonably expected to be spent within 6 months.

b. Comments. As noted above, disposition proceeds include property derived from the transfer of bond financed property. The scope of the term "property" must be made clear if any issuer is to take advantage of this exception.

5. No Disposition Proceeds.

a. Overview. Prop. Reg. § 1.141-1(c)(1) provides that if disposition proceeds arise, any proceeds of the issue allocable to the transferred property cease to be treated as proceeds of the issue. In effect, the disposition proceeds are thereafter traced to determine if the private activity bond tests are met. If the *de minimis* exception applies and, thus no disposition proceeds arise, however, the provision seems to require that the issuer continue to look to the transferred bond-financed property for purposes of applying the private activity bond tests.

b. Comments. The Committee believes that if this interpretation of the provision is proper, the *de minimis* exception will have little if any utility. Therefore, The Committee recommends that the provision be modified to include situations where disposition proceeds will arise but for the *de minimis* exception.

D. REQUIREMENT OF PROP. REG. § 1.141-13(a)(1).

1. Overview.

In order to obtain the relief provided under Prop. Reg. § 1.141-13, four requirements, set forth in Prop. Reg. § 1.141-13(a)(1) through (4), must be met in addition to the remedial requirements set forth in Prop. Reg. § 1.141-13(b) through (e). Prop. Reg. § 1.141-13(a)(1) requires that an issuer have covenanted on the bond issuance date that it would take no action that would cause the bonds to be private activity bonds and that it would not fail to take any action that would prevent the bonds from being private activity bonds.

2. Comments.

The requirement of Prop. Reg. § 1.141-13(a)(1) precludes the application of Prop. Reg. § 1.141-13 to any bond issue that does not contain this covenant and, technically, any issue of qualified bonds under Code § 141(e). Furthermore, it effectively precludes all bonds issued prior to December 30, 1994, the date the Proposed Regulations were published in the Federal Register, from obtaining relief unless an issuer had been prescient enough to include such a covenant in its bond documents. The Committee contends that the change-in-use rules should not contain procedural requirements that would make them unavailable to such a broad spectrum of bond issues. Since an issuer must certify as to its reasonable expectations at the time the bonds are issued, and the issuer must take certain remedial actions, the Committee recommends that this requirement be deleted.

E. REMEDIAL ACTION UNDER SECTION 1.141-13(b): REDEMPTION OF NONQUALIFIED BONDS.

1. **Transfer for Cash.**

a. Overview. Prop Reg. § 1.141-13(b)(1) provides that if a financed facility is transferred exclusively for cash, the redemption requirement is satisfied if an amount equal to the disposition proceeds is used to redeem or defease a *pro rata* portion of the nonqualified bonds. Thus, if a financed facility were sold at a loss, the issuer would be required to use only the proceeds received from the sale to redeem bonds, unlike Rev. Proc. 93-17, which requires the issuer to make up the difference with another source of revenues.

b. Comments. This provision is a tremendous improvement over Rev. Proc. 93-17. One question still remains, however, regarding its application to transactions that involve an installment sale or lease of a financed facility. As noted above in the discussion with respect to the definition of disposition proceeds, governmental entities may transfer bond financed assets in return for cash and other consideration, *e.g.*, an agreement by the purchaser to use the transferred property in a manner that continues to provide the same services at some negotiated rate to be paid by taxpayers. If the receipt of an agreement to provide services prevents the transaction from being treated as made exclusively for cash, the issuer would have to use other money, which it may not have, or to borrow at taxable rates to make up the difference between the amount of bonds allocable to the financed facility and the amount of the cash consideration received. This provision thus appears to require factoring of non-cash consideration, which is not easily accomplished for this type of obligation. The Committee recommends that the final regulations address the treatment of non-cash consideration in a manner that does not force issuers to choose between negotiating a benefit for its populace and using other money or borrowing at taxable rates to redeem or defease all nonqualified bonds allocable to a transferred facility.

One technical problem with Prop. Reg. § 1.141-13(b)(1) involves its interaction with Prop. Reg. § 1.141-1(c)(2), which provides that, regardless of the amount received in connection with a transfer, the amount of disposition proceeds is equal to the proceeds of the issue allocable to the transferred property. Under the rules, if a financed facility were sold for $1 million but the amount of bond proceeds allocable to the property were $3 million, the amount of disposition proceeds is treated as equal to $3 million. Carrying that definition over to Prop. Reg. § 1.141-13(b)(1) would seem to require $3 million, the deemed amount of disposition proceeds, to be used to redeem bonds instead of $1 million, the actual amount received. The Committee believes that this result was unintended, and recommends that it be corrected in final regulations.

2. Special Limitations.

a. Overview. Prop. Reg. § 1.141-13(b)(4) provides that the establishment of a defeasance escrow does not satisfy the requirements of Prop. Reg. § 1.141-13(b) if more than a remote possibility existed that the financed property would be transferred to a nongovernmental person and the terms of the bonds did not provide for a redemption of the bonds within six months of the date of the deliberate action. For purposes of this provision, the possibility of transfer to a nongovernmental person is treated as remote if the facility is of a type that is not customarily owned and operated by nongovernmental persons.

b. Comments. As stated above, most state and local governments are looking at privatization of governmentally-owned assets as a way of downsizing government and managing the cost of governing. It may even be said that most governmentally-owned assets are potential targets of privatization. Therefore, it is difficult to say that the possibility of transfer is remote. Furthermore, many of the potential objects of privatization are customarily owned and operated by nongovernmental persons, *e.g.*, hospitals, water facilities, sewer facilities, parking garages, prisons, office buildings. In light of the foregoing, this provision would require bonds to have a six-month redemption provision, which would increase borrowing costs given that the marketplace would extract a penalty for such redemption provision. The Proposed Regulations already apply the private activity bond tests based on an issuer's reasonable expectations and deliberate actions. The concept of remote possibility is vague in its scope, difficult to apply, and unnecessary for the fair application of the private activity bond tests. The Committee recommends that it be deleted.

F. REMEDIAL ACTION UNDER PROP. REG. § 1.141-13(c): ALTERNATE USE OF FACILITY.

1. Overview.

Prop. Reg. § 1.141-13(c) provides that a remedial action is taken if the bond-financed facility is used in an alternative manner, the nonqualified bonds are treated as reissued and satisfy all applicable requirements for qualified bonds for the remaining term of the nonqualified bonds, and the purchaser does not finance the acquisition with the proceeds of another issue of tax-exempt bonds. Prop. Reg. § 1.141-13(g)(1) requires allocations to nonqualified bonds to be made on a *pro rata* basis.

2. Comments.

The Committee notes that this *pro rata* allocation requirement may prevent an issue from meeting the weighted average maturity limitation of Code § 147(b), which applies to all qualified bonds. For example, assume that an issue of governmental bonds financed 100 different projects with a weighted average economic life of 20 years and the bonds have a weighted average maturity of 24 years. Assume further that one of the projects, which was financed with 10% of the issue, had an economic life of 15 years and was sold to a Code § 501(c)(3) organization for use within its exempt purposes. If the issuer were required to allocate 10% of each maturity of the bonds to nonqualified bonds, the nonqualified bonds would have a weighted average maturity of 24 years, which is greater than 120% of the 15-year economic life of the property sold. Consequently, the bonds would not satisfy the requirement of Code § 147(b) and the issuer would not be able to use the alternate use of the facility remedy. The Committee therefore recommends that final regulations provide that an issuer be able to allocate nonqualified bonds according to Treas. Reg. § 1.148-9(h), *i.e.*, under any reasonable allocation method.

G. CODE § 150 CHANGE-IN-USE RULES SHOULD BE INDEPENDENT OF CODE § 141.

The Committee contends that it is important to recognize that different purposes are served by the Code § 141 and Code § 150(b) rules with respect to the use of facilities and proceeds. While a great deal of similarity exists between the two sections, rules that are appropriate for one section are not necessarily appropriate for the other. Under Code § 141, whether sufficient nongovernmental use causes bonds to be considered private activity bonds is the essential determination; under Code § 150(b), however, bonds are acknowledged to be subject to the private activity bond rules, and the determination is whether the facilities are being used in a qualifying manner. In this context, Code § 141 explicitly includes concepts of direct or indirect use and the legislative history of Code § 141 can be viewed as supporting[87] the principles adopted in the Proposed Regulations for determining whether a particular arrangement

[87] Subject to the comments made elsewhere in this report.

constitutes private business use of tax-exempt bond proceeds (or facilities financed with such proceeds).

Such Code § 141 principles should not be assumed to be applicable in all respects to the changes in use of exempt facilities, which is the central issue under Code § 150(b). For example, Code §§ 150(b) and (c) include specific provisions that govern allocations among exempt and non-exempt use and that are, in some respects, inconsistent with the Proposed Regulations. Thus, Code § 150(c) clearly mandates proportional allocation in the case of facilities when portions thereof cease to serve their tax-exempt function. The Committee knows of no support in Code § 150 for the approach used in the Proposed Regulations that permits certain allocations to be made between qualifying and non-qualifying uses only with respect to discrete facilities. Nor have we found any basis for the treatment of common areas in Prop. Reg. § 1.150-4(b). While the overlap of the two sections is obvious, the Committee urges that the Proposed Regulations under Code §§ 150(b) and (c) be modified to remove any inference that all Code § 141 principles are necessarily applicable under both Code sections.

Even if Prop. Reg § 1.141-16(c) is corrected to eliminate this ambiguity, issuers will continue to lack guidance regarding the proper interpretation and application of § 150(b) in the case of transitional refundings, which are not subject to Code § 141. In light of the clear Congressional mandate contained in the detailed transition provisions of the 1986 Act generally exempting transitional refundings from such application, the Committee presumes that Treasury does not intend to apply the Proposed Regulations to bonds that are explicitly excluded from the reach of Code § 141.

Nevertheless, the two Code sections are treated as governed by the same rules because Prop. Reg. §§ 1.150-4(a) and (b) integrate the Proposed Regulations with the change-in-use rules applicable under Code §§ 150(a) and (b). For example, Prop. Reg. § 1.150-4(b) contemplates that an issuer is required to take one of the remedial actions prescribed in Prop. Reg. § 1.141-13 in order to preserve interest deductions that otherwise would be disallowed because of a change in use under Code § 150, and Prop. Reg. § 1.150-4(b) imposes a penalty on issuers in the form of an allocation rule that is clearly inappropriate for a transitional refunding that is exempt from Code § 141. Under Prop. Reg. § 1.150-4(b), issuers are required to comply with the rules of the Proposed Regulations to avoid having the costs of "common areas," as defined in Prop. Reg. § 1.141-1, entirely allocated to "nonqualified bonds," as defined in Prop. Reg. § 1.141-13(g)(1), thereby increasing the amount subject to disallowance of deductions under § 150(b).[88] The Committee contends that a legitimate question exists regarding whether such penalty is authorized by the statutory mandate of the 1986 Act in the case of Transition Refundings. Accordingly, we suggest that Prop. Reg. § 1.150-4 be revised to recognize that Code § 150 must operate independently from the Code § 141 rules, at least in the case of bonds to which Code § 141 does not apply. Alternatively, if Treasury wishes to encourage issuers of obligations subject to Code § 150 (but not Code § 141) to avail themselves of the Code § 141 rules on an elective basis as a touchstone for compliance with Code § 150, then final regulations should provide (1) an appropriate election and (2) an adequate grace period after promulgation of final regulations during which issuers could bring their outstanding obligations into compliance with the new rules or enter into closing or other agreements with the IRS in cases where the underlying documents do not permit immediate compliance.

XI. PROP. REG. § 1.141-14: REFUNDINGS

A. PRIVATE ACTIVITY BOND STATUS.

1. In General. a. Overview. Prop. Reg. § 1.141-14(a)(1) states that whether a refunding issue satisfies the Private Business Tests or the Private Loan Financing Tests is "determined exclusively on the use of the proceeds of the refunding issue and the private security or payments with respect to that issue (that is, without regard to whether the prior issue satisfies those tests)."

b. Comment. The Proposed Regulations are confusing and inconsistent in stating that the Private Business Use Tests are determined exclusively by reference to the use of the proceeds of the refunding issue since Prop. Reg. § 1.141-14(a)(2)(i) provides that the proceeds of the refunding issue are treated as used for the same purposes as the proceeds of the refunded issue. The Committee suggests that final regulations provide that the tests are applied separately to the refunding issue without regard to whether the refunded issue satisfied the tests. We also believe that, in applying the Private Security or Payment Test to a refunding issue, the fact that the refunding issue has a lower interest rate than the refunded issue should not itself result in

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88 For example, in the case of an issuer that has financed a building with tax-exempt bonds where 82% of the building is used for government operations, 8% is used by private business and the remaining 10% is common area, if because of unanticipated privatization of certain governmental functions governmental use were reduced to 75% and private business use increased to 15%, the portion of the issue that would lose its deduction for interest under Code § 150(c) would be 15%. Under the Proposed Regulations, the 10% that is allocated to the common areas would also become "nonqualified bonds" and the issuer would lose deductibility for 25% of the issue. The Committee contends that no basis exists for this result in the legislative history of the 1986 Act.

the refunding issue becoming private activity bonds, if the refunded issue was not. Consider the following example:

> City C issues long-term bonds the proceeds of which are used to build an office building. Eleven percent of the space in the building is rented to a private party under a long-term lease. The present value of the rent from the private party, however, is less than ten percent of the debt service on the bonds and so the bonds are not private activity bonds. Interest rates drop and C would like to refund the bonds. C discovers that as a result of the lower anticipated debt service, however, the present value of the rent from the private party will cause the Private Security or Payment Test to be satisfied, even if the option to treat the refunding issue as a continuation of the refunded issue is elected. C is left with the alternatives of not refunding the bonds, issuing taxable bonds, or lowering the rent of the private party.

The Committee contends that such result is not supported by statute or any policy consistent with the statute. We note that the Proposed Regulations have adopted a rule in connection with variable rate financing that does not require a retesting after every change in interest rate. We recommend that a similar rule be applied to refundings.

2. Rules of Application: Private Use and Private Loan Financing Tests.

a. Overview. Prop. Reg. § 1.141-14(a)(2)(i) provides that, unless the special rule Prop. Reg. § 1.141-14(a)(2)(ii) (the 120% test) applies, the proceeds of a refunding issue are treated as used for the same purposes as the proceeds of the refunded issue except that the use of the property financed with the refunded issue before the issue date of the refunding issue is not taken into account.

b. Comment. The Committee favors the adoption of this principle. If our prior recommendation with respect to a cumulative measurement of use over the term of the issue is not accepted and final regulations continue to apply the Private Business Use Test on an annual basis, such a rule will allow at least some flexibility to issuers to finance a facility on a taxable basis during the period when the test will be exceeded, and on a tax-exempt basis when the test will not be exceeded--a form of allocation based on time.

3. Rules of Application: Special Rule.

a. Overview. Prop. Reg. § 1.141-14(a)(2)(ii) provides that if the weighted average maturity of the refunding issue is greater than 120 percent of the remaining average economic life of the property financed with the proceeds of the refunded issue, the proceeds of the refunding issue are treated as being used for the same purposes as the proceeds of the refunded issue and use of the property financed with the proceeds of the prior issue before the issue date of the refunding issue is taken into account.

b. Comment. While the Treasury may be concerned with bond issues that bear no relation to the life of the property financed, the Committee fails to see what relevance the use of the property prior to the date of the refunding issue has to this concern. The concern, if any, would seem to be the determination of the use of the proceeds for the period subsequent to the useful life of the property being financed. We note that the arbitrage rules and maturity restriction on private activity bonds already address this issue, and believe that its application here has no merit.

4. Optional Treatment as Continuation of Prior Issue.

a. Overview. Prop. Reg. § 1.141-14(a)(3) provides that an issuer may treat the refunding issue as a continuation of the prior issue for purposes of applying the Private Business Use Test and the Private Security or Payment Test to a refunding issue. The Proposed Regulations further provide that the issuer may use the yield on the refunded issue to present value payments and security from arrangements that were not entered into in contemplation of the refunding issue.

b. Comment. The Committee endorses the option of being able to treat the refunding as a continuation of the prior issue. Once again, if the Private Business Use Test is applied on an annual basis (except for output facilities) under final regulations, the effect of treating the refunding as a continuation seems generally to have relevance only with respect to the Private Security or Payment Test. As noted in the example above, the use of the refunded issue's yield for purposes of present valuing payments may still cause the Private Security or Payment Test to be satisfied because the Proposed Regulations are unclear on the determination of present value of debt service on the "combined issue." In addition, the Proposed Regulation does not indicate what yield should be used to present value arrangements if the issuer chooses not to use the yield on the refunded issue or if the issuer is not permitted under the regulation to use the yield on the refunding (*e.g.*, where an arrangement is entered into in contemplation of the refunding). The Committee recommends that final regulations clarify these points.

B. QUALIFIED BONDS.

1. In general.

a. Overview. Prop. Reg. § 1.141-14(b)(1) provides that whether bonds issued as part of a refunding are qualified bonds (other than under Code § 144(a)) is determined exclusively on the basis of the use of the proceeds of the refunding issue, determined in the same manner as under Section A. 2., described above. The Proposed Regulations further provide that the prohibition on acquisition of existing property in Code § 147(d) is applied as of the issue date of the refunded bonds and the refunded issue meets the requirements of Code § 147(b) (maturity not to exceed 120% of economic life) "if the refunded issue met the requirement and the weighted average maturity of the refunding bonds is not greater than the remaining weighted average maturity of the refunded bonds."

b. Comment. The Committee reiterates our comments under Section A.2., above. In addition, we recommend that the Proposed Regulation be revised to remove any inference that if the weighted average maturity of the refunding issue *does* exceed the remaining average maturity of the refunded issue, but does not exceed the 120% restriction in Code § 147(b), the requirement of Code § 147(b) is not satisfied. For instance, merely because a refunded issue had a weighted average maturity of less than 120% of the average economic lives of the property financed with the proceeds does not mean that the refunding issue cannot have a longer weighted average maturity within the 120% limitation.

2. Discontinued use in certain qualified bonds.

a. Overview. Prop. Reg. § 1.141-14(b)(2) provides that if, as of the issue date of the refunding bonds, the property that was financed by the proceeds of the refunded bond is not used (or is not reasonably expected to continue to be used) and the refunded bond was a qualified bond under Code §§ 142, 144(a), 144(c), or 1394, the refunding bond is a qualified bond only if:

(i) The refunding issue does not have a weighted average maturity that exceeds the remaining weighted average maturity of the refunded bonds; and

(ii) The refunded bonds were qualified bonds.

b. Comment. The Committee contends that some situations may exists where the restriction on maturity to that of the refunded bonds is too harsh. Consider a situation in which a manufacturer who is experiencing financial difficulties and can no longer operate the bond-financed factory negotiates a lower interest rate and delayed principal payments with its lenders. Such a change would result in a refunding that under the Proposed Regulations would be taxable. The Committee recommends that final regulations provide an exception for such a situation, provided the requirements of Code § 147(b) are satisfied.

XII. PROP. REG. § 1.141-15: ANTI-ABUSE RULES

A. AUTHORITY OF COMMISSIONER TO REFLECT SUBSTANCE OF TRANSACTIONS.

1. Overview.

The Proposed Regulations provide that if an issuer enters into a transaction or series of transactions with respect to one or more issues with a principal purpose of transferring to nongovernmental persons (other than as members of the general public) significant benefits of tax-exempt financing in a manner that is inconsistent with the purposes of Code § 141, the Commissioner may take any action to reflect the substance of the transaction or series of transactions, including:

(1) Treating separate issues as a single issue for purposes of the private activity bond test;

(2) Reallocating proceeds to expenditures, use, or bonds; and

(3) Reallocating payments to use or proceeds.

2. Comment.

The Committee questions the justification for this broad and very vague rule, which allows the IRS to determine when "significant benefits of tax-exempt financing are transferred to nongovernmental persons" despite the rather detailed attempt to provide some certainty as to what constitutes a private activity bond in the preceding sections of the Proposed Regulations. We do not think that the same justification exists for such a broad rule as may be appropriate in the arbitrage area, where, although complex, the rules of arbitrage are at least better understood. In the use of proceeds area, however, there has been little general agreement or understanding of what constitutes private use. Further, the Proposed Regulations contain only three examples (one of which is a variation of one of the other examples). Example 1 states that, treated separately, the 1995 general obligation issue meets the Private Business Use Test, but not the Private Security or Payment Test, and that the 1996 tax increment issue meets the Private Security or Payment Test, but not the Private Business Use Test. The result in the first example is reachable under the basic statutory language, and it is possible to conclude that the payment of the 1995 bonds is indirectly derived from the tax increment payments because the 1995 bonds would not likely have been issued without the existence of the arrangements with respect to the 1996 bonds. The Committee recommends that this example be moved to the Proposed Regulation addressing the private payment test.

The result in Example 2 seems wrong to us. Consider a variation of the facts in which the City pays for the 30% private use from the equity and requires payments from the IOU based on a hypothetical cost of funds equal to the rate on its tax-exempt issue. Under such circumstances would the Issuer be required to allocate a portion of the private use to the tax-exempt bonds? The payments from the private user should not be a factor in this analysis, as long as the portion of the facility attributable to private use is paid from a source other than the proceeds of tax-exempt bonds.

Example 3 concludes that if the IOU payments to the City were based only on the debt service with respect to the A Bonds, the B Bonds would not be taxable. What if the A Bonds are not intended as a conduit financing? What if the A Bonds are paid off in 2 years? Isn't is reasonable to expect that the City will continue to charge the IOU for more than just operating expenses? The Committee requests that these examples be reconsidered.

B. ALLOCATIONS OF PRIVATE USE.

1. Overview.

The Proposed Regulations do not provide guidance on the allocation of private use between an unrefunded portion of a bond issue and a refunded portion.

2. Comments.

The Committee recommends that such guidance be given. For instance, assume that a facility with 50% private use is financed with taxable bonds. Final regulations should provide that 50% of the taxable bonds can be refunded on a tax-exempt basis (*i.e.*, private use should be able to be allocated to the unrefunded portion). Such a regulation could provide that the refunded bonds must be representative of the entire issue.

XIII. PROP. REG. § 1.141-16: EFFECTIVE DATES

A. OVERVIEW.

Prop. Treas. Reg. § 1.146-16 sets forth four rules with respect to the effective dates of the Proposed Regulations: (1) a general rule providing for prospective application of the regulations, (2) an exception for refunding bonds meeting certain criteria, (3) a rule permitting application of the regulations to (a) refunding bonds issued after the general effective date and (b) other bonds issued after December 30, 1994 and before the effective date, and (4) a rule permitting specified portions of the regulations to be applied to any bonds issued before the general effective date.

B. COMMENTS.

Although the Proposed Regulations do not so expressly state, the Committee assumes that the latter two rules with respect to permissive application of all or portions of the regulations contemplate that application of the regulations would be at the option of the issuer and not the Commissioner.

The general prospective effective date rule and the exception for refunding bonds, particularly when considered in light of the rule providing for permissive application of the regulations to refunding bonds and other bonds issued after December 30, 1994, represent a sound policy decision that should be applauded. Certain details of these rules do, however, seem to present unnecessary, and in some instances counterproductive, complications.

The exception for refunding bonds is limited to situations in which the weighted average maturity of the refunding bonds does not exceed the weighted average maturity of the refunded bonds. Although the Treasury's concern with respect to extensions of weighted average maturity of outstanding bonds through issuance of refunding bonds is understandable, the rule unfairly penalizes issuers who, for whatever reason, chose to issue bonds initially for less than the maximum term allowable under applicable tax and state laws. Rules of this type ultimately provide additional inducement for issuers to maximize the term of their bonds to the detriment of the interests of the Treasury. A more equitable and rational limitation would permit application of the exception to refunding bonds having a weighted average maturity not longer than the greater of the weighted average maturity of the refunded bonds or 120% of the weighted average economic life of the bond-financed facilities.

Prop. Reg. § 1.141-16(d) provides that the regulations may be applied in whole to (i) bonds issued after December 30, 1994 and before the general effective date, and (ii) refunding bonds issued after the effective date. No readily apparent reason exists for the differentiation between new money bonds and refunding bonds issued between December 30, 1994 and the general effective date. In either case, issuers should have the opportunity to apply the regulations. A contrary rule could easily result in refunding bonds issued during this period as being required to be refunded after the general effective date in order to apply the regulations. Although "churning" of this type would be greatly appreciated by bond lawyers and investment bankers (particularly in times of reduced new-money issue volume), the result seems undesirable at best.

Prop. Reg. § 1.141-16(e) permits specified portions of the regulations to be applied to any bonds issued before the general effective date. The rationale for limiting this option to the enumerated sections is unclear. The Proposed Regulations purport to interpret the rules adopted in the 1986 Act, nine years later. At least in the case of bonds issued after the effective date of the 1986 Act, greater flexibility in application of the Proposed Regulations should be provided to issuers whose bonds are subject to the statutory rules being interpreted by the regulations. The absence of such flexibility will unquestionably result in some bonds being refunded for the primary purpose of gaining the ability to apply the regulations.

Regardless of the scope of permitted retroactive application of the Proposed Regulations, it should be recognized that portions of the Proposed Regulations cannot be satisfied in the case of bonds issued before publication of the Proposed Regulations except by chance. For example, Prop. Reg. § 1.141-13(b)(4)(i) requires that bonds be subject to redemption within six months of a "deliberate act." As described above, because of the additional cost of such a provision, outstanding fixed-rate bond issues rarely, if ever, contain such redemption provisions. Similarly, Prop. Reg. § 1.141-13(a)(1) and (3) mandate inclusion of specific covenants and certifications that may or may not be satisfied by outstanding bond issues.[89] If retroactive application of Prop. Reg. § 1.141-13 is to be at all useful, these portions of the regulations should not be required to be satisfied.

The Proposed Regulations are ambiguous or worse with respect to their intended application to transitional refundings permitted by §§ 1311-1318 of the 1986 Act.[90] First, Prop. Reg. § 1.141-16(a) and (b) correctly provide that Prop. Reg. §§ 1.141-1 through 1.141-16, 1.145-1, 1.150-1(a)(3), and 1.1394-1 are applicable only to bonds subject to § 1301 of the 1986 Act. For some reason, Prop. Reg. § 1.150-4 is not included even though Prop. Reg. § 1.150-4(c) explicitly refers to § 1.141-16 for its effective date. This is particularly

[89] Bonds issued in the last 15 years or so probably contain at least general covenants by the issuer to maintain the tax-exempt status of interest on the bonds, but may not specifically address private activity or industrial development bond status.

[90] Because of changes in prevailing interest rates in the capital markets and the expiration of the period during which many such bonds could not be called, a significant number of such transitional refundings have recently been done and many others are now being prepared for market.

troublesome because, pursuant to § 1313 of the 1986 Act, Code § 150(b) is generally applicable to refundings not governed by § 1301. Furthermore, Prop. Reg. § 1.141-16(c) does not explicitly exclude from its reach refundings not subject to § 1301 of the 1986 Act as is done in § 1.141-16(b), and so whether transitional refundings are intended to be brought within the scope of the private activity bond regulations is not clear. The Committee assumes that this result is unintended in light of the explicitly statutory mandate of the transitional provisions of the 1986 Act.

XIV. PROP. REG. § 1.145-1: CODE § 501(c)(3) BONDS

Prop. Reg. § 1.145-1 adopts the requirements of the Proposed Regulations under Code § 141 in their entirety, rather than creating new regulations for qualified 501(c)(3) bonds. Although some of the provisions of these regulations will obviously be inapplicable because of the nature of the organizations involved, the Proposed Regulation formalizes what has been the practice of both the IRS and practitioners.

A. PROP. REG. § 1.145-1(a): IN GENERAL.

1. Overview.

This paragraph adopts the requirements of Prop. Reg. §§ 1.141-1 through -16 for determining whether use by, security or payments from, or loans to persons or entities that are neither governmental entities nor Code § 501(c)(3) organizations using facilities in activities that are not unrelated trades or businesses has occurred.

2. Comments.

The Committee finds especially helpful that, as under Rev. Proc. 93-19, the rules for management and service contracts are the same for both qualified 501(c)(3) bonds and governmental bonds. The continued prohibition against a Code § 501(c)(3) organization controlling the service provider or manager is somewhat puzzling, however. The Committee asks that this provision be reconsidered in light of the minor potential for abuse that exists in this area.

B. PROP. REG. § 1.145-1(b): REASONABLE EXPECTATIONS AND DELIBERATE ACTIONS.

1. In general.

Prop. Reg. § 1.145-1(b)(1) provides that the reasonable expectations of both the issuer and the Code § 501(c)(3) organization control in determining whether an issue meets the requirements of Code §§ 141(e) and 145. As under Prop. Reg. § 1.141-2, the section makes clear that actions of either the issuer or the 501(c)(3) organization can cause the bonds to cease to be qualified. The section imports the notion of "deliberate action" and specifically adopts the tests of Prop. Reg. § 1.141-2(d)(2). Under this standard, an action is deliberate if it is within the control of the entity, whether or not any intention to violate a requirement of either Code § 141 or Code § 145 existed. The paragraph specifically states that losing tax-exempt status as a result of private inurement is a deliberate action.

2. Comments.

This statement seems obvious, but it may be intended to imply that losing exempt status would not always be treated as a deliberate action. The Committee finds it hard to imagine a situation in which an organization could lose its status other than through its own actions or inactions, however, and requests clarification of this provision.

3. Remedial actions.

Following the policy set forth in Rev. Proc. 93-17, Prop. Reg. § 1.145-1(b)(2) permits the issuer or the 501(c)(3) organization to take the same remedial actions permitted governmental issuers to keep previously-issued bonds qualified under Code § 145. The rules contained in Prop. Reg. § 1.141-13, however, which is adopted by Prop. Reg. § 1.145-2(b), are far more complex than the rules of Rev. Proc. 93-17, requiring, for example, a certification with respect to the use of the bond proceeds at the time of bond closing. The Committee reiterates its comments with respect to those rules made in Section X, and notes that as applied to Code § 501(c)(3) organizations, while not presenting unique problems, are extremely burdensome and fail to recognize the changing environment of the healthcare industry.

July 18, 1995