Module L

Change in Use Rules

Overview

Introduction

When bonds are issued to finance a specific project, the parties involved in the transaction expect that all will go as planned. For example, when a county issues bonds to construct and equip a hospital, it may expect that it will be able to operate the hospital indefinitely. The county also may expect that the hospital will generate enough profit to cover the debt service on the bonds. Sometimes, however, projects don't work out as planned. Assume that after a few years, the county realizes that it cannot operate the hospital at a profit because of rising operating costs and inadequate management skills. It decides that its only option is to sell the hospital. The highest bidder turns out to be a for-profit hospital system. This transaction would cause the bonds to meet the private business tests, resulting in the bonds being classified as private activity bonds. Would the interest on these bonds still be tax-exempt? In this case, they may be if certain requirements are met.

This module discusses post-issuance events and how they can affect the tax exempt status of the bonds.

Objectives

At the end of this module, the student will be able to:

- Define and identify a deliberate action.
- Explain the effect of a deliberate action on the tax-exempt status of certain bonds.
- Determine if proper remedial action has been taken to avoid jeopardizing the tax-exempt status of the bonds.
- Determine if the IRC § 150(b) change in use disallowances apply to the transaction.
- Explain how the disallowances affect the owner and user of the tax-exempt bond-financed property.

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Typical Changes Which May Affect the Bond's Status

Typical transactions which may affect the status of tax-exempt bonds usually involve the sale, transfer, or lease of property financed with bond proceeds to another entity. Often this other entity is a for-profit entity.

These types of transactions jeopardize the tax-exempt status of bonds because they can allow the bonds to meet the private business use and private security or payment tests of IRC § 141(a) long past the issuance date. Even though the issuers did not expect to issue taxable bonds, these types of post-issuance events can cause the bonds to become taxable private activity bonds.

Retroactive Effect of Change of Use

When a change in use occurs, the bonds are usually considered to be taxable as **of the date of issuance**. This is because the issuers took a deliberate action after the issuance date which caused the bonds to be taxable.

Applicability

These provisions generally apply to all governmental and private activity bonds. **However, see Figure L-1 for specific applications and exceptions**.

Current Rules

This lesson will cover the current change in use rules which are generally effective for all bonds issued on or after May 16, 1997. These rules are contained in Treas. Reg. §§ 1.141, 1.142, 1.144, 1.145, 1.147, and 1.150.

Many of the rules may also be applied in whole, BUT NOT IN PART, to bonds that were issued before, but were still outstanding on May 16, 1997. **(See Treas. Reg. §§ 1.141-15 and 1.141-16 for specific information**.)

Section 1

Change in Use Remedies

Overview

Introduction

"Change in use" means a change in the use of proceeds of an issue of State or local bonds from the use for which those proceeds were used, or expected to be used, as of the date of issue.

The test for private activity bonds is based on the issuer's reasonable expectations on the issuance date AND subsequent deliberate actions of the issuer. Even though an issuer reasonably expects on the issuance date to use the bond proceeds for a governmental purpose throughout the life of the bonds, obviously events will occur which are unexpected. These unexpected - though deliberate - actions affect the taxability of the interest on the bonds FROM THE ISSUANCE DATE, even though the events may occur much later!

The regulations provide for certain actions, which, if properly taken by issuers, will preserve tax-exemption of the bonds starting from the issuance date. This section explains these remedial actions and the other conditions which are also required.

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Concept of Use

Use vs. User

The use of bond proceeds and of bond-financed property is the basis for determining whether bonds are issued for general government operations or for an activity of a nongovernmental person.

When speaking of "use", we tend to think of the actual use of the property rather than the user. For example, when you were reading the example about the county's hospital in the Overview to this lesson, you may not have thought that the sale of the hospital constituted a change in use, because the hospital would still be used as a hospital. If so, then you need to change your way of thinking about these rules. Instead of thinking in terms of actual use of bond-financed property, think about the user of the property. Now when you review the example, does your position change? It should - because now we have a bond-financed hospital being used by a nongovernmental person.

Purpose

The private use rules and the change of use rules work to limit the amount of tax-exempt subsidy being transferred to a nongovernmental person.

Who is a User?

A person can be a user of bond proceeds or a user of bond-financed property through both direct and indirect use.

A person can be treated as a user of bond proceeds or bond-financed property as a result of:

- ownership of property, or
- actual or beneficial use of property pursuant to a
  - lease,
  - management contract, or
  - an arrangement such as a take-or-pay or output contract.

Management Contracts

Rev. Proc. 97-13, 1997-1 C.B. 632, provides the conditions under which a management contract does not result in private business use under IRC § 141(b) and does not result in IRC § 145(a)(2)(B) being met.

Research Agreements

Rev. Proc. 97-14, 1997-1 C.B. 634, provides the conditions under which a research agreement does not result in private business use under IRC § 141(b) and does not result in IRC § 145(a)(2)(B) being met.

Reasonable Expectations and Deliberate Action

Section 141 Revisited

According to Treas. Reg. § 1.141-2(d)(1), an issue is an issue of private activity bonds if the issuer:

- **reasonably expects**, AS OF THE ISSUE DATE, that the issue will meet either the private business tests or the private loan financing test, OR
- takes a **deliberate action**, SUBSEQUENT TO THE ISSUE DATE, that causes the conditions of either the private business tests or the private loan financing test to be met.

Example 1

Hospital Q borrows the bond proceeds from County X to renovate its main facility. Hospital Q reasonably expects that sometime soon it will build an entirely new facility, and sell the current one to a for-profit entity. But on the issuance date, it does not know when this will happen.

Technically, these bonds are private activity bonds, because the issuer reasonably expects, ON THE ISSUANCE DATE, that the bonds will eventually meet the private business tests. (We will see later, though, how the issuer can avoid this.)

Example 2

County A issues bonds in the principal amount of $40M. The proceeds are loaned to an organization exempt under IRC § 501(c)(3) and are used to build the organization's main facility. On the issue date, A reasonably expects that the issue will not meet the private business tests or the private loan financing test as applied under IRC § 145. Subsequently, the organization engages in a series of transactions with for-profit subsidiaries which result in revocation of the organization's tax-exempt status.

The organization has taken a deliberate action, which can effect the tax-exempt status of the bonds. The organization as the conduit borrower is treated as the issuer. **(See Treas. Reg. § 1.141-1(a) and 1.148-1(b) for definitions.)**

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Example 3

County B issues qualified small issue bonds in the principal amount of $9M, making the $10M election under IRC § 144(a)(4). The proceeds are loaned to Partnership X, who exceeds the $10M capital expenditure limit within three years after issuance.

Partnership X has taken a deliberate action, which can affect the tax-exempt status of the bonds, and under the regulations there is no remedial action that can prevent these bonds from being taxable.

Safe Harbor Exceptions

Treas. Reg. § 1.141-2(d)(3)(ii) provides for the following safe harbor exceptions from the definition of deliberate action:

- involuntary or compulsory conversions under IRC § 1033, and
- actions taken in response to a regulatory directive made by the federal government.

Example 4

City C issues bonds to finance the purchase of land. On the issue date, C reasonably expects that it will be the sole user of the land for the entire term of the bonds. Subsequently, the federal government acquires the land in a condemnation action. C sets aside the condemnation proceeds to pay debt service on the bonds but does not redeem the bonds on their first call date.

The bonds are not private activity bonds because C has not taken a deliberate action after the issue date.

Special Rules for Governmental Bonds Only

The regulations provide special rules as follows: (Note that these special rules apply only to governmental bonds.)

Treas. Reg section…	Provides special rules relating to…
1.141-2(d)(4)	dispositions of personal property in the ordinary course of an established governmental program
1.141-2(d)(5)	general obligation bond programs that finance a large number of separate purposes.

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Exception for Mandatory Redemption Provision

Treas. Reg. § 1.141-2(d)(2)(ii) provides that actions reasonably expected ON THE ISSUANCE DATE to occur, which when they occur they will cause the bonds to meet the private business tests, may be disregarded if the bonds are redeemed within six months of the date of the action, AND certain other requirements are met.

City C issues bonds to renovate an existing hospital that it currently owns. On the issuance date, C reasonably expects that the hospital will be used for a governmental purpose for a substantial period. Also on the issuance date, C plans to construct a new hospital but is uncertain about when this will occur. C reasonably expects that when the new hospital is placed in service, it will sell or lease the renovated hospital to a private hospital corporation. The bond documents require that the bonds must be redeemed within six months of the sale or lease of the renovated hospital (regardless of the amount actually received from the sale.) The bonds meet the reasonable expectations requirement of the private activity bond tests if the mandatory redemption of bonds meets all of the conditions of a remedial action under IRC § 1.141-12(a).

Remedial Actions

Introduction

Treas. Reg. § 1.141-12 provides for certain remedial actions that, if properly undertaken, will prevent a deliberate action from causing an issue to meet the private business use test or the private loan financing test.

Note that these actions do not protect against a violation of the private security or payment test, but since violations of the private business use test and the private loan financing test will be cured, then the bonds will be tax-exempt.

Remedial actions are inapplicable to the $10M capital expenditures limit and the $40M principal user bond limit on qualified small issue bonds.

There are four possible remedial actions, and five conditions, which must be met before those actions, will apply.

Required Conditions

The five conditions as provided by Treas. Reg. § 1.141-12(a) that are required to be met are:

1. The reasonable expectations test must be met;
2. The maturity cannot be unreasonably long;
3. The terms of the arrangement that satisfies the private business tests or private loan financing test must be bona fide, arm's length, and the new user must pay fair market value. **(See Treas. Reg. § 1.141-12(f));**
4. Disposition proceeds are treated as gross proceeds for arbitrage purposes; AND
5. Proceeds affected by the deliberate action are expended on a governmental purpose. **(See Treas. Reg. § 1.141-12(d)).**

Remedial Actions

The four possible remedial actions as provided by Treas. Reg. §§ 1.141-12(d) through (f) provide for certain:

1. Redemptions or defeasances of nonqualified bonds.
2. Alternate uses of disposition proceeds.
3. Alternate uses of affected facility.
4. Additional remedial actions provided by publication.

These actions are discussed below. Note that they do not apply in all cases.

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Redemption of Defeasance of Nonqualified Bonds

Treas. Reg. § 1.141-12(d) provides that this action is met if all of the nonqualified bonds of the issue:

- are redeemed within 90 days of the deliberate action, or
- if not redeemed, then a defeasance escrow is established within 90 days of the deliberate action. (The first call date cannot be more than 10.5 years from the date of issuance.)

Example 5

On June 1, 1997, City C issues bonds with an issue price of $10M to finance the construction of a hospital building. On the issue date, C reasonably expects that it will be the only user of the building for the entire term of the bonds. Six years after the issue date, C leases the building to Corporation P for 7 years. C uses other funds to immediately retire all of the bonds within 90 days of entering into the lease agreement. The five required conditions are also assumed to be met.

The transaction does not cause the bonds to be private activity bonds (retroactively) because C has taken a remedial action, which prevents P from being treated as a private business user of bond proceeds.

Special Rule for Cash Received

Treas. Reg. § 1.141-12(d)(2) provides that if the disposition proceeds are exclusively cash, only a pro rata portion of the bonds needs to be redeemed. This is helpful in situations where the cash received is less than the amount due on the outstanding bonds.

Example 6

An issuer has $15M in bonds outstanding at the time of the sale of tax-exempt financed property to a private business. The disposition proceeds are $10M in cash.

Under the special rule, the issuer need only redeem $10M of the outstanding bonds within 90 days. Alternatively, if the first call date is beyond 90 days, the $10M is used to establish a defeasance escrow to redeem $10M of the bonds.

The remaining $5M in bonds is not affected by the change in use.

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Notice of Defeasance

Treas. Reg. § 1.141-12(d)(3) requires that the issuer must provide written notice to the Commissioner of the establishment of the defeasance escrow within 90 days of the date the defeasance escrow is established.

Treas. Reg. § 1.150-5 provides that this notice must be filed with the Internal Revenue Service, 1111 Constitution Avenue NW, Attention: T:GE:TEB:O, Washington, DC 20224**.**

Alternate Use of Disposition Proceeds

Treas. Reg. § 1.141-12(e) provides that the requirements of this remedial action are met if:

- the deliberate action is a disposition exclusively for cash,
- the issuer reasonably expects to expend the disposition proceeds within two years of the date of the deliberate action,
- the disposition proceeds:
    - are treated as proceeds for purposes of IRC § 141,
    - are used in a manner that does not cause the issue to meet either the private business tests or the private loan test, AND
    - the issuer does not take any action subsequent to the deliberate action to cause either of the above tests to be met, AND
    - any excess disposition proceeds are used for redemption or defeasance, in a manner described in “1” above.

Example 7

On June 1, 1997, County B issues bonds with a principal amount of $10M to finance the construction of a hospital building. On the issue date, B reasonably expects that it will be the only user of the building for the entire term of the bonds. Five years after the issue date, B sells the building to Corporation P for $5M, which is the fair market value of the building. B expects to use the $5M disposition proceeds for the construction of roads within two years of receipt. B treats these proceeds as gross proceeds for purposes of IRC § 141.

The bonds are not private activity bonds because B has taken appropriate remedial action. Note that the bonds are NOT redeemed.

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Special Rule for Use by 501(c)(3) Organizations

In addition to the rule set forth above, if the disposition proceeds are to be used by a 501(c)(3) organization, the nonqualified bonds are treated as reissued for purposes of IRC §§ 141, 145, 147, 149, and 150. In addition, the nonqualified bonds must satisfy all of the applicable requirements for qualified 501(c)(3) bonds.

Alternate Use of Facility

Treas. Reg. § 1.141-12(f) provides that the requirements for this remedial action are met if:

- The facility with respect to which the deliberate action occurs is used for a qualified governmental or private activity bond purpose,
- The nonqualified bonds:
    - are treated as reissued for purposes of IRC §§ 55 through 59, 141, 142, 144 through 147, 149, and 150, AND
    - the nonqualified bonds satisfy all the applicable requirements for qualified bonds throughout the remaining term of the nonqualified bonds,
- The deliberate action does not involve a disposition to a purchaser that finances the acquisition with proceeds of another issue of tax-exempt bonds, AND
- Disposition proceeds (other than those arising from an agreement to provide services) resulting from the deliberate action are:
    - used to pay debt service on the bonds on the next payment date, OR
    - are deposited (within 90 days of **receipt)** into an escrow that is yield restricted AND used to pay debt service on the bonds on the next available payment date.

Example 8

County F issues bonds with an issue price of $10M to finance the construction of a health care center. Five years later, the county realized that the needs of the rural residents would be better served if the facility were operated by another organization. The county leased the facility to a 501(c)(3) organization for 30 years. The lease payments to be paid equal the debt service payments due on the bonds. Lease payments, as received, will be deposited into a yield-restricted escrow account and used to pay debt service on the bonds. At the expiration of the term, all assets revert to the authority, including any tenant improvements. The bonds are treated as reissued under the appropriate code sections.

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Example 8 (continued)

The actions taken meet all of the requirements for alternative use of a facility. The bonds are treated as qualified 501(c)(3) bonds beginning with the date of the lease. The bonds are NOT redeemed AND must meet the requirements for qualified bonds while outstanding.

Closing Agreement

Treas. Reg. § 1.141-12(h) provides that the Commissioner may provide for additional remedial actions through publication. Pursuant to this authority, the Internal Revenue Service released Rev. Proc. 97-15, 1997-1 C.B. 635 on February 3, 1997. Rev. Proc. 97-15 can be found in your Deskbook.

Provisions of Rev. Proc. 97-15

The Revenue Procedure permits an issuer to enter into a closing agreement to prevent interest on the bonds:

- from becoming taxable due to a deliberate action which causes the bonds to fail to meet certain requirements of sections 141-150, and
- from being treated as a tax preference item in cases where the bonds were issued as governmental bonds but as a consequence of a remedial action taken by an issuer are qualified private activity bonds.

Required Issuer Actions

To prevent interest on its bonds from being included in gross income, the following must be met:

- The requirements of Treas. Reg. §§ 1.141-12, 1.142-2, 1.144-2, 1.145-2 or 1.147-2, as applicable, relating to conditions for remedial action must be satisfied, AND
- The issuer must:
    - submit a proper request for a closing agreement which describes the subsequent action and explains the proposed closing agreement amount within 180 days of the subsequent action,
    - agree to redeem the bonds at the next call date,
    - notify the bondholders that the bonds will be redeemed on the next redemption date, and if not redeemed, the bonds will be nonqualified private activity bonds,
    - not make any closing agreement payment from tax-exempt bond proceeds,
    - sign a disclosure consent authorizing the Service to make certain documents relating to the agreement public if the bonds are not redeemed in accordance with the terms of the agreement, AND
    - pay the full amount due upon execution of the closing agreement.

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Remedial Actions, Continued

Effective Date

This revenue procedure is effective for bonds issued on or after May 16, 1997. Issuers may apply the revenue procedure to any bonds issued before May 16, 1997.

Prior to the issuance of this revenue procedure, Rev. Proc. 93-17, 1993-1 C.B. 507, 1993 IRB 1993-10 I.R.B. 41, controlled changes in use.

Special Note Regarding Eligibility

A bond issue that is under an examination by the Service is NOT eligible for the program. An issue is under examination if the issuer of the bonds has been notified in writing, by the Service that the issue has been selected for examination.

Example 9

County T issues bonds with a principal amount of $50M on June 1, 1995. The bond proceeds are loaned to a 501(c)(3) organization, which uses the funds to construct a hospital wing. The first call date of the bonds is on June 1, 2007. On June 1, 1997, the exempt status of the 501(c)(3) organization is officially revoked due to inurement. Revocation of exempt status due to inurement constitutes a deliberate action.

The closing agreement program is not available to the County because the organization's deliberate action was uncovered during an IRS examination.

Example 10

County X issues $75M bonds used to develop and operate a solid waste treatment facility. Three years later, the county finds that operation of the facility is beyond its abilities. It decides to sell the facility to a private for-profit firm at fair market value. All of the conditions precedent to a remedial action are satisfied. The county uses the disposition proceeds to establish a proper escrow account to defease the bonds on the next call date. The bonds are considered to be reissued qualified exempt facility bonds and meet all of the requirements.

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Remedial Actions, Continued

Example 10 (continued)

Although the tax-exempt status of the bonds has been preserved by the remedial action, the interest on the reissued bonds is subject to the alternative minimum tax.

The county may request a closing agreement under the provisions of Rev. Proc. 97-15 to prevent the interest from being a tax preference item for a specific period of time.

Figure L-1: Applicability

The table below summarizes how the change of use provisions, apply to various types of bonds.

SUBJECT	T. REG SECTION	GOVT	EXEMPT FACILITY*	IRC SEC 144*	QUAL 501(c)(3)	IRC SEC 147*
Deliberate action	**1.141-2(d)(3)**	YES	no	no	YES	no
Failure to properly use proceeds	**1.142-2(a)**	no	YES	YES	no	YES
Special rules	**1.141-2 (d)(4) and (d)(5)**	YES	no	no	no	no
Conditions for Remedial Action	**1.141-12(a)**	YES	no#	no#	YES	no#
Redemption	**1.141-12(d)**	YES	no	no	YES	no
Redemption	**1.142-2(c)**	no	YES	YES	no	YES
Dispositions of personal property	**1.142-2(c)(4)**	no	YES	YES	no	YES
Dispositions for cash	**1.141-12(d)(2)**	YES	no	no	YES	no
Alt use-proceeds	**1.141-12(e)**	YES	no	no	YES	no
Special rule for 501(c)(3) orgs	**1.141-12(e)(2)**	no	no	no	YES	no
Alt use-facility	**1.141-12(f)**	YES	no	no	YES	no
Nonqualified bonds	**1.141-12(j)(1)**	YES	no	no	YES	no
Nonqualified bonds	**1.142-2(e)**	no	YES	YES	no	YES
Rev Proc 97-15	**1.141-12(h)**	YES	YES	YES	YES	YES
NOTES:			* N/A to IRC §§ 142(d) and 142(f)(2) **# But see Treas. Reg.§ 1.142-2(b).**	*N/A to IRC §§ 144 (a)(4), (a)(10), (b) **(See Treas. Reg.§ 1.144-2)**	***See modifications in 1.145-2(b) and (c)(2). N/A to IRC §§ 145(b),(c),(d).**	*Applies only to IRC §§ 147(c)(3); (d)(2),(3); (e),(f). **(See Treas. Reg. § 1.147-2)**

Section 2

Change in Use Disallowances

Overview

Introduction

The change in use disallowances of IRC § 150(b) apply to certain qualified private activity bonds when an event occurs subsequent to the issuance date, which causes the bonds to become nonqualified private activity bonds.

Example 11

On January 1, 1994, City X issues bonds in the principal amount of $50M. On that date the bonds satisfied all of the requirements for tax-exempt qualified 501(c)(3) bonds under IRC §§ 141 through 150. Hospital Y borrows the proceeds and uses them to finance construction and renovation of its facility, to fund a debt service reserve fund, and to pay costs of issuance. Five years later, the hospital proposes to enter into a partnership with a for-profit affiliate. Seven percent of the facility will be leased and operated by the partnership. The lease payments will be used to pay greater than 5 percent of the debt service on a portion of the bonds.

Absent appropriate remedial action, these bonds would become nonqualified private activity bonds on the agreement date. The interest on the bonds would be taxable back to the issuance date, and IRC § 150(b)(3) would apply.

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Purpose

IRC § 150(b) affects the users of tax-exempt private activity bond-financed facilities who fail to use the facilities for a tax-exempt purpose. The change in use disallowances are generally separate and distinct from any retroactive or prospective loss of exemption of bond interest that may result if applicable Code requirements are not met.

The disallowances were enacted in response to the concern that the proper use of bond-financed facilities was generally under the control of the users of such facilities, and that such users should be penalized for any misuse.

Effective Date

IRC § 150(b) was added to the Code in 1986 and generally applies to changes in use of bond-financed property occurring after August 15, 1986, with respect to financing provided after that date.

Applicability

The provisions of IRC §§ 150(b) and (c) apply only to the following types of qualified private activity bonds:

- mortgage revenue bonds (IRC § 143)
- qualified residential rental projects (IRC § 142(d))
- qualified 501(c)(3) bonds (IRC § 145)
- exempt facility bonds (IRC § 142(a) other than 142(a)(7))
- qualified small issue bonds (IRC § 144(a))
- bonds financing facilities required to be owned by governmental units or 501(c)(3) organizations (IRC §§ 142(a)(1), (2), (3), and (12), AND 145(a)).

The provisions do NOT apply to property financed with governmental bonds.

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Overview, Continued

Exception and Special Rules

IRC § 150(c) provides an exception and several special rules which relate to IRC § 150(b). The exception is discussed below. The special rules concern:

- the treatment of amounts payable for the use of facility that are not interest, (such as leases), AND
- allocations where only a portion of a facility is used for private use. (**See Treas. Reg. § 1.150-4(c).)**

Effect of Remedial Action

Treas. Reg. § 1.150-4 provides generally that the rules of IRC §§ 150(b)(3) through (5) and 150(c) **apply even if the issuer takes a remedial action described in Treas. Reg. §§ 1.142-2, 1.144-2, or 1.145-2.**

Exceptions

The change of use rules have limited application if the remedial action taken is:

- redemption within 90 days of the deliberate action under Treas. Reg. § 1.145-2 or within 90 days of the date on which a failure to properly use proceeds occurs under Treas. Reg. § 1.142-2 or 1.144-2,
- an alternative qualifying use of a bond-financed facility under Treas. Reg. § 1.145-2 and 1.141-12(f), OR
- an alternative use of disposition proceeds under Treas. Reg. § 1.145-2, 1.141-12(e), 1.142-2(c)(4), or 1.144-2. (See Treas. Reg. § 1.150-4(b) for specific rules.)

Note

IRC § 150(c)(1) provides that any use with respect to facilities financed with proceeds of an issue which are not required to be used for the exempt purpose of such an issue shall not be taken into account.

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Example 12

Hospital Y enters into an agreement whereby approximately 10 percent of Hospital Y's facility will be leased to and managed by a partnership. The entire facility was financed with tax-exempt bonds.

IRC § 145(a)(2)(B) provides that one of the requirements for qualified 501(c)(3) bonds is that no more than 5 percent of the property is used for private business use. This means that up to 5 percent of the tax-exempt financed property can be used for private business use without jeopardizing the tax-exempt status of the bonds. The change in use rules under IRC 150(b) will apply only when the private business use exceeds 5 percent. In this example, 10 percent of the facility (and the bond proceeds) are treated as being used by the partnership. That percentage is not reduced by the 5 percent that may be used for non-exempt purposes under IRC § 145(a). If the private use amounted to less than 5 percent, then the 150(b) penalties would not apply.

Mortgage Revenue Bonds

General rule

IRC § 150(b)(1) provides for a penalty when a residence financed with qualified mortgage bonds or qualified veterans' bonds is not the principal residence of at least one of the mortgagors who received the financing for a continuous period of at least one year. Legislative history indicates that the term "principal residence" has the same meaning as under former IRC § 1034. (See also Treas. Reg. § 1.1034-1(c)(3).)

IRC § 150(b)(1)(B) provides an exception if the Secretary determines that:

- application of the penalties would result in undue hardship, AND
- the failure to meet the requirements was beyond the mortgagor's control.

Disallowance

If a residence financed with qualified mortgage bonds or qualified veterans' mortgage bonds is no longer the principal residence of at least one of the mortgagors for a continuous period of one year or more, the mortgagors are denied a deduction for interest paid. **(S. Rep. No. 313, 99th Cong., 2d Sess., page 852 (1986)**). This applies to interest which accrues on or after the date that the period began, and before the date such residence is again the principal residence of at least 1 of the mortgagors who received the financing. The disallowance of interest deductions for bond-financed housing ceases prospectively if the residence again qualifies as the mortgagor's principal residence.

Qualified Residential Rental Projects

General Rule

IRC § 150(b)(2) applies when a bond-financed qualified residential rental project no longer meets the requirements of IRC § 142(d).

Applicable Events

If the project does not meet the residency test elected by the issuer under IRC § 142(d), the rule applies.

Disallowance

No deduction shall be allowed for interest on the financing which accrues during the period:

Beginning on…	Ending on…
the 1st day of the taxable year in which the project fails to meet the requirements	the date the project meets the requirements

Example 13

The issuer elected, at the time of issuance, that during the qualified project period 20 percent or more of the units would be occupied by individuals whose income is 50 percent or less of the area median gross income. Eight years later, during the qualified project period, less than 20 percent of the residents meet the income qualifications. In year 10, 20 percent of the residents meet the income qualifications.

No deduction is allowed for interest for the two-year period that the 20 percent requirement was not met.

Note

If the conduit borrower pays the issuer lease payments or other payments that are a substitute for principal and interest, then IRC § 150(c)(2) disallows a deduction for that part of the payment which equals the amount of interest on the bonds for the period.

Qualified 501(c)(3) Bonds

General Rule

There are two provisions of IRC § 150(b) that directly apply to qualified 501(c)(3) bonds - section 150(b)(3) and section 150(b)(5).

IRC § 150(b)(3) applies when over 5 percent of the facility is used in a trade or business of any person other than a 501(c)(3) organization or a government unit, but continues to be owned by a 501(c)(3) organization.

Disallowance

The results of IRC § 150(b)(3) are twofold:

- The owner of the property (the 501(c)(3) organization) is treated as engaged in an unrelated trade or business with respect to the portion of the property used by that other person, AND
- no deduction is allowed for interest on financing which accrues during the period that the property is so used.

The amount of income derived is equal at least to the fair rental value of the portion of the property so used.

IRC § 150(c)(2) limits the denial of the deduction to the amount of bond interest accruing for the period.

Example 14

County G issues bonds in the principal amount of $75M. The bond is issued as a qualified 501(c)(3) bond. L (a 501(c)(3) organization) borrows the proceeds and uses them to finance construction and renovation of its hospital. Six years later, L enters into an agreement with Partnership M to lease the oncology department of the hospital for a period of 10 years. The amount of the lease payments is equal to the fair rental value of that portion of the facility. Approximately 6 percent of the proceeds of the bonds are allocable to the renovations made to the property to be used by the partnership. The bonds cannot be redeemed within 90 days because the first call date is beyond that date. However, the bonds are defeased and a proper escrow account is established within 90 days.

Continued on next page

Example 14 (continued)

In this situation, remedial action has been taken which prevents the lease with Partnership M from being a deliberate action that causes the private business use test under IRC § 145(a) to be met. However, defeasance does not prevent IRC § 150(b)(3) from applying. **(See Treas. Reg. § 1.150-4(b)(2).)** Therefore, the change in use rules apply and L is required to file Form 990T for the period beginning on the date the agreement is signed and continuing until the private use ceases or the bonds are redeemed. In computing the amount of unrelated business taxable income shown on the return, L is not allowed a deduction for interest accruing on the loan from County G for the portion of the property used by the partnership.

Facilities Required to be Owned by Governmental Units or 501(c)(3) Organizations

General rule

IRC § 150(b)(5) provides for a denial of interest deduction when property financed by tax-exempt bonds is required to be owned by a governmental unit or a 501(c)(3) organization, and there is a change in ownership to an organization which is other than a governmental unit or a 501(c)(3) organization.

Applicable

This provision applies to bonds issued under the following Code sections:

- IRC § 142(a)(1), (2), (3), and (12), AND
- IRC § 145(a).

Disallowance

The owner is denied a deduction for interest on the financing which accrues during the period:

Beginning on the date…	Ending on the date…
the property is not owned as required	the property is owned as required.

Example 16

County H issued bonds and loaned the proceeds to a 501(c)(3) organization to construct a nursing home. Five years after the nursing home had begun operations, the organization discovered financial difficulties precluded it from meeting the financial obligations of the bonds. The nursing home was sold to a private, unrelated operator of nursing home facilities. Terms of the sale called for the new operator to assume the 501(c)(3) organization's note to the County. Within 90 days of the sale, a defeasance escrow was established to redeem the bonds. The first call date was one year after the sale.

Although the redemption qualifies as a remedial action, which prevents the bonds from becoming nonqualified private activity bonds, the defeasance escrow is not an exception under Treas. Reg. § 1.150-4(b)(2). Therefore, the general rule of 1.150-4(b)(1) applies. As a result, the new owner is denied a deduction for interest incurred on the assumption of the note until the loan is repaid, the bonds are redeemed, or the nursing home is sold. The amount of the denied deduction is limited to the amount of interest on the bonds.

Exempt Facility Bonds and Small Issue Bonds

General Rule

IRC § 150(b)(4) applies when a facility is not used for a purpose for which a tax-exempt bond could be issued on the date of the issue.

Disallowance

No deduction is allowed for interest on such financing which accrues during the period beginning on the date such facility is not so used and ending on the date such facility is so used.

Example 15

City Z issues $25M principal amount of bonds and loans the proceeds to a Private Transit Company X to build, own, and operate a high-speed intercity rail facility, as described in IRC § 142(i). After a few years of operation, public ridership declines. X decides to give Business ABC discounted fares and a special schedule for ABC's employees such that the requirements of IRC § 142 are no longer met.

At this point, these bonds are no longer qualified bonds. In addition to the interest on the bonds becoming taxable to the bondholders, X loses the deduction for interest on the loan from City Z (not to exceed the amount of bond interest).

Small Issue Bonds Exceeding the Capital Expenditure Limitation

General Rule

IRC § 150(b)(6) provides that when a small issue bond becomes nonqualified because it has exceeded the $10M capital expenditure limitation, the owner is denied a deduction for interest during the time the bond is nonqualified.

Example 17

County Z issues $8M of qualified small issue bonds under IRC § 144(a) loaning the proceeds to Corporation X. Upon examination by the Internal Revenue Service, it is determined that Corporation X exceeded the capital expenditures limitation of IRC § 144(a)(4)(A)(ii) in the third year after issuance.

Exceeding the capital expenditure limitation not only causes the bonds to become taxable on the date the limit is exceeded, but Corporation X also loses a deduction (not to exceed the amount of bond interest) for the interest payments made to the County.

Remember, too, that no remedial action can cure these bonds.

Auditing Techniques

IRC § 150(b)(3)

Use by other than an IRC § 501(c)(3) organization or governmental unit - WHICH EXCEEDS 5 PERCENT- will result in UBIT to the section 501(c)(3) organization for the fair rental value of the use of bond-financed facility.

Interest deductions are denied equal to the amount of bond interest.

Audit tips

During an examination, the agent should:

- review conduit borrower's records/facilities to determine non-IRC § 501(c)(3) use,
- analyze sources of revenue that would disclose use by others,
- analyze contracts and agreements that would disclose use by others,
- review in-house publications to uncover private activities, AND
- tour the facilities looking for private use.

Example 18

Assume that you are examining a bond issue, the proceeds of which are used by an IRC § 501(c)(3) membership organization ("sub.") The sub is controlled by a parent organization ("parent"), which is a section 501(c)(4) membership organization.

You reviewed the publications of each organization. These publications list the facilities available to the members of the sub and the parent. Your review disclosed that some of the facilities available to the parent's members are those that are owned by the sub and were financed with tax-exempt bonds.

This bond is potentially a nonqualified section 145 bond. If so, then the 501(c)(3) organization could be liable for UBIT on the fair rental value of the portion of the facility used by the parent.

The next page illustrates the financial aspects of this situation.

Continued on next page

Example 18
(continued)

Remember that use by the parent's members must exceed 5 percent in order to cause a private use problem. Also remember that the private payment test must be met. Assume the following:

Fair rental value of entire facility	$200,000/annually
Portion used by parent's members	7 percent
Fair rental value of portion of facility used by parent's members	$ 14,000
Bond gross proceeds	$1,700,000
Bond interest rate	6.5 percent
Annual interest payment	$110,500
Bond term	20 years
Lease payments made by sub:	
Principal portion	$ 85,000
Interest portion	110,500
UBIT:	
Gross income	$ 14,000
Operating/mtnce expense	< 3,500>
Specific deduction	< 1,000>
Taxable income	$ 9,500
Interest portion of lease payment for portion used by parent's members	7,735 (110,500x.07)

This $7,735 is not permitted to be deducted from gross income.

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Auditing Techniques, Continued

IRC § 150(b)(5)

Tax exempt bond facilities owned or used by an IRC § 501(c)(3) or governmental entity must remain owned by any such entity, or no interest deduction is allowed for the portion, which is not owned.

Audit Tips

During an examination, the agent should review records of issuer/conduit borrower noting the following:

- depreciation schedule for disposals,
- in-house publications for discussion of sales, etc,
- CPA reports for decrease in assets, notes for disposals or future dispositions, AND
- minute books for discussions of dispositions.

Summary of Module L

Review of Module L

Module L discussed the change in use rules included in Treas. Reg. §§ 1.141,1.142, 1.144, 1.145, 1.147 and the change in use disallowances provided by IRC §§ 150(b) and (c) and the accompanying regulations.

Note that the disallowance rules of IRC § 150(b) and (c) and the accompanying regulations apply only to certain qualified private activity bonds, while the other change in use regulations generally apply to ALL types of bonds.

The 1.141 regulations clearly state that a private activity test considers both the issuer's:
- reasonable expectations about the use of bond proceeds on the issuance date, AND
- subsequent deliberate actions.

These subsequent deliberate actions become very significant to us as examining agents. Bond counsel renders an opinion on the tax status of the bonds on the issuance date based on reasonable expectations. Even though he these expectations are quite reasonable on the issuance date, circumstances frequently change, resulting in a situation which can suddenly affect the bonds. Bond counsel is usually no longer involved in the bond issue, but the issue can be subject to an IRS examination. Upon arrival, the agent reviews the bond transcript noting the expected plans for the proceeds, and also analyzes the subsequent use of the proceeds to determine if those plans actually were carried out. Sometimes it is determined that the use of the proceeds has changed in some way, and this is where the change in use rules come into play.

When a change in use occurs it can result in the bond issue becoming a nonqualified issue retroactive to the issuance date. Therefore, it becomes necessary for the agent to verify that proper remedial action was taken in order to preserve the tax-exempt status of the bonds.

The regulations provide four different remedial actions, which if properly performed by the issuer, will prevent the private use or private loan financing test from being met. In addition to meeting all of the requirements of the specific remedial action, the issuer must also meet five required conditions. If accomplished correctly, then the subsequent action will not be a deliberate action causing the private use or loan financing test to be met.

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Summary of Module L, Continued

Review of Module L (continued)

The change in use disallowances apply only to certain types of qualified private activity bonds. These rules apply whenever a subsequent deliberate action has caused the bonds to become nonqualified, but their effects are limited by the remedial action that is taken.

Module L concludes the text's discussion of qualified private activity bonds. You will recall that the purpose of this discussion related to the exception in IRC § 103(b)(1), which stated that only the interest from qualified private activity bonds could be tax-exempt.

Preview of Module M

Module M discusses a new concept in municipal financing - arbitrage. You will recall that IRC § 103(b)(2) prohibits the interest on a bond from being tax-exempt if it is an arbitrage bond.

The arbitrage rules are designed to prevent issuers from investing the proceeds of tax-exempt bonds in higher yielding taxable investments, thus taking advantage in the difference in the yields between the two markets.

The arbitrage rules are in IRC § 148 and the accompanying regulations. They apply to all types of bonds, although there are exceptions and special rules for governmental bonds, refundings, and other types of bonds.

Since the interest on an arbitrage bond cannot be tax-exempt, these rules are very significant to us.

Exercises

Exercise 1

County A issues bonds in the principal amount of $30M for the benefit of Company Y on January 1, 1996. County B issues bonds in the principal amount of $15M for the benefit of Company Z on June 1, 1996. Company Y owns 100 percent of the outstanding stock of Company Z. The issuance of the $15M bonds for Company Z violates the $40M limitation of IRC § 144(a)(10.)

Is this a deliberate action as described in Treas. Reg. § 1.141-2(d)(3)?

Why or why not?

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Exercise 2-A

City B issues bonds to finance the purchase of land. On the issue date, City B reasonably expects that the land will be used for governmental purposes throughout the life of the bonds. Three years later, City B decides that this land will not be suitable for its intended purposes, and sells the land to an unrelated private developer at fair market value. The disposition proceeds are invested pending the first call date, which is 2 years after the sale date. At the time of deposit, the city had no plans to begin another project. The debt service on the bonds continues to be paid out of the city's general fund.

Does the sale of the property constitute a deliberate action?

If the sale is a deliberate action, has the city taken proper remedial action to save the tax-exempt status of the bonds?

If not, what effect will the deliberate action have on the bonds?

Continued on next page

Exercise 2-B

City B issues bonds to finance the purchase of land. On the issue date, City B reasonably expects that the land will be used for governmental purposes throughout the life of the bonds. Three years later, City B decides that this land will not be suitable for its intended purposes, and sells the land to an unrelated private developer at fair market value. The disposition proceeds are invested pending the first call date, which is 2 years after the sale date. At the time of deposit, the city had no plans to begin another project. The debt service on the bonds continues to be paid out of the city's general fund.

Does the sale of the property constitute a deliberate action?

If the sale is a deliberate action, has the city taken proper remedial action to save the tax-exempt status of the bonds?

If not, what effect will the deliberate action have on the bonds?

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Exercises, Continued

Exercise 3

On June 1, 1997, City C issues 30-year bonds with an issue price of $10M to finance the construction of a hospital building. The bonds have a weighted average maturity that does not exceed 120 percent of the reasonably expected economic life of the building. On the issue date, C reasonably expects that it will be the only user of the building for the entire term of the bonds. Six years after the issue date, C sells the building to Corporation Y for $5M. The fair market value of the building at the time of the sale is $6M. C uses all of the sale proceeds to immediately retire a pro rata portion of the bonds.

Has C met all of the requirements for proper remedial action?

Why or why not?

Continued on next page

Exercise 4

On June 1, 1987, County M issues $70M of 20-year bonds, the proceeds of which are used to build a county administration building. The bonds have a weighted average maturity that does not exceed 120 percent of the reasonably expected economic life of the building. On the issue date, County M reasonably expects that it will be the only user of the building for the entire term of the bonds. After 10 years, the county decides that the building is too small and agrees to sell it at fair market value to an unrelated non-governmental person. Part of the disposition proceeds are placed into a defeasance escrow account which will pay debt service on the bonds until redemption in 1999. The remainder of the proceeds are used to begin construction of a new administration building.

Has the county taken proper remedial action to prevent the bonds from becoming taxable? Explain your answer.

Is the county subject to the change in use rules of IRC § 150(b)? Why or why not?

Is the new owner subject to the change in use rules of IRC § 150(b)? Why or why not?

Continued on next page

Exercises, Continued

Exercise 5

On May 1, 1990, County K issues $40M bonds, the proceeds of which are loaned to Hospital L. The hospital uses the bond proceeds to construct an adjacent medical office building. On the issuance date, the bonds are qualified 501(c)(3) bonds. Upon examination by the Internal Revenue Service in August 1997, it is determined that over 5 percent of the office building is used by commercial enterprises unrelated to the hospital's exempt purposes. This use causes the bonds to meet the private business tests. The leases for this unrelated use are dated January 1, 1997.

Are these bonds qualified 501(c)(3) bonds?

If not, what options are available for the county to save the tax-exempt status of the bonds?

Do the change in use rules of IRC § 150(b) apply to the hospital and the lessees?

If the rules apply, explain the effect the rules will have on the hospital and the lessees.

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