M. 501(c)(3) BONDS
A Mini-Text

by
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1. Historical Overview

Historically, any state or local governmental bond was tax exempt. Prior to World War II there was one kind of bond, a government purpose bond, issued by the government and backed by the full faith and credit of the government. Such bonds were as secure as the governments that issued them because they were backed by tax revenues or revenue from other government sources. During World War II the direct link between the government, the purpose of the bond, and the user of the bond proceeds became attenuated. Quasi-governmental authorities (like the New York Port Authority) that could not issue government bonds because they did not have the taxing power to back them up, discovered that investors would buy bonds that were just secured by the revenue generated by the facility being built. These new bonds were called revenue bonds (limited obligation security instruments). Bondholders could no longer look to the taxing power of the issuing governmental unit, only the revenue generated by the facility supported the payments to the bondholders.

In addition, there was another development taking place. A number of states decided to permit their municipalities to issue bonds not for the use of the municipality but for the use of private parties, these were called conduit bonds. It did not take long before revenue bonds and conduit bonds were joined into the type of conduit revenue bonds we have today. In the exempt organization context, a government authority issues bonds the proceeds of which are lent by the government issuer to an exempt organization to construct a facility. The use by the exempt organization of bond proceeds is the conduit aspect. The bondholders will be paid interest from revenue generated by the project, not by the government issuer, this is the revenue aspect.

Postwar changes retained historical governmental use bonds but added governmental bonds issued for the benefit of nongovernmental users and secured only by the revenue generated by the bond financed facility. The risks to the investor are certainly much greater. The risks to the federal government are also much greater. As the tie between the governmental issuer and the user of the bond proceeds weakens, the process becomes more vulnerable to abuse. The rationale

for federal tax exemption on the interest payments received by the bondholders also weakens. During the debates in Congress concerning the Tax Reform Act of 1986, testimony was introduced that for every two dollars that a state saves in interest costs from being able to issue tax exempt bonds, the federal government loses three dollars in revenue.

Tax exempt bonds generally bear a lower interest rate than taxable debt. For example, if a tax exempt bond issued by a city has a 6% interest rate, the comparable taxable debt could be 8%. This 2% difference represents the federal subsidy of the city's bond issue. The Joint Committee on Taxation estimated that the cost of tax-exempt bonds in fiscal 1990 to the federal treasury was $18 billion. Taking advantage of the difference in the interest rates is called "arbitrage". Arbitrage involves bonds which are used directly or indirectly to acquire higher yielding investments or to replace funds which were so used. Arbitrage is a significant area of concern. Arbitrage issues are not discussed in this article; however, further guidance and training will be made available.

Under the Tax Reform Act of 1986, historical government bonds are treated differently than conduit revenue bonds. Conduit revenue bonds are termed "private activity bonds" by the Act. Governmental bonds are tax-exempt, subject to general requirements, and derive their exemption from IRC 103(a). The interest on private activity bonds is only tax exempt if the bond is a "qualified private activity bond" as described in IRC 103(b). ***Governmental bonds are less regulated because the proceeds are used by a governmental unit for governmental purposes, such as schools and roads. Qualified private activity bonds are highly regulated because the proceeds are used by private parties to finance an activity that the governmental unit desires to encourage but is not an essential government activity.***

IRC 150(a) defines bonds to which the tax exemption applies as "any obligation". Therefore, a certificate of participation or other debt instrument may constitute a "tax exempt bond" for purposes of the exemptions of IRC 103(a) or (b). In determining whether a purported bond is an obligation of the issuing authority, the pertinent question to ask is whether a normal debtor-creditor relationship exists. If the relationship exists, the bond is an obligation.

For example, Rev. Rul. 60-179, 1960-1 C.B. 37, illustrates the possible informality of a governmental obligation that is still considered a tax exempt bond. In the ruling interest was paid by the State of Idaho in connection with the construction of a house on state-owned property. The house was used in the

operation of a state institution. Interest was excludable from the gross income of the recipient under IRC 103(a), even though the obligation to pay such interest was evidenced only by an ordinary written agreement of purchase and sale.

2. Overview

Tax exempt bonds represent an area of continuing emphasis by the Service, and in particular, by Exempt Organizations. The 1992 CPE set out the basics regarding Exempt Organization's role, including a discussion of internal revenue law governing tax exempt bonds and guidance for EO specialists.

This year's article focuses on troublesome areas which require a more in depth review. In particular, the article will distinguish the less regulated governmental bonds from private activity bonds, which include qualified 501(c)(3) bonds. It will also look at private business use and the IRC 150 change in use provisions. Questions concerning bonds posed by EO agents will be answered.

Parts 1 and 2 of the article provide an overview of the tax exempt bond provisions. Part 3 of the article discusses governmental bonds and "on behalf of" organizations. Governmental bonds are bonds issued by a governmental unit for governmental purposes such as roads and schools. The government is usually the user of the bond financed facility. The bonds are subject to some, but not all, of the private activity bond provisions. Certain entities can issue their own bonds and those bonds will also be treated as governmental bonds. These organizations are referred to as "on behalf of" organizations because they issue bonds on behalf of a governmental unit. An IRC 501(c)(3) organization may have the ability to issue "on behalf of" bonds. It will be necessary to distinguish those bonds from qualified IRC 501(c)(3) bonds because the rules differ.

Part 4 discusses the difference between governmental bonds and private activity bonds. IRC 141 provides certain tests to determine whether a bond is a governmental bond or a private activity bond. The principal test concerns whether there is private use of a bond financed facility.

Part 5 of the article discusses change in use issues and the legislative history of the IRC 150 provisions. IRC 150 contains two provisions that effect exempt organizations, IRC 150(b)(3) and IRC 150(b)(5). IRC 150(b)(3) concerns use by an entity other than a 501(c)(3) organization or governmental unit of facilities that were financed with qualified 501(c)(3) bonds. The exempt organization will have deemed unrelated business taxable income equal to the fair market rental value of

the portion used by the nonqualified user. IRC 150(b)(5) is a penalty for the sale of a facility financed by qualified 501(c)(3) bonds. The penalty is on the purchaser who is denied a deduction for mortgage or similar payments equal to the interest paid on the bonds.

Allocations are discussed in Part 6 of the article. When bonds have been used to finance a mixed use facility, i.e., use by an exempt organization and a private user, allocations are needed between the private use and the exempt use. In addition, facilities that are financed with tax exempt bond financing and with taxable financing will raise allocation questions.

IRC 145(b) provides that there will be a $150,000,000 cap on qualified 501(c)(3) bonds issued for an IRC 501(c)(3) organization and its related entities. Qualified hospital bonds are excluded from this limitation. Part 7 of the article discusses IRC 145(b).

IRC 145(d) contains the rules for qualified 501(c)(3) bonds that are issued to build residential rental units. The section provides that bonds issued for residential rental units will not be tax exempt unless the units are either new, meet the requirements of IRC 142(d) for low income housing, or the property was substantially rehabilitated. The provisions of this section are discussed at Part 8 of the article.

The tax exempt status of the bonds can be lost under certain circumstances as the bonds mature. Part 9 of the article discusses four situations that effect the tax exempt status of the bonds. This section discusses the restructuring of a public hospital, the sale of a bond financed facility, a bond default, and a change in bond terms.

IRC 147 contains a number of rules that effect the qualification of bonds. Not all of the rules apply to qualified IRC 501(c)(3) bonds. Part 10 of the article discusses the rules of IRC 147(b), the 120% rule and IRC 147(f), the public approval requirement. The purpose of IRC 147(b) is to make sure that the term of the bonds is not longer than is necessary for completion of a facility. For example, it would prevent the purchase of equipment that would be obsolete in three years by the issuance of bonds that would not mature for 20 years. The purpose of IRC 147(f) is to require that the public or public officials approve of all tax exempt bond financing.

IRC 149 contains the reporting requirements. A bond will lose its tax exempt status if the issuer (the governmental unit) fails to report as required. Part 11 contains a discussion of the reporting requirements. Part 12 sets out questions and answers.

3. Governmental Bonds

A. Introduction

In the 1992 CPE text, we stated that the Tax Reform Act of 1986 tightened the rules under IRC 103. IRC 103 provides that the interest earned on certain governmental bonds (not federal) and qualified private activity bonds will not be taxable to the bondholders.

When examining an exempt organization whose facilities have been financed by tax exempt bonds or other types of obligations, it is necessary to determine whether the outstanding obligations are governmental bonds or private activity bonds. This determination is necessary because different rules apply. In particular, the state volume cap does not apply to governmental bonds but the arbitrage rules do. Arbitrage, registration, federal guarantee, authorization and advance refunding rules apply. Governmental bonds are usually obligations issued by the government to finance essential government operations. Private activity bonds are issued by a governmental unit but the proceeds are used by a private user. In the case of qualified 501(c)(3) bonds, the user is a 501(c)(3) organization. To be a "qualified 501(c)(3) bond" so that the interest received by bondholders is deductible from gross income under IRC 103, the bond must meet all of the requirements of IRC 103 and IRC 141 through IRC 150.

The story gets more complicated because governmental bonds can be issued by entities other than a typical governmental entity, such as a city or a county. There are entities that are not governmental units that can issue bonds for their own use. These bonds also may be treated as governmental bonds. This is because under IRC 103(a) gross income does not include interest on any state or local bond. IRC 103(c) defines the term "state or local bond" as any obligation of a State or political subdivision thereof. The regulations interpret these provisions as including obligations issued on behalf of a state or local government.

> Reg. 1.103-1(a) provides that interest upon obligations of a state, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof (hereinafter collectively or individually referred to as "state or

local governmental unit") is not includable in gross income, except as provided under section 103(c) and (d) and the regulations thereunder.

Regs. 1.103-1(b) provides that obligations issued by or on behalf of any State or local governmental unit by constituted authorities empowered to issue such obligations are the obligations of such a unit.

EO specialists need to be aware of these entities because they will be encountered in examining universities, hospitals, and other exempt organizations.

If an organization falls into any of three broad categories based on how closely tied the entity is to a governmental unit, the bonds it issues for itself will be considered governmental bonds. This article will discuss each category in detail but an overview should be helpful.

B. Overview of "On Behalf Of" Organizations

1. Political Subdivisions

In the first category are entities that are considered political subdivisions. The determination of whether an entity is a political subdivision depends on whether it has in significant measure one of the three standard governmental powers. The power to tax, the power of eminent domain, and the police power are normally considered the three standard governmental powers. A university may have been granted significant police power by the state. This power would make the university a political subdivision for IRC 103 purposes and it could issue its own bonds. These bonds would be subject to the rules for essential purpose bonds. Significant police power in the university setting is more than the power to regulate traffic. A power independent of the municipality would be required. For example a university with the power to detain prisoners and turn them over to the municipal police would not have the power to exercise an essential governmental function. Library districts and fire districts are often given the power to tax. However, the power to tax must be actual, more than the ability to certify or request a governmental unit to assess tax, and more than the ability to charge a user fee or service charge.

2. Constituted Authority

The second category of entities having the ability to issue governmental bonds are "constituted authorities", a statutory term. The best example would be a nonprofit organization, created by state statute to be the state housing authority.

This type of entity is tightly controlled by a governmental unit. Usually it is formed by statute rather than merely formed in compliance with a state statute. The board of directors is appointed or controlled by a governmental unit, and the assets of the organization are dedicated to the governmental unit.

3. 63-20 Corporations

The third category contains entities that are normally referred to as 63-20 corporations because Rev. Rul. 63-20, 1963-1 C.B. 24 discusses many of the requirements for these entities. A 63-20 corporation is a nonprofit corporation, it is not created by state statute and its governing board is not controlled by any governmental unit. It could be formed by a group of citizens to achieve a specific objective. In order for it to issue bonds that will be treated as governmental bonds, it must satisfy a number of requirements. The most important requirement is that a governmental unit must have a beneficial interest in the property to be financed. The governmental unit can acquire a beneficial interest by (1) using 95% of the facility, or (2) having the right to pay off the obligations and acquire the facility at any time. In addition, the governmental unit must acquire the property when the obligations are paid off. In order to satisfy the beneficial interest requirement, an organization must have a close tie to the government. One can readily see why beneficial interest is required, because 63-20 corporations are private corporations who issue their own bonds but receive preferential treatment as an issuer of government bonds. If these organization's were not 63-20 corporations, the interest on their bonds would not be tax exempt. They would not satisfy the rules for "qualified 501(c)(3) bonds", because there is no governmental issuer. Rev. Proc. 82-26, 1982-1 C.B. 476, is designed to provide an advance ruling procedure for 63-20 corporations. The revenue procedure is very detailed but it is only utilized in applying for an advance ruling. If an organization does not wish to apply for an advance ruling, it can take the chance that its bonds will be considered essential purpose bonds upon examination.

4. Failed "On Behalf Of" Organizations

If an entity other than a governmental unit issues bonds but the entity does not meet one of the above categories, i.e., a political subdivision, a constituted authority, or a 63-20 corporation, the bonds will not be tax exempt because there was no governmental authority issuing the bonds. The organization will not benefit from lower interest rates. Only a governmental unit or a corporation tightly controlled by a governmental unit can issue bonds that will treated as tax exempt by IRC 103. We will undoubtedly examine cases where the bonds are not issued by

a governmental unit but are issued by an organization claiming to be a political subdivision, a constituted authority, or a 63-20 corporation. The more typical type of bond we will see is a private activity bond. Such bonds may be qualified 501(c)(3) bonds issued by a governmental unit for use by a 501(c)(3) organization. In addition the bonds may be issued by a constituted authority such as a housing authority for use by a 501(c)(3) organization. Although we may see relatively few organizations issuing their own bonds, it is important to be able to identify these situations so that the correct law is applied.

5. First Questions To Ask

The first question to ask when examining an organization that has facilities financed by tax exempt bonds, is who issued the bonds? If the bonds were issued by a governmental unit, were the bonds issued by the governmental unit for its own use or for the use of a beneficiary organization such as a 501(c)(3) organization. If the bonds were issued by a governmental unit for its own use, the tests of IRC 141 must be applied. If the bonds were issued by a governmental unit for use by an IRC 501(c)(3) organization, the rules of IRC 145 should be applied. These rules are discussed in Part 4.B of the article.

If the bonds were issued directly by the organization, it is necessary to determine whether the organization is a political subdivision, a constituted authority, or a 63-20 corporation that is permitted to issue bonds "on behalf of" a governmental entity. If it was permitted to issue bonds on behalf of a governmental entity, the tests of IRC 141 must be applied as if it were a governmental unit. If it was not authorized to issue bonds on behalf of a governmental entity, the bonds would not be tax exempt bonds for purposes of IRC 103.

The following steps may be taken as part of a bond analysis where there is some question about whether the bond is a governmental bond or a qualified 501(c)(3) bond:

1. Determine if the obligations were issued by the organization for its own purposes.

2. If they were, determine if the organization was a political subdivision, a constituted authority, or a 63-20 corporation, which is discussed in detail in this section of the article.

3. If so, determine if the payments made constitute interest on an obligation of a governmental entity.

4. If the payments include interest on the obligations of a governmental entity, apply the private use and security interest test of IRC 141.

5. If the IRC 141 tests are not exceeded (i.e. there is less than 10% nongovernmental use), apply the rules for governmental bonds rather than qualified 501(c)(3) bonds because the bonds are governmental bonds not private activity bonds.

The following portion of this section provides the law and analysis necessary to make the determination whether the bonds or obligations issued by a nongovernmental entity should be treated as governmental bonds. Many examples have been included so that this section may serve as a reference.

C. What is an Obligation?

1. Explanation

Can interest paid on obligations of municipalities which are not in the form of "bonds" be considered tax exempt under IRC 103(a)?

The Code refers to "obligations" rather than bonds. The term "obligations" is much broader than the term "bonds". Under certain circumstances informal documents can give rise to interest that is exempt from tax. The key is whether the document creates an obligation for a governmental unit to pay interest. Obligations entered into by organizations operating "on behalf of" a governmental unit [political subdivisions, constituted authorities, and 63-20 corporations] can also take forms other than as bonds.

Rev. Rul. 60-179, 1960-2, 37, concerns a contract for a house entered into by the Governor of a state. Pursuant to the provision of an authorizing statute, the Governor entered into an agreement with a corporation for the construction of a house on state-owned realty for use by the superintendent of a state institution. Under the agreement, the corporation retains title to the house until all payments are received. The State is bound to make a series of periodic payments, including interest. The ruling states as follows:

> IRC 103 and Regs. 1.103-1 generallyprovide that gross income does not include interest on the obligations of a State. The exemption is not limited to interest on obligations evidenced by some particular form of obligation, such as a conventional bond or promissory note. The exemption is equally applicable to an obligation evidenced by an ordinary written agreement of purchase and sale

> entered into by duly constituted authorities empowered to enter into such an agreement, in which the State or political subdivision agrees to pay interest.

The ruling concluded that the interest paid by the State is excludable from the gross income of the recipient under IRC 103(a), even though the obligation to pay such interest is evidenced only by an ordinary written agreement of purchase and sale. It should be noted that excludable, tax-exempt interest must be paid in the exercise of the government's borrowing power.

2. Examples

A Mortgage

PLR 8937007 concerns a bank which requested a ruling concerning interest paid to it by a district library. The issue to be determined was whether the payment was an obligation of the state. If it was, the bank could exclude the interest it earned. The district library had a contract to build a new library to be paid for by a 20 year mortgage loan through a bank. The district library was formed under the Library Act of a state and approved by a circuit court. The district library levied an annual public library tax. The board of trustees of the library had the power to execute a note secured by a mortgage for the purpose of constructing a new library building. The ruling cites Rev. Rul. 60-179 as follows.

> Rev. Rul. 60-179, 1960-2 C.B. 37, considered whether interest paid by a state in connection with the construction of a house on state-owned property, to be used in the operation of a state institution, was excludable from gross income under section 103 of the Code. The ruling holds that the exemption from gross income provided by section 103 can apply to an ordinary agreement where the state or political subdivision agrees to pay interest.

The first issue to consider is whether the district library is a political subdivision within the meaning of Regs. 1.103-1(b). The analysis, which will be discussed in more detail in the next section, hinges on whether the District has one of the three essential governmental powers, the power to tax, the power of eminent domain, or police power. Since the district had the power to tax, it was concluded that it was a political subdivision. Based on Rev. Rul. 60-179, it was concluded that the obligation to pay a mortgage to the bank resulted in interest paid on an obligation of a political subdivision of the state within the meaning of IRC 103(c)(1).

An Installment Contract

PLR 1034 concerns a city that requested a ruling that interest to be paid by it to the seller of real property will be excludable from the gross income of the seller. A city planned to purchase the property to be used as a fire hall. Part of the purchase price would be paid to the seller in installments of principal plus interest. The payments would be made from property tax revenue and the payments were backed by the full faith and credit of the city. One issue presented by the ruling request is whether interest payments on a sales contract are obligations for purposes of section 103(c). The ruling concludes that they are, relying on the following cases.

> In Stewart v. United States, 739 F. 2d 411 (9th Cir. 1984), the court stated Section 103 of the Internal Revenue Code exempts from income interest paid on the obligations of a State or subdivision. I.R.C. section 103 (1970). Obligations are not limited to bonds or other securities, but may include interest paid under an agreement for the sale of property. Kings County Development Co. v. Commissioner, 93 F. 2d 33 (9th Cir, 1937).

D. Does A Bond Need To Be In Registered Form?

An issue in, PLR 8721034, supra, is whether the obligations need to be in registered form. Registered form requires that the trustee maintain a list of the bondholders. If the bonds were required to be in registered form but were not, the interest earned on them would be taxable.

> Section 149(a)(1) provides that, nothing in section 103(a) or in any other provision of law shall be construed to provide an exemption from Federal income tax for interest on any registration-required bond unless such bond is in registered form.
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> Section 149(a)(2) provides, that, for purposes of paragraph (1), the term registration-required bond means any bond other than a bond which is not of a type offered to the public.

E. Information Reporting

An additional issue in PLR 8721034 is whether the information reporting requirements have been met.

> Section 149(e) provides, in relevant part, that nothing in section 103(a) or any other provisions of law shall be construed to provide an exemption from Federal

income tax for interest on any bond unless such bond satisfies the requirements of paragraph (2).

> (2) INFORMATION REPORTING REQUIREMENTS.-- A bond satisfies the requirements of this paragraph if the issuer submits to the Secretary, not later than the 15th day of the 2d calendar month after the close of the calendar quarter in which the bond is issued (or such later time as the Secretary may prescribe with respect to any portion of the statement), a statement concerning the issue of which the bond is a part which contains --
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> (A) The name and address of the issuer,
>
> (B) The date of the issue, the amount of the net proceeds of the issue, the stated interest rate, term, and face amount of each bond which is part of the issue, the amount of issuance costs of the issue, and the amount of the reserves of the issue,
>
> (E) a description of any property to be financed from the proceeds of such issue.'

The reporting requirements of section 149 are satisfied by the timely filing of Form 8038. The requirements (A), (B), and (E) of IRC 149(e)(2) apply to governmental purpose obligations. There are more detailed requirements contained in sections (C) and (D). Sections (A) through (E), in their entirety apply to qualified private activity bonds. The ruling concludes that the obligations arising from the deed of sale to one individual is not of the type offered to the public for sale, thus registration is not required.

F. Is the Entity a Political Subdivision?

1. Explanation

The determination of whether an entity is a political subdivision depends on what type of governmental powers a governmental unit has permitted it to exercise and what governmental purposes it attempts to achieve. The three fundamental governmental powers are the power to tax, the power of eminent domain, and the police power. A political subdivision need only have one power, but that power must be substantial. The following revenue rulings and private letter rulings demonstrate how the Service analyzes governmental powers in this context.

Rev. Rul. 77-164, 1977-1 C.B. 20, concerns the issue of whether a community development authority qualifies as a political subdivision within the meaning of Regs. 1.103-1(b). Under state law a private developer can petition a county to establish a community development authority for overseeing the orderly development of a new community. The authority can collect service and user fees. It can enter into agreements with the county whereby the county may in its discretion acquire property by eminent domain for the authority, and adopt and enforce rules as to the use of community facilities. The municipal corporation retained full police power. The revenue ruling analyses the facts to determine whether the authority qualifies as a political subdivision.

> Three generally acknowledged sovereign powers of states are the power to tax, the power of eminent domain, and the police power. Estate of Alexander J. Shamberg, 3 T.C. 131 (1944), acq. 1945 C.B. 6, aff'd 144 F. 2d 998 (2d Cir. 1944), 1945 C.B. 335, cert. denied, 323 U.S. 792 (1944). It is not necessary that all three of these powers be delegated. However, possession of only an insubstantial amount of any or all sovereign powers is not sufficient. All of the facts and circumstances must be taken into consideration, including the public purposes of the entity and its control by a government.

The authority's power to impose and collect service and user fees is not analogous to the power to tax, which must be clearly delegated by state statute. The service and user fees are not imposed and collected for the purpose of raising revenues to be used for public or governmental purposes. They are raised for the purpose of benefiting the property owners of one community by increasing the value of their property. The fees are not real property taxes within the meaning of IRC 164. See Rev. Rul. 61-152, 1961-2 C.B. 42, and Rev. Rul. 71-49, 1971-1 C.B. 103, that deal with the definition of taxes.

> M [the authority] is not vested with any power of eminent domain. The authority given to M to enter into agreements with the county that provide for the county acquiring property for M by eminent domain is not analogous to the possession of the power of eminent domain by M.

> Further, M does not possess police power. The legislature of state X had given M only a very limited rule making and enforcement power over the use of community facilities and such power is always subordinate to the police power of a municipal corporation in the case of a conflict.

Thus, the authority was not considered to be a political subdivision within the meaning of Regs. 1.103-1(b).

Rev. Rul. 77-165, 1977-2 C.B. 21, concerns the issue of whether a state university will qualify as a political subdivision within the meaning of Regs. 1.103-1(b). The state university is supported by legislative appropriations. It is authorized to create a police force for the purpose of regulating traffic and it can detain persons until the city police arrive. The state may make limited and specific delegations of the state's power of eminent domain to the university. The revenue ruling contains the same law section as Rev. Rul. 77-164. The analysis is as follows:

> In the instant case, support of U [the state university] by legislative appropriations from state X does not represent the right of U to exercise the power of taxation. The right to exercise the power of eminent domain in specific projects designated by the legislature of state X does not represent a substantial right to exercise the power of eminent domain. Although U has been granted the limited power of regulating traffic within its confines and a limited arrest power, the delegation of these limited powers is not a delegation of a substantial power to U.

Accordingly, since U does not possess a substantial right to exercise the sovereign powers of the state, U does not qualify as a political subdivision within the meaning of section 1.103-1 of the regulations.

2. Examples

A Housing Development

PLR 8630027 concerns the issue of whether a "District" will qualify as a political subdivision within the meaning of Regs. 1.103-1(b). A corporation will develop about 2000 acres as a mixed-use complex of single-family homes, multi-family housing units, schools, recreational facilities, and commercial areas. It will petition to establish a 'Development District'. The District is described as follows.

> The District will be administered by a five-member board of supervisors who will be elected by District landowners [initially the developer only]. The District will have the power to assess and impose ad valorem taxes, benefits taxes, and maintenance taxes upon lands in the District as provided by the Act. The District will also have the power of eminent domain over District property (and over other property with the prior approval, by resolution, of the County or Municipality) for purposes relating solely to District roads, and water and sewage management. Residents of the District remain subject to the powers of taxation and eminent domain exercisable by the Municipality over its residents. The District will have no police power.

The private letter ruling relies on Rev. Rul. 77-165 to reach the conclusion that the District was not a political subdivision. The conclusion was reached because the powers conferred upon the District were insubstantial. The municipality had not given up any of its power to tax, police, or take by eminent domain. This organization's power to tax seems similar to the power held by the organization in Rev. Rul. 77-164. The power to tax for the benefit of property owners is not similar to the power to raise general revenue. The power of eminent domain and the police power were equally limited. The following is the rationale contained in the ruling.

> Applying the above criteria, we have concluded that the District's powers do not represent substantial powers of taxation or eminent domain. In effect here, the District (wholly controlled by the non-exempt corporation) has been delegated no materially greater 'sovereign powers' over District land (the corporation's inventory) than the Corporation inherently will have if the District is never created.
>
> Accordingly, since the District will not possess a substantial right to exercise any of the sovereign powers of a state, it will not qualify as a 'political subdivision of a state' within the meaning of section 1.103-1(b) of the regulations. Therefore, interest paid on obligations to be issued by the District will not be exempt from Federal income tax under section 103(a).

A Nursing Home

PLR 9117066 fits into two categories. It deals with the issue of what is a government obligation for purposes of IRC 103. It also deals with the issue of whether interest paid on the obligation will be considered interest paid by a political subdivision of a state. A District was organized to maintain a nursing home for area residents. It was authorized and approved by the County. It had the power to levy and collect a property tax. It had the power to police its property and to exercise police powers in the enforcement of any rule or regulation provided by the ordinances of the District. The District purchased an existing nursing home, borrowing the money from a bank. The ruling relies on Estate of Shamberg and Rev. Ruls. 77-164 and 77-165 on the issue of what is a political subdivision. It relies on Rev. Rul. 60-179 on the issue of whether the interest arising from an ordinary agreement can be tax exempt. The ruling concludes that the organization is a political subdivision because it had taxing as police power. The conclusion reads as follows.

> Based on the facts submitted and representations made, we conclude that District has sufficient sovereign powers for characterization as a political subdivision

within the meaning of section 103 of the Code. Accordingly, the amounts designated as interest paid to Bank will be considered interest paid on an obligation of a political subdivision of a state within the meaning of section 103(c)(1).

G. Is the Entity a Constituted Authority?

1. Explanation

The concept of a "constituted authority" is derived from Regs. 1.103-1. This type of entity is a nonprofit corporation, (1) it is created by a state statute, and, (2) it is controlled by the state. Do not confuse creation by a state statute with creation under a state statute. If an organization is created by a state statute, it is the organization named in the statute and the statute is its formative document. If an organization is created under a statute, it would be the type of organization contemplated by the statute but would be incorporated under the state incorporation laws. For example, a corporation is organized under state incorporation statutes. It gets its authority to issue bonds from a state statute providing that housing authorities can issue bonds. This is an example of incorporation under a state statute. A statute that provides that XYZ Housing Authority will be created to issue bonds is an example of creation by a state statute.

The following revenue rulings and private letter rulings interpret "constituted authority." The rulings determine when an obligation entered into by a nongovernmental unit can be considered as an obligation of the governmental unit so as to be treated as a governmental bond.

2. Revenue Rulings

Rev. Rul. 57-187

Rev. Rul. 57-187, 1957-1 C.B. 65, concerns the taxability of interest earned on bonds issued by an Industrial Development Board of the State of Alabama. A Board is a nonprofit corporation authorized by the Alabama Code to promote industrial development. A Board is formed after formal approval and certificate of incorporation pursuant to the State statute. It is formed by the governing body of a municipality which also appoints the governing board. The Board's property vests in the municipality upon dissolution. The ruling stated that the bonds were payable solely out of revenues and receipts derived from the leasing or sale by the corporation of its projects. The municipality is not liable for the payment of

principal or interest on any of the bonds of the corporation. Nevertheless, the ruling concluded that the interest on the bonds would be excludable from the gross income of the recipient. The conclusion is based on the State statute and the control exercised by the state.

Rev. Rul. 60-248

Rev. Rul. 60-248, 1960-1, 35, concerns bonds and notes issued by the New York State Housing Finance Agency which was formed by a State statute and was given the authority to issue bonds. The statute provided that the Agency was a public benefit corporation and a corporate governmental agency. The officers were various state officials appointed by the governor and serving at his sufferance. At termination, all of the Agency's rights and property would belong to the State. Its employees were treated as State employees. It could issue bonds that were backed by the State and those that were not. The ruling concluded:

> Accordingly, in view of the responsibility which the State of New York has assumed by reason of its actions and the substantial control which it, in effect, has over the management and operation of the Agency, it is held that the obligations issued by the New York State Housing Finance Agency are considered as issued on behalf of the State by a duly constituted authority empowered to issue such obligations, and the interest received from such obligations is exempt from Federal income tax under the provisions of section 103(a)(1) of the Code.

3. Examples

University with Two Governing Bodies

PLR 8628081 concerns whether bonds issued by a university will be considered to be issued on behalf of a state. The university had been a private institution, but pursuant to specific legislation was incorporated within the state's educational system. By statute, management and administration were allocated between a board of governors and a board of trustees. The central issue is which governing body has control. To be a constituted authority the Board of Governors, which is controlled by the State, must be in control of the university. The board of governors had general supervision. The 13 member board was comprised of the president and the chancellor of the Department of Higher Education. Six members appointed by the governor, and five appointed by the board of trustees. Thus, the governor appointed a controlling interest on the board. The board of trustees is not controlled by the state because the governor appoints only eleven of its 59 members. There is an opinion of the Attorney General that the board of governors

has general supervisory capacity and the board of trustees does not control university policy. The board of trustees had the power to approve the issuance of bonds under certain circumstances.

The ruling cites Rev. Ruls. 57-187 and 60-248 on the issue of whether bonds issued by certain entities are considered issued on behalf of a state or political subdivision. It identifies the following characteristics.

(1) The entities were public corporations authorized by the enabling statutes to promote certain specific activities.

(2) The entities were each controlled by a board of directors, the members of which were elected by the governing body of the state or political subdivision.

(3) The entities had the power to issue bonds in furtherance of their corporate purposes.

(4) The entities were nonprofit corporations, no part of the net earnings of which could inure to the benefit of any private person.

(5) On dissolution of the entities, title to their property was to vest in and become the property of the state or political subdivision that created it.

There are two issues raised relating to whether the university is controlled by the board of governors in a manner sufficient to satisfy the second criteria relating to state control. In the revenue rulings all the members of the governing boards were selected by the governmental unit. One issue is whether the bonds will be considered issued on behalf of a state or political subdivision if the governor just appoints enough members for the political appointees to have control. The ruling concludes that majority control is sufficient, relying on the following case.

> In Philadelphia National Bank v. United States, 666 F. 2d 834 (3d Cir. 1981), cert. den., 102 S. Ct. 2904 (1982), the government successfully contended that Temple University was neither a political subdivision of the state nor a constituted authority because Temple was governed by a privately-controlled board of trustees. Temple was originally founded as a private educational institution. In 1965, Temple was reorganized under state legislation which purported to establish the school as an instrumentality of the Pennsylvania higher education system. Under the legislation, Temple's governing board of trustees consisted of thirty-six regular members, only twelve of whom were appointed by the state. The court held that Temple was not a state agency because the state-appointed trustees constituted a one-third minority of the board, leaving the majority of private trustees with the power to manage and control the university.

The second issue of the private letter ruling is the primary issue. The board of trustees has certain powers and responsibilities concerning the issuance of the bonds but the board of trustees is not controlled by political appointees. If the nonpolitical board of trustees had significant power over the issuance of bonds, the university would not be considered a constituted authority. There would not be significant control by the governmental unit. The following is the analysis of the ruling.

> The first question to consider under the control issue is whether the University's borrowing power is subject to the discretion or supervision of [the board of trustees] a private group rather than under the control of State Y. Because the trustees' function in granting of consent to the issuance of bonds relates solely to their responsibility for trust assets according to the endowment terms, we conclude that the board of governors' borrowing power is not subject to the supervision and control of the board of trustees; rather, the borrowing power may be independently exercised by the board of governors for University purposes. We have also considered the trustee's power to veto the board of governors' selection of University's president and have concluded that this power is subject to standards of reasonableness and is therefore insubstantial for purpose of this ruling request. Therefore, University is a constituted authority, within the meaning of section 1.103-1(b) of the regulations.

A Purchasing Authority

PLR 8649072 concerns a corporation issuing obligations to finance acquisitions of equipment and property to be used solely by the City and other political subdivisions of a State that have become subscribers under the State's Interlocal Cooperation Act. The issue is whether the Authority, created by the City, is similar to the organization described in Rev. Rul. 60-248 even though the obligations are not solely for the benefit of the City. The Authority was created by an ordinance of the City. The governing board was appointed by the City and the City approved the Articles of Incorporation. The assets were dedicated to the City upon dissolution and the Authority's employees were considered employees of the City. The ruling concludes that the corporation was a constituted authority because of the control exercised by the City. The conclusion reads as follows.

> Upon comparison, we have determined that the City's role in the administration of the Agreement and its substantial control over the management and operations of the Authority create a relationship between the City and Authority that is, in material respects, similar to the one existing between the State of New York and

its Housing Finance Agency which was the subject of Revenue Ruling 60-248, 1960-2 C.B. 35.

A Planning Authority

PLR 8906058 concerns an Authority formed to do all acts necessary for the sound planning and development of the County. Members of the authority are appointed by the governor. Initial funding is from state funds and audits are conducted for the benefit of the county. The authority can issue revenue anticipation certificates but can not create a debt against the state. The ruling relies on Rev. Ruls. 57-187 and 60-248 and concludes as follows.

> In this case, the Authority receives its authorization from a specific State law. The Authority's public purpose is the sound planning for, and development of the County. The Authority's emphasis is on attracting new industry, or assisting existing industry to expand in order to create new jobs. The governing body of the Authority is controlled by the governor of the State through appointment of its members. The Authority has the power to acquire hold and dispose of, and lease or make contracts with respect to personal and real property. Further, the Authority has the power to issue revenue anticipation notes.
>
> Thus, based solely on the information submitted, the representations made, and provided no earnings of the Authority inure to the benefit of private persons and that title of all property owned by the Authority reverts to the State upon dissolution of the Authority, we conclude that the Authority is empowered to issue bonds on behalf of the State.

A University Issuing Bonds On Behalf of a State

PLR 8912008 concerns whether bonds issued by a university are issued on behalf of the State for purposes of section IRC 103. The ruling relies on Rev. Rul. 57-187, and concludes as follows.

> Significantly, University was created by act of the State's legislature in 1865 and was formed thereafter. Each member of the Board of Trustees is either nominated or appointed by the State's governing body. The governing body may institute removal proceedings against a trustee. Pursuant to statutory authority, the university may issue bonds in furtherance of the purposes for which is was established. The University is a nonprofit organization and no part of its net earnings may inure to any private person's benefits. Because of the University's state agency status, all property owned by the University would become state property if the University were dissolved. Accordingly, under the situation

presented, University may, for purposes of section 103 of the Code, issue bonds on behalf of the State.

From the above rulings it can be seen that a constituted authority has a close relationship with a governmental unit. It is created by the governmental unit and its governing body is controlled by the governmental unit. Much less control is present with a 63-20 corporation.

H. Is the Entity a 63-20 Corporation?

1. Explanation

Can the interest on bonds issued by a corporation not created by a state statute and controlled by a governmental unit be treated as interest paid on bonds issued on behalf of a governmental unit? The constituted authorities discussed in the prior section were fairly clear cut. It was necessary to look at the enabling legislation and the degree of control exercised by the governmental unit. In this section, the corporations are created under the general not for profit laws and are not controlled by a governmental unit. The obvious question is, why would bonds issued by these entities ever be considered as issued on behalf of a governmental unit. To achieve this treatment, the government either, (1) has to be the user of the facility, or (2) have the ability to purchase the facility at any time by retiring the debt. In addition, (3) the facility must be turned over to the governmental unit when the obligation is satisfied. The use by the government or the government's ability to take over the facility is termed the government's "beneficial interest". The following revenue rulings, revenue procedures, and private letter rulings are intended to provide a working knowledge of this area.

2. Three Key Revenue Rulings

Rev. Rul. 54-296

Rev. Rul. 54-296, 1954-2 C.B. 59, concerns a nonprofit corporation formed by a group of public spirited citizens of a city to provide for a structure suitable for general civic and recreational purposes. The city had not been able to appropriate the funds necessary to convert a municipal structure for this use. The City did not create the organization nor did it control the board. What it did have is control of the assets. It was the organization's sole stockholder. The ruling describes the activities of the organization as follows:

> It is proposed that a nonprofit corporation be formed to effect the desired improvements to the municipally owned property and that all of the capital stock of the corporation be issued to the city of M in exchange for a lease on the property, the lease to provide that at the end of its term or as soon as the indebtedness of the corporation is retired by it, or when the city assumes or discharges the outstanding debt of the corporation, whichever occurs first, the city would then become absolute owner of the improvements.
>
> Under the plan the funds necessary to make the improvements would be borrowed on debenture notes [the obligations] issued by the corporation, secured by a pledge of the net revenues from the rentals of the improved property, and the debt would be liquidated from the proceeds of operations over a period approximately the length of the lease. None of the revenue will ever accrue to the benefit of any person, firm, or corporation, except the city of M, whose only direct benefit would be the value of the improvements.

The revenue ruling concludes that proposed debentures are issued on behalf of the municipality which is the sole stockholder of the corporation. Although the municipality did not control the corporation, its position as sole stockholder gave it control of the assets. The interest paid on the debentures will be exempt from federal income tax.

Rev. Rul. 59-41

Rev. Rul. 59-41, 1959-1 C.B. 13, concerns the issue of whether income earned by a nonprofit corporation organized at the request of a city to finance the acquisition of a system for the supply and distribution of water in and near the city will be subject to federal income tax. In the ruling, the obligations issued by the nonprofit corporation are considered as obligations of the city since (i) none of the net earnings or assets of the corporation inures to any private person, (ii) the city has the right to purchase the system at any time for the outstanding indebtedness of the corporation plus interest, (iii) the city will receive, without demand or further action, fee ownership and immediate exclusive possession of the system when the corporation's debt is paid, (iv) the city has stated its intention to take title at that time, and (v) the city has approved the issuance of the obligations and has the right to make recommendations to the corporation regarding operation of the system. A constituted authority is created and controlled by a governmental unit. This type of control is not required of the 63-20 corporation because the governmental unit has control of the assets.

Rev. Rul. 63-20

Rev. Rul. 63-20, 1963-1 C.B. 24, concerns a general nonprofit corporation that was organized to promote industrial development. Its members were members of the local chambers of commerce and various municipal officials. Upon dissolution, the county would have a beneficial interest in the organizations's assets. Operating funds were contributed by the municipalities, the chambers of commerce, and manufacturing organizations. The organization built a factory and leased it to a manufacturer. The revenue ruling concludes that the corporation could not issue "on behalf of" bonds. In doing so the ruling established the criteria for a successful "on behalf of" corporation, referred to as a 63-20 corporation.

The Criteria

The Internal Revenue Service holds that obligations of a nonprofit corporation organized pursuant to the general nonprofit corporation law of a state will be considered issued on behalf of the state or a political subdivision thereof for the purposes of section 1.103-1 of the Income tax Regulations, provided each of the following requirements is met: (1) The corporation must engage in activities which are essentially public in nature; (2) the corporation must be one which is not organized for profit (except to the extent of retiring indebtedness); (3) the corporate income must not inure to any private person; (4) the state or a political subdivision thereof must have a beneficial interest in the corporation while the indebtedness remains outstanding and it must obtain full legal title to the property of the corporation with respect to which the indebtedness was incurred upon the retirement of such indebtedness; and (5) the corporation must have been approved by the state or a political subdivision therefor, either of which must also have approved the specific obligations issued by the corporation.

Analysis of the Facts

In the instant case, P county does not have a beneficial interest in S corporation during the period the revenue bonds will be outstanding; nor will the county necessarily acquire full legal title to the land and factory upon retirement of the bonds. The articles of incorporation provide only that, upon retirement of any corporate indebtedness, or upon dissolution of the corporation, P county will have a beneficial interest in the assets of the S corporation. Therefore, there will not necessarily be a vesting of full legal title to the land and factory in P county.

Conclusion

Furthermore, while the fact that P county and its participating municipalities are represented among the membership of the S corporation and contribute money to its operations indicates governmental authorization of the corporation and approval of its general objectives, such activities alone are not deemed to constitute approval of the specific bonds issued by the S corporation.

> Upon the circumstances in the instant case, it is held that the revenue bonds issued by the S corporation are not issued on behalf of a political subdivision within the meaning of section 1.103-1 of the regulations. Therefore, the interest received on the bonds will be included in the gross income of the bondholders under the provisions of section 61(a)(4) of the Code.

To explain what is intended by the requirement that the municipality have a beneficial interest in the nonprofit corporation prior to the retirement of the debt the ruling cites Rev. Rul. 54-296, supra. The beneficial interest of the municipality consisted of its ownership of all of the stock of the nonprofit corporation and its right under the lease at any time to acquire the improvements by discharging the corporation's indebtedness. The ruling also cites Rev. Rul. 59-41, supra, in which the municipality's beneficial interest consisted of its contractual right to purchase the water system at any time for an amount equal to the indebtedness then outstanding with interest.

It also distinguishes Rev. Ruls. 57-187, supra, and 60-248, supra. In each ruling there was a special statute creating the organization while in this case the organization was not created by a special statute.

3. An Advance Ruling Procedure

Rev. Proc. 82-26, 1982-1 C.B. 476, was issued in order to set forth the circumstances under which the Service will issue advance rulings that obligations issued by a corporation organized under the general nonprofit corporation law of a state will be considered obligations of a state or a political subdivision. It is not intended to add new law, but to explain and consolidate prior Service positions. In large measure, it builds on Rev. Rul. 63-20. Organizations do not have to follow Rev. Proc. 82-26 unless they want an advance ruling. An organization can consider itself a 63-20 corporation but it would run the risk of having the bonds disqualified if examination disclosed that it did not qualify. The following is an outline of, Section 3 - General Operating Rules, the significant elements of the procedure.

Section 3

The Service will ordinarily rule that obligations issued by a nonprofit corporation are issued on behalf of a governmental unit if the following requirements are met.

.01 Its activities are essentially public in nature. Defined as follows:

1 activities and purposes permitted under nonprofit corporation law, and

2 property to be financed is located within the geographical boundaries or as a substantial connection with the governmental unit.

.02 The corporation must not be organized for profit. This requirement is met if the corporation is formed under state law and the articles indicate that it is not organized for profit.

.03 The articles must provide that there can be no inurement and there must actually be no inurement.

.04 The government must have a beneficial interest in the corporation while the bonds are outstanding. [The requirements for this provision are very detailed.]

1(a) In general, the governmental unit has exclusive beneficial possession and use of a portion of the property financed equivalent to 95% or more of the fair market rental value for the life of the obligations, or

1(b) A nonprofit corporation has exclusive beneficial possession and use equal to 95% of the fair market rental value of the bond financed property and (A) it appoints at least 80% of the Board of the corporation and (B) it has the power to remove members of the Board for cause, or

1(c) By placing into escrow an amount that will be sufficient to defease the obligations and paying reasonable costs incident to the defeasance, the government unit has the right at anytime to obtain unencumbered fee title and exclusive possession of the property. [Defeasance is the ending of a property interest expressed in a deed or other instrument.] 2 In the event the corporation defaults, the government unit has an exclusive option (at least 90 days) to purchase the property.

.05 The governmental unit must obtain full legal title to the property upon retirement of the indebtedness.

1 The obligations are issued on behalf of only one governmental unit and unencumbered fee title to the property will vest solely in the governmental unit, and

2 In general, all original proceeds and investment proceeds are used to provide tangible real or personal property. This is to prevent the financing of working capital. If the proceeds of obligations issued by a nonprofit corporation are used to acquire property from a charitable organization and the corporation subsequently leases the property back to the charitable organization, the proceeds are not used to provide tangible property.

3 In addition, the governmental unit obtains upon discharge of the obligations unencumbered fee title and exclusive possession and use of the property without further demand or further action on its part. For example, all leases, management contracts, and other similar encumbrances must terminate upon discharge of the obligations, and

4 Before the obligations are issued, the governmental unit adopts a resolution stating that it will accept title to the property, and

5 In general, the indenture or other documents under which the obligations used to originally provide the property provide that any other obligations issued by the nonprofit corporation whether to make improvements or to refund a prior issue will be discharged no later than the latest maturity date of the original obligations, and

6 The proceeds of fire or other casualty insurance received, will, subject to the claims of the holders of the obligations be used to reconstruct the property or be remitted to the governmental unit, and

7 A reasonable estimate of the fair market value of the property on the latest maturity date of the obligations is equal to at least 20 percent of the original cost of the property.

.06 The governmental unit must approve both the nonprofit corporation and specific obligations to be issued by the corporation.

Section 4 contains special rules for refunding issues.

4. Examples of Rev. Proc. 82-26

Constructing a University Parking Garage

PLR 8618022 concerns a foundation organized for charitable and educational purposes to support the activities of a university. Its Articles of Incorporation provide that it is not organized for pecuniary profit and that upon dissolution, its property vests in the trustees of the university. The university is a land grant college that holds a ruling stating that it is a political subdivision within the meaning of Regs. 1.103-1(b). The university is engaged in a long range parking improvement program. The foundation has purchased property for this purpose and proposes to build Parking Garage VI with borrowed funds. It will lease the facility to the university for the university's sole use. The ruling determined whether bonds issued by the foundation itself can be considered essential purpose bonds. If the bonds are not essential purpose bonds, the interest would be taxable.

The foundation will lease the facility to the trustees of the university. The rental payments received from the university will pay off the principal and interest on the loan. During the term of the lease, the trustees will have exclusive beneficial use of the facility. The lease agreement provides that the foundation will convey to the trustees all of the leased premises upon expiration of the term of the lease.

The private letter ruling cites Rev. Ruls. 54-296, 63-20 and Rev. Proc. 82-26 and concludes as follows.

> Based on the information submitted, we find that the Foundation is a nonprofit corporation organized to promote educational purposes in connection with the University by construction of education facilities for the use of the University. Also, the Foundation's Articles of Incorporation provide that the Foundation is not organized and shall not be conducted for pecuniary profit. Upon dissolution of the Foundation, all of its property shall vest immediately and absolutely in the Trustees of the University.
>
> During the term of the Lease-Purchase Agreement the University will have exclusive beneficial use and possession of the entire Parking Garage VI. Additionally, the University will obtain full legal title to Parking Garage VI upon retirement of the indebtedness. Based upon the facts submitted and representations made we find that the requirements of Rev. Proc. 82-26, 1982-1 C.B. 476 have been complied with. Therefore, we conclude that the obligations proposed to be issued by the Foundation will be considered obligations of the University, a political subdivision within the meaning of section 103(a)(1).

This ruling presents an interesting combination of entities permitted to issue governmental bonds. The university has the authority to issue governmental bonds because it is considered a political subdivision, based on its ability to exercise essential governmental powers. Because the university has the ability to issue essential purpose obligations, it can vest that authority in a 63-20 corporation. But, the corporation must meet the requirements of Rev. Rul. 63-20. In this case, the organization has requested an advance ruling under the procedures of Rev. Proc. 82-26. It would be useful for this discussion to analyze the facts within the framework of Rev. Proc. 82-26. Keep in mind, that this organization gets its bond issuing authority not from a governmental unit directly. It gets its authority from the university because of its political subdivision status.

Section 3.01 requires that the activities of the foundation be essentially public in nature. This test is met by looking at the purposes in the Articles of Incorporation and by determining whether the project will be located in

geographical boundaries of the governmental unit. The organization was organized for generally charitable and educational purposes and had operated for the benefit of a state university. General charitable purposes are sufficient to meet this requirement. The geographic locale requirement has clearly been met as the facility is on the grounds of the university.

Section 3.02 requires that the corporation not be organized for profit. The foundation meets this requirement by virtue of its Articles of Incorporation stating that it is nonprofit.

Section 3.03 requires that the Articles provide that there will be no inurement and there actually is no inurement. The foundation's Articles are in compliance. The ruling does not discuss actual inurement, but there is no evidence that inurement existed. Upon examination, it would be important to determine whether inurement actually existed.

Section 3.04 requires that the government must have a beneficial interest in the corporation while the bonds are outstanding. The foundation will lease the entire facility to the university. Thus the governmental unit will have exclusive beneficial possession and use of a portion of the property financed equivalent to more than 95% of the fair market rental value, which is one way of establishing beneficial interest.

Section 3.05 contains seven criteria concerning whether the governmental unit can obtain full legal title to the property upon retirement of the indebtedness.

> Section 3.05(1) is met because the obligations are issued on behalf of only one governmental unit and unencumbered fee title to the property will vest solely in that unit.
>
> Section 3.05(2) is met because the original proceeds of the loan will be used to acquire tangible property. Section 3.05(2) discusses a situation where property is purchased from a charitable corporation and than leased back to it. This situation is not present here, because the foundation purchased the property from a third party.
>
> Section 3.05(3) is met because the university will obtain unencumbered fee title and exclusive possession and use of the property without further demand. When the indebtedness has been retired, the university will receive the fee interest in the property under the terms of the lease. This section also requires that all encumbrances be retired, such as leases and management agreements. There is no evidence here of any encumbrances.

> Section 3.05(4) requires that before the obligations are issued the governmental unit adopts a resolution stating that it will accept title to the property. The ruling does not speak to this issue, but the University has signed the lease. The lease contains a provision which transfers the property to the University upon satisfaction of the obligation.
>
> Section 3.05(5) requires that any other obligations issued by the nonprofit corporation must be discharged no later than the latest maturity date of the original obligations. The facts do not disclose whether this requirement was met.
>
> Section 3.05(6) concerns the use of insurance proceeds. The facts do not disclose whether this requirement was met.
>
> Section 3.05(7) requires that a reasonable estimate of the fair market value of the property on the latest maturity date of the obligations is equal to at least 20 percent of the original cost of the property. The private letter ruling does not address this issue.

Section 3.06 contains the governmental approval requirement. The ruling does not specifically address this issue. But as the project was instigated at the behest of the University, it is apparent that this requirement has been met.

Purchasing Food Service Equipment for a University

PLR 8643050 concerns another organization formed to assist a university. N, provides the campus book store and food service for the university. N proposed to issue bonds to purchase equipment for the food service. The ruling letter indicates that the facts are as follows:

> The Articles of Incorporation of N in effect provide that corporate income will not inure to any private person, and you have specifically represented that in fact corporate income does not inure to any private person.
>
> The facilities are the property of the State, and improvements (including equipment) become the property of the State as they are constructed or installed. N operates the facilities under an agreement with the State. According to the terms of the amended Agreement, State will have the right at any time to obtain unencumbered fee title and exclusive possession of property financed by bond proceeds by (1) placing into escrow an amount that will be sufficient to defease the obligations, and (2) paying reasonable costs incident to the defeasance. If the state exercises this right, N must immediately cancel all encumbrances on the property. The State, at any time before it defeases the obligations, may not agree or otherwise be obligated to convey any interest in the property to any person for

any period extending beyond or beginning after the State defeases the obligations. In addition, at any time before the defeasance, the State will not agree or otherwise be obligated to convey a fee interest in the property within 90 days after the State defeases the obligations to any person who was a user of the property (or a related person) before the defeasance.

Should N default in its payments on the obligations, the State has an exclusive option to purchase the property financed by the obligations (and additions) for the amount of outstanding indebtedness and accrued interest to the date of default. The State shall have (a) not less than 90 days from the date it is notified by N of the default in which to exercise the option, and (b) not less than 90 days from the date it exercise the option to purchase the property.

You represent that the obligations will be issued on behalf of no more than one governmental unit; that without demand or further action on the part of the State unencumbered fee title to the property will vest solely in the State when the obligations are discharged; and that all of the original proceeds and investment proceeds of the obligations will be used to provide tangible real or tangible personal property or a reasonably required reserve. Before the obligations are issued, the State will adopt a resolution stating that it will accept title to the property financed by the obligations, including any additions, when the obligations are discharged. You represent further that there are no outstanding obligations relating to the facilities to be remodeled and re-equipped, and that should N issue any obligations in the future the maturity date of such obligations will not extend beyond the latest maturity date for the proposed obligations. In addition, you represent that the proceeds of fire or other casualty insurance policies received in connection with damage to or destruction of the property financed by the claims of the holders of the obligations, be used to reconstruct the property, regardless of whether the insurance proceeds are sufficient to pay for the reconstruction; and that (a) a reasonable estimate of the fair market value of the property on the latest maturity date of the obligations will be equal to at least 20 percent of the original cost of the financed property, and (b) a reasonable estimate of the remaining useful life of the property on the latest maturity date will be the longer of one year or 20 percent of the originally estimated life of the financed property, or N will be required to replace the property financed by the obligations with property meeting the requirements of (a) and (b) of this paragraph.

The ruling concludes that the organization complies with the advance ruling requirements of Rev. Proc. 82-26 provided that the university passes a resolution approving of the bonds. The ruling does not contain a detailed analysis but provides the facts necessary for an analysis to be made. The discussion of the previous private letter ruling illustrated an analysis of the facts according to Rev. Proc. 82-26. Why not try a small quiz. Please analyze the above facts for their compliance with Rev. Proc. 82-26 and test your knowledge with the authors' answers included below.

A Quiz

The Questions

Section 3.01 requires that the activities of the corporation be essentially public in nature. How has this requirement been met? Has the geographic locale requirement been met?

Section 3.02 requires that the corporation not be organized for profit. How has this requirement been met?

Section 3.03 requires that the Articles provide that there will be no inurement and there actually is no inurement. How has this requirement been met?

Section 3.04 requires that the government must have a beneficial interest in the corporation while the bonds are outstanding. How has this requirement been met?

Section 3.05 contains seven criteria concerning whether the governmental unit can obtain full legal title to the property upon retirement of the indebtedness.

Section 3.05(1) requires that the obligations are issued on behalf of only one governmental unit and unencumbered fee title to the property will vest solely in that unit. How has this requirement been met?

Section 3.05(2) requires that the original proceeds of the loan be used to acquire tangible property. How has this requirement been met?

Section 3.05(3) requires that the governmental unit obtain unencumbered fee title and exclusive possession and use of the property without further demand. How has this requirement been met?

Section 3.05(4) requires that before the obligations are issued the governmental unit adopt a resolution stating that it will accept title to the property. How has this requirement been met?

Section 3.05(5) requires that any other obligations issued by the nonprofit corporation must be discharged no later than the latest maturity date of the original obligations. How has this requirement been met?

Section 3.05(6) concerns the use of insurance proceeds. How has this requirement been met?

Section 3.05(7) requires that a reasonable estimate of the fair market value of the property on the latest maturity date of the obligations is equal to at least 20 percent of the original cost of the property. How has this requirement been met?

Section 3.06 contains the governmental approval requirement. How has this requirement been met?

The Answer

The ruling presents the facts necessary to perform the Rev. Proc. 82-26 analysis. If an organization is claiming on examination to be a 63-20 corporation, the analysis in Rev. Proc. 82-26 should be performed to determine if a valid 63-20 corporation exists. The EO specialist should solicit the information necessary to complete an analysis similar to the one just performed. The following is the authors' analysis of the facts of PLR 8643050. When analyzing this case, it is important to consider its similarities and differences to the previous ruling, PLR 8618022. The facts of the two rulings are almost identical except for one major difference. In PLR 8618022, the proposed 63-20 corporation received its authority from the university. That was only possible because the university had been held to be a political subdivision. In this private letter ruling, the proposed 63-20 corporation has to take its authority from the state. Its university apparently was not a political subdivision. Keep in mind that an entity does not have to receive a ruling from the Service that it is a political subdivision. It would need to be examined to determine if it had essential governmental powers.

How does the following analysis differ from the readers?

Section 3.01 requires that N's activities be essentially public in nature. This test is met by looking at the purposes in the Articles of Incorporation and by determining whether the project will be located in geographical boundaries of the governmental unit. The ruling indicates that N was organized to "promote, and assist in the carrying out, the educational services of the University." These specific purposes are sufficient to meet the public purpose requirement. The geographic locale requirement has clearly been met as the geographic locale is the state and the equipment will be used on the grounds of the state university.

Section 3.02 requires that the corporation not be organized for profit. The foundation meets this requirement by virtue of its incorporation under the general nonprofit corporation law.

Section 3.03 requires that the Articles provide that there will be no inurement and there actually is no inurement. N's Articles are in compliance. The ruling accepts representations that there is no evidence of inurement. Upon examination, actual inurement would have to be considered.

Section 3.04 requires that the government must have a beneficial interest in the corporation while the bonds are outstanding. In the prior rulings discussed, beneficial interest was demonstrated by use by the governmental unit. The alternative method is demonstrated here. The state will have the right at any time to obtain unencumbered fee title and exclusive possession of the property financed by bond proceeds by (placing into escrow an amount that will be sufficient to defease the obligations, and (paying reasonable costs incident to the defeasance). This option was chosen because N will be the user of the financed equipment.

Section 3.05 contains seven criteria concerning whether the governmental unit can obtain full legal title to the property upon retirement of the indebtedness.

Section 3.05(1) is met because the obligations are issued on behalf of only one governmental unit and unencumbered fee title to the property will vest solely in that unit.

Section 3.05(2) is met because the original proceeds of the loan will be used to acquire tangible property.

Section 3.05(3) is met because the state will obtain unencumbered fee title and exclusive possession and use of the property without further demand. This section also requires that all encumbrances be retired, such as leases and management agreements. N has agreed to this provision.

Section 3.05(4) requires that before the obligations are issued the governmental unit adopts a resolution stating that it will accept title to the property. The state had not adopted a resolution to this effect but the ruling is issued based on the understanding that it will.

Section 3.05(5) requires that any other obligations issued by the nonprofit corporation must be discharged no later than the latest maturity date of the original obligations. N has agreed to this condition.

Section 3.05(6) concerns the use of insurance proceeds. N has agreed to use all insurance proceeds to rebuild.

> Section 3.05(7) requires that a reasonable estimate of the fair market value of the property on the latest maturity date of the obligations is equal to at least 20 percent of the original cost of the property. N has agreed to this and has agreed to replace property if its useful life turns out to be less than the 20 percent.

Section 3.06 contains the governmental approval requirement. The governmental approval requirement was made a condition of the ruling.

There may be other entities, not neatly fitting into these categories that may be integral parts of a government or "on behalf of" issuers. The powers of each entity will have to be examined.

4. Governmental Bonds vs. Private Activity Bonds

A. Introduction

After determining whether a bond has been issued by a valid governmental issuer, i.e., a governmental unit, a political subdivision, a constituted authority, or a 63-20 corporation, it is necessary to apply the private business use test under IRC 141. The private use test has two components - the private use test and the security interest test. Meeting both tests has a negative result. Both tests must be met in order for the private use test to be met and the bonds to be considered private activity bonds. As a short hand, we often refer to meeting the private use test as if it was the sole determinative. The security interest test cannot be forgotten. Generally, not more than 10% private use is permitted. If a bond or obligation exceeds this test limit, and it meets the security interest test, it is considered a private activity bond rather than a governmental bond. The bond's tax exempt status would then depend on whether it is a "qualified" private activity bond. One type of "qualified" private activity bond is a qualified 501(c)(3) bond issued by a governmental unit on behalf of an IRC 501(c)(3) beneficiary. However, a qualified 501(c)(3) bond is subject to a private use limitation under IRC 145. Generally, not more than 5% private use is permitted. If private use exceeds this test limit, the interest received by the bondholders is not excludable. This is because the bonds are not qualified private activity bonds within the meaning of IRC 103(b).

This article discusses a number of private letter rulings. Both pre-1986 and post-1986 law will be discussed. The concept of private use was in the Code prior to 1986. But prior to 1986, a bond would be considered an industrial development

bond [interest would not be deductible by the bondholders] if more than 25% of the facility was utilized for a private use.

IRC 103 was amended and IRC 141 through 150 were added to the Code by the Tax Reform Act of 1986 (H.R. 3838, 99th Cong. Public Law 99-514) to govern tax exemption for interest on certain bonds by replacing the industrial development bond provisions of former section 103(b).

The Conference Report to Accompany H.R. 3838, No. 98-841, 99th Cong. 2d Sess. II-1 (1986) 1986-3 C.B. 687, states the following:

> The conference agreement generally retains the present-law rules under which use by persons other than governmental units is determined for purposes of the trade or business use test. Thus, as under present law, the use of bond-financed property is treated as use of bond proceeds.

B. Private Business Use Test For Governmental Bonds

The initial distinction to be made is between governmental bonds and private activity bonds. The purpose of IRC 141 is to make this distinction. IRC 141 contains several tests. It is easiest to think of the tests as two main tests. One test is the private use/security interest test. The other test is the private loan financing test. If the bond meets both tests, it is a private activity bond. Although this section speaks in terms of "meeting a test", in this case meeting these tests has a negative consequence. If the tests are met, the bond is not a liberally treated governmental bond. It is a potentially taxable private activity bond. For the purpose of understanding the statutory framework, an understanding of these tests is necessary. But in practical terms, most of the bonds reviewed by EO specialists are clearly private activity bonds because they "meet" these tests.

1. Private Business Use Test

a. In General

As the term "private activity bond" implies, we are testing for private business use. Private business use is use of the proceeds by anyone other than the government. An IRC 501(c)(3) organization is considered nongovernmental and its use of the proceeds is a private business use. It is easy to see that a bond issued by a municipal issuing authority on behalf of an IRC 501(c)(3) beneficiary would involve private use. The IRC 501(c)(3) organization is the user. In this situation,

the bond may be a qualified private activity bond (if the other tests are met). The interest would not be excluded unless all applicable rules of IRC 141 through IRC 150 are complied with. A bond will be deemed a private activity bond if all of the following tests are met.

b. Private Business Use Test and Private Security Test

IRC 141(b)(1) provides that the bond will be a private activity bond if more than 10% of the proceeds are used for a private business purpose and 10% or more of the bond debt service is derived from private business use and is secured by privately used property. The private security test is discussed at Section 4(F) of this article. Thus, when the government is using more than 90% of the proceeds for its own purposes and more than 90% of the debt is serviced by government income and secured by government property, the bonds are not private activity bonds. Any IRC 501(c)(3) bond should be a private activity bond because use by a 501(c)(3) organization is private business use. In addition, the debt is serviced by the income from the property. Thus any bond issued for an IRC 501(c)(3) organization is most likely a private activity bond. An exception to the rule is where a 501(c)(3) organization is the bond issuer and it is acting in a quasi-governmental capacity as a constituted authority or a 63-20 corporation. These types of entities are also subject to the IRC 141 tests just discussed.

c. 5% Reduction for Use Unrelated to the Purpose of the Bond

IRC 141(b)(3)focuses on the 10%that can be private business use. If the private business use is not related to the purpose for which the bonds were issued, no more than 5% of the proceeds may be devoted to such unrelated private business use. To be a governmental bond, only 5% can be truly unrelated to the governmental purpose. For example, assume 90% of the bond proceeds went to pay for public schools. It appears that 10% of the proceeds could be used to fund a new kitchen for the private contractor that provides meals to the schools. That would be a 10% private business use, but it would be related to providing a school facility which is the purpose for which the bond was issued. Keep in mind that if over 10% went for this admittedly related use, the bonds would be private activity bonds because the private business use test would be met. While 141(b)(3) uses the term "related", it means related to the purpose for which the bonds were issued. If 10% of the school bond issue were used to provide a loan to a minority business person to establish a radio station, that would also be a private business use. It would be unrelated to the school purpose of the bond and it would be more than

5%. The bond would be a private activity bond (provided the other test was met) rather than a governmental bond.

d. Use in a Trade or Business

IRC 141(b)(6) defines "private business use" as any use (direct or indirect) in a trade or business carried on by any person other than a governmental unit. The section indicates further that any activity of any person other than a natural person [an individual] is to be treated as a trade or business. This additional definition should simplify the task of determining private use. It is not necessary to determine whether any entity other than an individual is engaged in a trade or business because use by any entity other than an individual is considered use in a trade or business.

e. Use by the General Public

Use can result from ownership of a financed property, actual or beneficial. All contracts must be examined to determine who is the actual owner of the facility. Use by a private person of a bond financed facility will not be considered "private business use" if the use is the same as the use by the general public. An example would be a bond financed road that goes past a particular manufacturing plant. While the manufacturing plant is a significant user of the road, the road is also used by the general public as the road goes to places other than the manufacturing plant. The use by the manufacturing plant would not make the bonds private activity bonds because the use is the same as the use by the general public. The result would be different if the road terminated at the manufacturing plant and there was no general public use. If there is private business use by more than one party, the use should be aggregated. If one private user creates 3% private business use and another user creates 8% private business use, private business use equals 11%.

2. Private Loan Financing Test

If the lesser of 5% of the bond proceeds or $5,000,000 is used for loans to nongovernmental entities, the bonds are private activity bonds. This is an attempt to curtail government loans to individuals. Almost all IRC 501(c)(3) bonds would meet this test because a nongovernmental entity, an IRC 501(c)(3) organization, would be loaned money from the bond proceeds.

3. A Simple Formula

90% Government Use + Not More Than 10% Private Business Use (With the 5% Unrelated Ceiling) = Essential Purpose Bond

C. Private Use Test for Qualified 501(c)(3) Bonds

1. In General

The formula confirms that a bond issued on behalf of an IRC 501(c)(3) organization is a private activity bond because the IRC 501(c)(3) organization is considered a private user. The interest on the private activity bonds is not tax exempt unless the bond is "qualified". Qualification for 501(c)(3) bonds is initially derived from IRC 145 although there are other requirements which must be met for the interest to be excluded and for penalties to be avoided. ***IRC 145(a) treats a private activity bond as a qualified 501(c)(3) bond if all property which is provided by the net proceeds is owned by an IRC 501(c)(3) organization or a governmental unit, and the IRC 501(c)(3) organization is substituted for the government in testing for private business use and not more than 5% of the net bond proceeds go to 1) private business use, or 2) for an unrelated trade or business use described in IRC 513(a).*** **In addition, there is a private security test that must also be satisfied**. If 5% or more of the bond debt service is derived from private business use or is secured by privately used property, the bonds will not qualify. The first step is to look at the private loan financing test of IRC 141. If the bond meets that test, the 5% tests of IRC 145 are used in place of the 10% tests of IRC 141.

2. Three Alternatives to IRC 145

Governmental Hospitals and Universities

If an entity is exempt under IRC 501(c)(3) and is also considered an instrumentality of the state, it may utilize "qualified 501(c)(3) bonds" by having a governmental authority issue bonds on its behalf, or it may issue bonds itself, as it would be considered a political subdivision capable of issuing bonds "on behalf of" a governmental authority. The following excerpt from the legislative history makes this point.

> The conferees further are aware that certain State or local governmental universities and hospitals (including certain public benefit corporation) also have received determination letters regarding their tax-exempt status under Code

> section 501(c)(3). The committee intends that, to the extent that such an entity is a governmental unit or an agency or instrumentality of a governmental unit (determined as under present law), bonds for the entity will be treated as governmental bonds rather than as qualified 501(c)(3) bonds. See Conference Rept. H.R. No. 99-841, to accompany H.R. 3838, 99th Cong. 2d Sess. II-725-728, (1986), 1986-3 (Vol. 4 C.B. 725-728).

Qualification as Other Type of Private Activity Bonds

"Qualified 501(c)(3) bonds" are not the only type of qualified private activity bonds that can be used to finance the activities of an IRC 501(c)(3) organization. Any other type of qualified private activity bond can be utilized provided that its requirements are met. In particular, residential rental property bonds may be encountered. However, qualified 501(c)(3) bonds are particularly attractive because they are not subject to the state volume cap and the alternative minimum tax. The following excerpt is from the legislative history.

> Additionally, the conference agreement permits section 501(c)(3) organizations to elect not to treat such bonds as qualified 501(c)(3) bonds, and to benefit thereby from exempt-facility bonds and qualified redevelopment bond financing, provided that financing is subject to the new State private activity bond volume limitations. For example, a section 501(c)(3) organization may participate in a multifamily residential rental project financed with bonds subject to the State volume limitations by making such an election. See Conference Rept. H.R. No. 99-841, to accompany H.R. 3838, 99th Cong. 2d Sess. II-725-728, (1986), 1986-3 (Vol. 4 C.B. 725-728).

Constituted Authority or 63-20 Corporation

An IRC 501(c)(3) organization can be a constituted authority or a 63-20 corporation. As previously discussed, these entities can issue their own bonds that are treated as if they were issued by a governmental authority.

3. Difference Between IRC 141 and IRC 145 Private Use Tests

The private business use test of IRC 141 and the private business test of IRC 145 differ in one material aspect. The 10% test of IRC 141 is calculated on 10% of "proceeds". The 5% test of IRC 145 is calculated on 5% of "net proceeds". The IRC 145 test is thus calculated on a smaller amount. The debt-service reserve fund, which is normally 10%, is subtracted to reach net proceeds. Also, keep in mind that issuance costs must be paid out of the 5% permitted private use.

4. A Simple Formula

501(c)(3) or governmental ownership of the facility + 95% 501(c)(3) Use + No More than 5% Private or Unrelated Business Use = Qualified 501(c)(3) Bond

5. The Code

> IRC 145(a) In General-For purposes of this part, except as otherwise provided in this section, the term "qualified 501(c)(3) bond" means any private activity bond issued as a part of an issue if:
>
> (1) all property which is to be provided by the net proceeds of the issue is to be owned by a 501(c)(3) organization or a government unit, and
>
> (2) such bond would not be a private activity bond if:
>
> (A) 501(c)(3) organizations were treated as governmental units with respect to activities which do not constitute unrelated trades or businesses, determined by applying IRC 513(a), and
>
> (B) paragraphs (1) and (2) of IRC 141(b) were applied by substituting 5% for 10% each place it appears and by substituting net proceeds for proceeds each place it appears.

6. Examples of Private Use vs. Use by the General Public

Multi-Use Convention Center

PLR 8831035 concerns a multi-use convention center to be built with bond financing by a county that is a political subdivision. The building will be managed by a for-profit manager. The issue presented is whether the entertainment bookings should be considered private use or are they use by the general public.

> It [the for-profit manager] will reserve dates for use of the convention center under annual and multi-year arrangements. The reservations will be confirmed during a period shortly before the event by the execution of a booking contract. No multi-year reservation will be confirmed until 6 months to 1 year before the event through the execution of a booking contract.

The private letter ruling concludes that the booking contracts would not be considered private use. This is because the rights of the occupants are similar to the rights of transients not of a lessee. The ruling relies on the following regulation.

> In Income Tax Regulations section 1.103-7(c) example 11, a city issued obligations to finance the construction of a municipal auditorium which it will own and operate. The auditorium is open for use to any one who wants to use it for a short period of time on a rate-scale basis. The rights of such a user are only those of a transient occupant rather than the full legal possessory interests of a lessee. It is anticipated that the auditorium will be used by schools, church groups, fraternities, and numerous commercial organizations. The revenues from the rentals of the auditorium and the auditorium building itself will be the security for the bonds. The bonds are not industrial development bonds because such use is not a use in the trade or business of a nonexempt person [now nongovernmental person].

This ruling is an example of a post-1986 ruling that relies on pre-1986 law. The ruling also considers whether use by the for-profit manager is private use.

Airport Parking Facilities

PLR 8926043 concerns bonds issued by an Authority for the purpose of constructing parking facilities and making road improvements at two airports which serve many commercial airlines. The issue is whether the airports are users of the new construction. If they are users the private use test would be met and the bonds would not be tax exempt bonds. The parking facilities and roads will be utilized by the Authority, the airlines, and the general public. Parking will be on a first come first serve basis. One level will be designed to accommodate the shuttle buses used by hotels, this portion will not be bond financed. The ruling lays the issue out as follows.

The roads and parking facilities located in the airports are owned and operated by the Authority. The airport terminals, however, are used in the trades or businesses of the private airlines, and the roads and parking facilities are used by passengers of the private airlines to travel to the terminals. The question that must be resolved is whether the roads and parking facilities should be considered used in the trades or businesses of the private airlines by reason of the fact that passengers of the private airlines use these facilities to travel to the terminals.

The analysis and conclusion of the ruling are as follows:

> One question that must be resolved in determining whether bonds issued by a governmental authority are governmental obligations or private activity bonds is whether more than 10 percent of the proceeds are to be used for a private business use. Depending on all of the facts and circumstances a road or parking

facility may be considered as used for a private business use. In this case, Road Improvements A and B, the Satellite Parking Facility, the Multilevel Parking and the Existing Parking Facilities are not directly used by the airlines on a basis different from that of other nongovernmental users. However, these roads and parking facilities are adjuncts to the Airport terminals and other portions of the Airports which meet the private business use test.

Both airports are mass transportation facilities that are used by a broad cross-section of the general public. Airport A is served by over 23 airlines on a regular base, and Airport B is served by over 27 airlines on a similar basis. The airlines passengers use the roads and parking facilities to travel to the terminals, but the terminals are not the final destinations of the passengers. The passengers travel to and park at the airports primarily to use facilities in other cities, not to use the terminals. This distinguishes the parking facilities from parking lots located at a shopping center or a sports stadium. The only reason for using a parking lot at a shopping center or sports stadium is to use the shopping center or sports stadium, and both uses are contemporaneous.

Therefore... Road Improvements, A and B, the Satellite Parking Facility, the improvements to the Existing Facility at Airport B (except that portion of the multilevel Parking Facility that is ever leased to rental car companies) will not be used for any private business use within the meaning of section 141 (b)(7).

Sewage Treatment Facilities

PLR 8929072 concerns bonds issued for modification of a sewage treatment facility operated by a District. The District was controlled by seven municipalities which were users of the system. In addition to municipalities, an Air Force base used the facility. The issue addressed in the ruling is whether use by the Air Force base should be considered private use.

The municipalities pay a monthly fee for the services they receive. In addition, 30 percent of its operating revenues came from an ad valorem tax levied on all taxable property location in the District's service area. The Air Force could not be charged on a simple fee for services system because of its contracting procedures. It should be noted that the federal government is a nongovernmental unit for bond purposes.

In attempting to charge the Air Force its fair share, the District is always playing what is characterizes as 'catch-up ball.' This is because the Air Force's fee structure is based upon the audit and analysis of historic revenue, cost, and expense information which continues to change after the Air Force's fees are negotiated.

The ruling relies in part on the following law.

> Section 141(b)(6) of the Code provides that for purposes of section 141(b), the term 'private business use' means use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit. For purposes of the preceding sentence, use as a member of the general public shall not be taken into account. Under section 141(b)(6)(B), any activity carried on by a person other than a natural person shall be treated as a trade or business. Section 150(a)(2) of the Code provides that the term governmental unit does not include the United States or any agency or instrumentality thereof.
>
> Section 141, which was added to the Code by the Tax Reform Act of 1986 (H.R. 3838, 99th Cong. Public Law 99-514) replaces the industrial development bond provisions of former section 103(b) of the 1954 Code.

The Conference Report to Accompany H.R. 3838 (the Conference Report) see Conference Report H.R. No. 99-841, to accompany H.R. 3838, 99th Cong. 2d Sess. 11-733, (1986), 1986-3 (Vol. 4 C.B. 647), states the following:

> The conference agreement generally retains the present-law rules under which use by persons other than governmental units is determined for purposes of the trade or business use test. Thus, as under present law, the use of bond-financed property is treated as use of bond proceeds. As under present law, a person may be a user of bond proceeds and bond-financed property as a result of (1) ownership or (2) actual or beneficial use of property pursuant to a lease, a management or incentive payment contract, or (3) any other arrangement such as a take-or-pay or other output-type contract. Use on the same basis as the general public (including use as an industrial customer) is not taken into account.

The Report of the Committee on Ways and Means of the House of Representatives on H.R. 3838 (the 'Ways and Means Report') states:

> Under the concept of use, bond proceeds and bond-financed facilities that are available for use by members of the general public on the same basis are not treated as being used in a nongovernmental activity. If any nongovernmental person or persons use bond-financed property other than as a member of the general public, however, the use of such property is considered to be use of the proceeds of the issue... In the case of most nonessential function bonds [private activity bonds], the determination of the nongovernmental user of the facilities will be clear, since one such person or a limited group of such persons will use most or all of the facility subject to an identifiable lease, contract, or other arrangement that differentiates that person's use of the facility from the use by the public at large. In other cases, a facility that is nominally governmental used, may in fact be used in whole or in part by a nongovernmental person or persons in such a manner as to render bonds for the facility nonessential function bonds. The

> committee intends that the determination of whether bonds for such facilities are nonessential function bonds is to be made on a case-by-case basis, under the principles of the trade or business use test of present law, taking into account all facts and circumstances regarding use of the property.

The Ways and Means Report also indicates that the fact a bond-financed facility provides a greater volume of services to particular customers, or that the rates charged to some customers are less than those charged to others, does not necessarily mean that the facility is not made available to members of the public on the same basis.

Section 1.103-7(b)(3)(i) of the Income Tax Regulations (applied under former section 103(b)) provides, in part, 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 person 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.

In example (10) of section 1.103-7(c) of the regulations, State F issues its obligations to finance the construction of a toll road and the cost of erecting related facilities. The toll road is to be owned and operated by F. Example (10) concludes that the trade or business test is not met solely by reason of the fact that vehicles owned by nonexempt persons engaged in their trades or businesses may use the road in common with, or as part of, the general public.

The ruling concludes that the contract with the Air Force is not private use for purposes of IRC 141. The analysis of the ruling is as follows.

> In this case, the Air Force has no ownership interest in the System and there is no lease or management or incentive pay contract pursuant to which the Air Force has any actual or beneficial use of the System. Further, the District's representation that it has exerted its best efforts to charge the Air Force as closely as possible the same amount for its use of District services as other District customers pay for the same amount of services, together with the reasons provided by the District to explain the law of parity in the rate charge, indicates that the System is made available to the Air Force on the same basis as the general public within the meaning of section 1.103-7(b)(3)(i) and Example (10) of section 1.103-7(c) of the regulations. Taking into account the above facts and circumstances, we do not believe the Air Force's use of the system rises to the level of a private business use within the meaning of section 141(b)(6)(A) of the Code. Accordingly, we conclude that the Base's use of the system will not cause

> the bonds to be private activity bonds within the meaning of section 141 of the Code.

Road Improvements Benefitting a Private Use

PLR 8945032 concerns road improvements contemplated by a state and two of its authorities. The issue is whether the benefit to the developer creates a private use situation or use by the general public. One authority proposed to finance its share of the improvements by bond financing. The roads to be improved will provide access to a large business park. Pursuant to the improvement of the roads, the private development company will invest in major improvements to the business park. The roads to be improved will have access to other facilities, including a community college, a university, and a civic center containing the City's administrative offices.

Authority 1, the authority that plans to issue bonds, will finance the bonds through tax increment revenues.

During the term of the bonds, all of the revenue will be derived from the business park owned by the development company. In addition, the development company will act as guarantor of the bonds. It is highly unlikely that the company will have to pay under the guarantee, because it is already financing the bonds under the tax increment scheme.

One of the issues in the ruling is whether use by the company should be considered private use. The ruling concludes that it would not be private use for the following reasons.

> In this case, none of the users of the Business Park has any ownership interest or priority right in the improvements to be made with the proceeds of the Bonds. While the improvements will benefit the businesses within the Business Park, these business users will have no right to use the roads on a basis different from other members of the general public. In addition, the facts show that the road improvements will be available for use by members of the general public because the improved roads are centrally located throughways in the City, will help to alleviate the traffic congestion of the City, and will facilitate access to the other facilities in the City as well as to the businesses located in the Business Park. Accordingly, because no nongovernmental person will use the improvements to be financed by the proceeds of the Bonds other than as a member of the general public, the Bonds will not meet the private business use test of section 141(b)(1).

This result was reached even though state law considered the development company to be the principal beneficiary of the road improvements, the company would pay for the road through its taxes, and the company guaranteed the bonds. Private use, in this case was judged solely on access. Because the road would be available to the general public the IRC 141(b)(6) exception was met.

Parking Garage

PLR 910722 concerns a public parking garage built by a city and bond financed. The city had excess parking facilities. A for-profit company wished to purchase parking permits in bulk for its employees. The issue is whether the purchases in bulk by one company create private use.

> The Employees will be subject to the same terms and conditions applicable to the bulk purchase rate as any other member of the general public and will not have any reserved parking spaces in the Garage. All parking, i.e., either monthly or hourly, is on a first come, first served basis regardless of whether the person is an employee of the Company. If an Employee with a monthly parking permit cannot find a parking spot, he will be unable to park at the Garage that day. Although the City does allow renewal of monthly parking permits on a month-to-month basis, the City can refuse to renew should a shortage of parking spaces in the Garage develop. Sufficient spaces will thus be available at all times to satisfy the demand of the general public for hourly parking.
>
> In Rev. Rul. 79-282, 1979-2 C.B. 34, 24.5 percent of the parking spaces in a garage owned by a city were leased to a nonexempt corporation. The remaining parking spaces were available to the general public, including business users, as hourly, daily, and monthly rentals on a first-come, first-served basis. The ruling, referring to section 1.103-7(b)(3)(i) of the regulations, concluded that the hourly, daily, and monthly use of the parking garage would not be considered use by nonexempt persons in their trades or businesses. Therefore, since the nonexempt corporation was not using more than 25 percent [pre-1986 rule] of the parking spaces, the bonds met the private business use test and were not considered industrial development bonds within the meaning of section 1.103-7(b).
>
> In this case, we believe that even though more than 10 percent of the Garage parking space will likely be leased to the Employees, the private business use test is nevertheless not met [the bonds are not private activity bonds]. First, the Employees will have no preference over the general public in leasing the spaces. The Employees (1) will pay the same bulk purchase rate for the monthly parking permits as the general public and (2) the permits will be available on a first-come, first-served basis regardless of whether the person is an Employee. Second, holders of monthly parking permits will not have reserved parking and will compete on a first-come, first-served basis with all other parkers. Finally, the

City retains complete flexibility on a month-to-month basis to allow or disallow renewal of a monthly parking permit. The general public is thus assured that sufficient capacity will be retained at the Garage to meet the needs of hourly parkers and non-Employee monthly parkers.

D. Private Use and UBI Use

1. In General

The question of whether an IRC 501(c)(3) organization is engaged in an unrelated trade or business must be addressed because unrelated business use is treated the same as private use for purposes of the private use business test of IRC 145.

2. Code Provisions

IRC 145 (a) provides that the net proceeds of a qualified 501(c)(3) bond can not be used to obtain property which is used in an unrelated trade or business activity determined by applying IRC 513(a).

> IRC 145(a) In General.--For purposes of this part, except as otherwise provided in this section, the term "qualified 501(c)(3) bond" means any private activity bond issued as part of an issue if--
>
> (1) all property which is to be provided by the net proceeds of the issue is to be owned by a 501(c)(3) organization or a governmental unit, and
>
> (2) such bond would not be a private activity bond if--
>
> (A) 501(c)(3) organizations were treated as governmental units with respect to their activities which do not constitute unrelated trade or businesses, determined by applying section 513(a),

Under IRC 513(a), an unrelated trade or business means any trade or business (1) which is not substantially related to the exercise or performance of an exempt function or purpose aside from the need for income or use of profits, or (2) which does not come within the specific exceptions under 513(a)(1), (2), or (3), such as for the convenience of members, students, patients, officers, or employees.

> IRC 512(a)(1) General rules. --Except as otherwise provided in this subsection, the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in

section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

3. IRC 145 Private Use is More Restrictive then IRC 512

Because IRC 145(a) cross references IRC 513(a) rather than IRC 512, the modifications of IRC 512(b) are not available. Therefore, income from interest, dividends, rents, or royalties can be excepted from unrelated business tax under the IRC 512(b) modification. But only related activities would be excluded from the 5% private use test of IRC 145. It applies a stricter standard than whether an activity generates unrelated business income tax.

4. Possible Effect of IRC 145

For purposes of IRC 145, the debt financed income rules of IRC 514 and the special definition of a private activity bond for purposes of IRC 145 must also be considered. The question to be answered is the effect of IRC 514. After all, any bond financed facility being examined will by definition be debt financed. The answer may be that with respect to the bond financed facility, IRC 514 does not have to be considered.

Again, this answer is derived from IRC 145 which cross references IRC 513(a) rather than IRC 512. Therefore, the debt financed income provisions would seem to be taken into consideration only when computing unrelated business taxable income under IRC 512. The Code provision reads as follows:

IRC 514(a) Unrelated Debt-Financed Income and Deductions.-- In computing under section 512 the unrelated business taxable income for any year--

Thus, when calculating the 5% private use limitation for purposes of IRC 145, it appears that the debt financed rules of IRC 514 should not be considered.

Unrelated business income and private business use are discussed below in the context of the treatment of parking lot revenue. (See G.C.M. 39825 [August 17, 1990] for a complete discussion of parking lot revenue.)

5. Private Use, UBI and the Taxation of Parking Lot Revenue

a. In General

It is helpful to examine parking lot revenue because it provides a demonstration of how the same fact pattern can produce a different result for IRC 512 than for IRC 145. Certain parking lot revenues are excluded from the calculation of unrelated business income because of the modifications contained in IRC 512. But these modifications do not apply for IRC 145 purposes. Thus, some parking lot revenue that is excepted from being unrelated business taxable income for exempt organization purposes will be considered private use. The tax exempt status of the bonds may be affected. Parking lot revenue is analyzed below for unrelated business income tax purposes and for IRC 145 purposes.

b. The Code and Regulations

IRC 511 provides, in part, for the imposition of tax on the unrelated business taxable income of organizations described in IRC 501(c).

IRC 512(b)(3) provides modifications for rents and, in part, excludes rents from real property from the definition of unrelated business taxable income.

Regs. 1.512(b)-1(c)(5) provides that, for the purposes of this paragraph, payments for the use or occupancy of rooms and other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, motor courts, or motels, or for the use or occupancy of space in parking lots, warehouses, or storage garages, does not constitute rent from real property. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exists, stairways, and lobbies, the collection of trash, etc., are not considered as services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, or offices in any office building, etc., are generally treated as rent from real property.

c. Discussion of Parking Lot Revenue

Regs. 1.512(b)-1(c)(5) can be clarified with the following discussion. If the exempt organization is operating the parking lot itself, it is considered to be providing services for the convenience of the occupant. The income is not excluded as rents from real property under IRC 512(b)(3). Unless this activity was found to be related to the organization's exempt purpose or otherwise excepted, it

would constitute an unrelated business use subject to tax. It would also constitute a private business use under IRC 145(a)(2)(A). The other extreme is the situation where the exempt organization, without providing any services at all, rents the whole property to a third party who operates it as a parking lot. The rent received by the exempt organization is excluded under IRC 512(b)(3) as rental income. It is excluded because it is the rental of real property and no services are provided. While this situation would not give rise to unrelated business income, it would be considered private business use. This is private business use because the exempt organization would not be the user of the facility.

In addition to the Regs. 1.512(b)-1(c)(5) analysis, there is one additional situation to consider. The operation of a parking facility by an EO or a for-profit contractor can be a related activity. If a hospital is solely providing parking for patients, doctors, and staff, it may be related if no other reasonable parking alternative exists. There is also an exception under IRC 513(a)(2) where the activity is conducted for the convenience of patients, students, members of the organization, or employees of the organization.

d. Examples

The following private letter rulings concern parking lots. The analysis of the rulings will be discussed as well as a reconsideration of the facts according to the 513(a) analysis just presented.

Hospital Parking Lot with Medical Office Building Use

PLR 8827065 concerns two borrowers, A and B. A and B were both hospitals with a common parent. The borrowers wish to use bond financing to construct a new parking ramp. The ramp would be used, in part, by the patrons of a medical office building. The issue is the effect of medical office building use of the parking facility on the exempt status of the bonds. The parking ramp will contain nine levels. The first level of the parking ramp will be restricted for use by the patrons of the medical office building. The remaining eight levels will be utilized almost exclusively by employees of the two hospitals. The patrons of the medical office building will be excluded from levels two through nine. Occasionally levels two through nine will be used for patients and visitors of the hospital, if the original parking facility is full. Level one will be financed without bond financing. Levels two through nine will be bond financed. The hospitals have adopted a number of safety measures to insure that the bond financed facilities are not used by patrons of the medical office building. The conclusion reached by the ruling is

that the medical office use has been effectively segregated to the portion of the facility financed by taxable bonds. The analysis is as follows:

> Based on the preceding, it is concluded that use of the proceeds of the bonds to finance the portion of the New Parking Ramp consisting of levels two through nine will not be a direct or indirect use of such proceeds by persons other than section 501(c)(3) organizations for purposes of section 145(a) of the Code. This ruling is expressly conditioned on the following: 1) that any loan of bond proceeds by Parent to Borrowers is not an unrelated trade or business with the meaning of section 513(a), 2) that the joint operation of levels two through nine of the New Parking Ramp is not an unrelated trade or business within the meaning of section 513(a), and 3) that, while any portion of the proposed bonds are outstanding, adequate control measures in fact will be maintained to assure that no physician-tenants of the New or Existing Office Buildings or their office staffs, patients, or visitors will be permitted to park on levels two through nine of the New Parking Ramp.

An analysis of the facts of the private letter ruling would lead to a conclusion that there would be no 513(a) consequences to the bonds although there will be unrelated trade or business consequences to the hospitals. Level one, the portion of the building that is not bond financed, will be used exclusively by patrons of medical office buildings. It is unlikely that this would be considered a related activity for the hospitals. According to GCM 39825, the renting of parking spaces by an exempt organization gives rise to unrelated business income provided the activity is not related. Thus, income generated by level one would probably be considered unrelated business income. This conclusion would not effect the bonds, because level one is not bond financed. The organizations have taken substantial steps to insure that patrons of the medical office building will solely use level one. Levels two through nine are bond financed. Although the exempt organizations will be providing the parking themselves, the activity should be considered related. These levels will be used almost exclusively by hospital employees.

Science and History Museum

PLR 9048022 concerns a science and history museum engaged in a program of expansion. As part of the expansion, the museum will replace a 463 parking space facility with a 600 parking space facility. The ruling considered whether the parking facility was a related activity for IRC 513(a) purposes. The facility will be used by staff and museum visitors. In addition, the facility will also be used by the general public. The museum indicates that this is because it is located in a downtown area. Hourly, daily, and monthly spaces will be available for a fee. The

facility will be operated under a management contract. The ruling concludes as follows.

> Revenue Ruling 69-269, 1969-1 C.B. 160, provides that the construction and operation of parking facilities contributes importantly to the accomplishment of a hospital's exempt purposes, and is substantially related to the purpose constituting the basis for the hospital's exemption.
>
> Based on the information provided, the proposed parking facility will perform an essential function for the Museum by accommodating its rapidly increasing number of visitors and corresponding increase in volunteers and employees. Thus it appears that the parking facility will contribute importantly to the accomplishment of the Museum's exempt purpose. See Revenue Ruling 69-269. Accordingly we conclude that the bond issued to finance the acquisition and construction of a parking facility to be owned by the Society [the museum] will satisfy the definition of a 'qualified 501(c)(3) bond' contained in section 145(a). This conclusion is conditional on at least 95 percent of the net proceeds of the qualified 501(c)(3) bonds being used solely by the 501(c)(3) organization as required by section 145.

The ruling presents at least two issues that need to be resolved. The principal issue is whether operating parking facilities for employees and visitors is a related activity. The second issue is whether use by the general public is an activity described in 513(a). While Rev. Rul. 69-269 held that the parking garage contributed importantly to the accomplishment of the hospital's exempt purpose, it was based on the specific facts of the case. The pivotal facts contained in the revenue ruling are as follows.

> The hospital was concerned with providing sufficient parking space for visitors because visitation is considered to be supportive therapy and part of the patient treatment. Because of a serious lack of adequate parking space, the hospital constructed adjacent to its main building a parking lot for patients and visitors only. The lot is not for general public utilization.

The facts recited in the private letter ruling are not sufficiently detailed to question the conclusion that the activity was substantially related. For instructional purposes, we can be "back seat drivers" and take another look at the situation. While it may be assumed that the parking was necessary, the fact that the museum is located in a downtown location may distinguish the facility from the facility built by the organization described in the revenue ruling. It may not be able to sustain the same claim of necessity. Also, the fact that the parking facility will be open to the general public with no apparent controls also distinguishes this facility from the facility described in the revenue ruling.

The consequences for determining that the facility is not related are steep. If the facility was considered operated by the museum then its use by the general public, other than for visitors, members, or employees, would be treated as an unrelated business activity under IRC 513 subject to taxation. If such use also exceeded the 5 percent private business use test, IRC 145 would serve to disqualify the bonds as IRC 501(c)(3) bonds. Finally, what if the facility was operated by a third party operator? For unrelated income tax purposes the income would fall under the IRC 512(b)(3) exception. For purposes of IRC 145 the activity would be described in 513(a) and, thus, the entire activity would be private use.

E. Security Interest Test

1. Private Business Use and Security Interest - Two Pronged Test

IRC 141 requires that both the private use test and the private security or payment test must be met before the bonds are considered private activity bonds. Therefore, if one test is not met [exceeded], the other test need not be calculated. There is no reason to calculate the second test because it requires satisfaction of the two tests for classification as a private activity bond rather than a governmental bond. The private security or payment test is contained in IRC 141(b)(2) which reads as follows.

> IRC 141(b)(2) Private security or payment test.--Except as otherwise provided in the subsection, an issue meets the test of this paragraph if the payment of the principal of, or the interest on, more than 10 percent of the proceeds of such issue is (under the terms of such issue or any underlying arrangement) directly or indirectly--
>
> (A) secured by any interest in—
>
> (i) property used or to be used for a private business use, or
>
> (ii) payments in respect of such property, or
>
> (B) to be derived from payments (whether or not to the issuer) in respect of property or borrowed money, used or to be used for a private business use.

The same rule applies under IRC 145(a)(1)(B) to qualified 501(c)(3) bonds except the limit is 5%.

If the bonds issued for that portion of the facility determined to be a private business use are secured by payments from the private users or generated by the private use, the security interest test is met. The bonds being tested under IRC 141 and 145 meet both the business use test and the security interest test. The bonds are considered private activity bonds. Both direct and indirect payments made by any person using the bond proceeds are counted towards the security interest test. Such payments are counted whether or not they are formally pledged as security or directly used to pay debt service. For example, payments by users will be counted towards the security interest test even if tax revenues are the stated source of bond payments. If this security interest test is not met, the private business use tests of IRC 141(b) and IRC 145 will not be met. The bonds will be governmental bonds even though there may be substantial private use. For purposes of IRC 141, there is a 10% security interest test. For purposes of IRC 145, for qualified 501(c)(3) bonds, there is a 5% security interest test.

For example, assume that bonds have been issued by a hospital authority to be used by State Hospital A to finance new hospital construction. As part of the new patient rooms, State Hospital A will build a day care center to be operated by a private day care company. The use of the day care center is a private use and more than 5% of net bond proceeds were used to finance the day care center portion of the facility. Clearly, the private use test is met. But the users of the day care facility will not pay for the service and the day care facility will generate no other revenue. State Hospital A will be picking up the entire cost of the day care facility from its general revenues. Thus, there will be no payments based on the use of the bond financed property and the security interest test will not be met. The bonds will not be private activity bonds, they would be governmental bonds. The result would be the same if the day care facility was financed by tax revenues.

2. Example

Wagering Income

PLR 9124025 concerns IRC 141(b). An Authority issued bonds for the purposes of a number of "associations". The associations were governmental units or instrumentalities treated like governmental units. The associations maintained cultural and recreational facilities for the benefit of the general public. The State Code provides for supervision of horse racing and wagering on horse racing. The State Code provides for satellite wagering facilities at various locations around the state including the facilities operated by the associations. Nongovernmental organizations run the gambling and the audiovisual displays at the facilities.

License fees paid to the state are derived from wagering. The amount generated at each facility is deposited into a separate account to pay expenses and debt service. Wagering income is used to pay the principal and interest on the bonds. The issue is whether these payments cause the bonds to meet the security payment test. The law and analysis contained in the ruling is as follows.

Section 103(a) of the Code provides that gross income generally does not include interest on state or local bonds. Section 103(b)(1) states, however, that section 103(a) does not apply to private activity bonds that are not qualified bonds.

Section 141(b)(1) provides that an issue meets the private business use test if more than 10 percent of the proceeds of the issue are to be used for private business use. Under section 141(b)(6), the term "private business use" means use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit. Use as a member of the general public is not taken into account.

Section 141(b)(2) of the Code provides that an issue meets the private security or payment test if the payment of the principal of, or the interest on, more than 10 percent of the proceeds of such issue is (under the terms of such issue or any underlying arrangement) directly or indirectly (A) secured by an interest in property used or to be used for private business use, or payments in respect of such property, or (B) to be derived from payments (whether or not to the issuer) in respect of property, or borrowed money used or to be used for a private business use.

The private security or payment test was enacted as part of the Tax Reform Act of 1986. Under the test, both direct and indirect payments made by any person (other than a governmental unit) who is treated as using the bond proceeds are counted. Such payments are counted whether or not they are formally pledged as security or are directly used to pay debt service on the bonds. Revenues from generally applicable taxes are not treated as payments for purposes of the private security or payment test; however, special charges imposed on persons satisfying the use test (but not on members of the public generally) are so treated if the charges are in substance fees paid for the use of bonds proceeds. H.R. Conf. Rept. No. 841, 99th Cong., 2d Sess. II-688 (1986), 1986-3 Vol. 4 C.B. 688.

Payment of the principal and interest on the Bonds is secured by an interest in the revenue in the Account, but not by an interest in any other real or personal property. The revenue pledged to pay the principal and interest on Bonds is derived from the portion of State license Fees from Facilities appropriated to the Department for the general purpose of the Associations. The license fees are payment to the State from all of the Facilities located within the State without

> regard to whether they are Bond financed facilities. Finally, the State license fees are measured as a percentage of the gross amount wagered at all of the Facilities. Consequently, the pledged revenue is not a payment in respect to bond financed property or private use property.

The Code provides that an issue meets the private security or payment test if the payment of the principal of, or the interest on, more than 10 percent of the proceeds of such issue is (under the terms of such issue or any underlying arrangement) directly or indirectly (A) secured by an interest in property used or to be used for private business use, or payments in respect of such property, or (B) to be derived from payments (whether or not to the issuer) in respect of property, or borrowed money used or to be used for a private business use. It is clear from this private letter ruling that the payment has to be "in respect to property". Because the payments in this case were based on a percentage of the wagers, the private security interest test was not met. The payments were not in respect to property.

The security interest test can not be ignored. Each instance must be closely examined to determine how the bonds will be repaid. It would be pointless to explore private use only to discover that the security interest test was not met.

5. Changes in Use Issues - IRC 150

A. In General

The following is an explanation of the IRC 150 provisions from a text on municipal bond law.

> In general, Section 150(b) penalizes users of tax-exempt private activity bond-financed facilities who fail to use part or all of the facilities pursuant to the applicable tax-exempt purpose. Section 150(b) was added to the Code by the 1986 Act and generally applies to changes in use of bond-financed property occurring after August 15, 1986, with respect to financing provided after that date. The change in use penalties are separate and distinct from any retroactive or prospective loss of bond tax exemption that may result if applicable Code requirements are not met.
>
> The change in use penalties 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 would be penalized for misuse.
>
> The change in use penalties are applied under the following general guidelines. If a person is misusing only a portion of the facility, only the interest accruing on the

financing allocable to such portion is taken into account. The portion of the use allocable to proceeds of an offering which are not required to be used for exempt purpose are not to be taken into account. If the amounts payable for use of the facility are not interest (e.g. lease payments), Section 150(b) applies as if such amounts were interest up to the amount of interest accruing on the financing for such period. The disallowance of any non-interest deduction is limited in amount to the amount of interest that has accrued on the bond financing for the period of disallowance. Fundamentals of Municipal Bond Law, National Association of Bond Lawyers, (1990) pg. 189.

B. 150(b)(3) and 150(b)(5)

There are two provisions of IRC 150(b) that directly apply to qualified 501(c)(3) bonds. IRC 150(b)(3) concerns change in use. It applies when a facility that was financed with "purported" qualified 501(c)(3) bonds, is no longer used by a 501(c)(3) organization or a governmental unit. Use can be changed to use by a different 501(c)(3) organization or a governmental unit without penalty. The penalty for a nonpermitted change in use is that the 501(c)(3) organization is deemed to have unrelated business income not less than the fair market rental value of the portion used in a trade or business of any person other than an IRC 501(c)(3) organization or a governmental user. In addition, no deduction can be taken for amounts paid to use the facility as an ordinary and necessary business expense. The denial of deduction is limited to the extent of the interest paid on the bonds.

IRC 150(b)(5) provides penalties for a sale of all or a portion of a facility financed with qualified 501(c)(3) bonds. The penalty is on the purchaser of the bond-financed facility.

C. The Code

IRC 150(b)(3)(A) In General.--In the case of any facility with respect to which financing is provided from the proceeds of any private activity bond which, when issued, purported to be a tax-exempt qualified 501(c)(3) bond, if any portion of such facility--

(i) is used in a trade or business of any person other than a 501(c)(3) organization or a governmental unit, but

(ii) continues to be owned by a 501(c)(3) organization,

then the owner of such portion shall be treated for purposes of this title as engaged in an unrelated trade or business (as defined in section 513) with respect

to such portion. The amount of gross income attributable to such portion for any period shall not be less than the fair rental value of such portion for such period.

(B) Denial of deduction for interest.--No deduction shall be allowed under this chapter for interest on financing described in subparagraph (A) which accrues during the period beginning on the date such facility is used as described in subparagraph (A)(i) and ending on the date such facility is not so used.

IRC 150(b)(5) -facilities required to be owned by governmental units or 501(c)(3) organizations.--If-

(A) financing is provided with respect to any facility from the proceeds of any private activity bond which, when issued, purported to be a tax-exempt bond,

(B) such facility is required to be owned by a governmental unit or a 501(c)(3) organization as a condition of such tax exemption, and

(C) such facility is not so owned

then no deduction will be allowed under this chapter for interest on such financing which accrues during the period beginning on the date such facility is not so owned and ending on the date such facility is so owned.

D. Legislative History

The legislative history explains the effect of 150(b)(3) on the exempt organization and on the user of the facility. See Conference Rept. H.R. No. 99-841, to accompany H.R. 3838, 99th Cong. 2d Sess. II-733, (1986), 1986-3 (Vol. 4 C.B. 733).

The House Bill provides that a change in use of property financed with private activity bonds to a use not qualifying for tax-exempt financing generally results in loss of income tax deductions for rent, interest, or equivalent amounts paid by the persons using the property in the nonqualified use. Section 501(c)(3) organizations realize unrelated business income with respect to any such use. These consequences apply in addition to any loss of tax exemption on bond interest provided under present law.

E. Tax Literature Interpretation

The 150(b) provisions have been interpreted in the tax literature as follows.

> Finally, if any part of a facility financed with proceeds of qualified 501(c)(3) bonds is no longer used by a qualifying organization, the Sec. 501(c)(3) organization that continues to own the part of the facility and benefits from the bonds has income from an unrelated trade or business. The amount of that income is at least equal to the fair rental value of the part of the facility for the period of unqualified use. According to the Senate Finance Committee, interest on the bond-financed loans isn't deductible against income from the business from the first day of the year when the change in use occurs.
>
> In addition, if all or part of the facility financed by tax-exempt bonds is required to be owned as a condition of the exemption by (or on behalf of) a government unit or Sec. 501(c)(3) organization, and stops being so owned, then the amounts paid or accrued for that part of the facility's use becomes nondeductible to the extent of interest accrued on the exempt financing from the date such ownership ceases.

See Prentice-Hall's Explanation of the Tax Reform Act of 1986, Prentice-Hall Information Services, (9/27/86).

F. Conclusion

The tax literature indicates that there are two penalties contained in IRC 150(b)(3). One is the unrelated business income tax consequences to the 501(c)(3) organization. The other, is the denial of deductions to the user of the facility. The denial is equal to the interest paid by the exempt organization to the bondholders on that portion of the facility that is used by the private user. There is only one penalty contained in IRC 150(b)(5). It is on the purchaser of the bond financed facilities and denies deductions equal to the interest paid to the bondholders. We are very interested in seeing cases presenting these issues under Technical Advice procedures.

G. Examples

Pre-1986 Change in Use

PLR 8747008 concerns pre-1986 bonds. A county had owned and operated a licensed skilled nursing facility since 1889. Refunding bonds were currently outstanding when the county decided to sell the facility to a nonexempt user [private use]. The decision was made because the county was no longer in a position to support the facility with tax revenues. The ruling concludes that the change in use will not affect the tax exempt status of the bonds for the following

reasons. Prior to the TRA of 1986, change in use was permitted under extenuating circumstances without affecting the exempt status of the bonds.

> In Rev. Rul. 77-416, 1977-2 C.B. 34, the Service considered a transaction in which a city proposed the sale of a facility financed by bonds the interest on which was exempt from taxation under section 103(a) of the Code. At the time of the proposed sale the city had operated the facility for many years. However, unforeseen changes in economic conditions had rendered the city's continued operation of the facility unfeasible. The terms of the sale did not indicate that the transaction was a mechanism to transfer the benefit of tax-exempt financing to the purchaser.
>
> In this case, as in Rev. Rul. 77-416, unforeseen changes in economic conditions have made it unfeasible for the County to continue operation of the Facility. The facts surrounding this change do not indicate that it is a mechanism to pass the benefits of tax-exempt financing through to a nonexempt person. Therefore, we conclude that the County's sale of the Facility to a nonexempt person within the meaning of section 103(b)(3) of the 1954 Code will not cause the Bonds to be treated as industrial development bonds within the meaning of section 103(b)(2).

Because the bonds were issued prior to the effective date of the Tax Reform Act, IRC 150 had no effect. The effect of Rev. Rul. 77-416 on post-1986 bonds is not clear because it interpreted former IRC 103(b).

Use by Another IRC 501(c)(3) Entity

PLR 8911053 concerns the change in use of a bond financed facility from a governmental user to a use by an organization described in IRC 501(c)(3). In 1987 bonds had been issued by a city in order to make certain improvements on a city owned hospital. In 1987 and 1988 the hospital suffered losses and it was projected that losses would continue unless major improvements were made. The administrator determined that the best plan would be to lease the facility to a local hospital which was described in IRC 501(c)(3). The 501(c)(3) hospital would pay an amount equal to the debt service on the bonds. The private letter ruling determined that the bonds would no longer be governmental bonds because a governmental unit would not be the user of the facility. The bonds would meet the private use and security interest tests of IRC 141 and thus would be considered private activity bonds. The ruling concluded that the bonds would be qualified private activity bonds because they would be described in IRC 145. The change in use rules of IRC 150 did not have to be considered. While the use changed, an IRC 501(c)(3) organization became the user.

Pre and Post 1986 Bonds and a Change in Use

PLR 912430 is a good illustration of how the pre-1986 and post-1986 rules would work. In the PLR a utility that was financed with bonds was sold to another system that would not qualify under the exempt facility rules of IRC 142. The seller had a number of bonds outstanding from before the Act and after the Act. The pre-1986 treatment is that under certain circumstances the interest on the bonds will still be tax exempt. The ruling relies on Rev. Rul. 77-416, Rev. Proc. 79-5 and Rev. Proc. 81-22. The conditions to be met are substantial. The ruling reads as follows:

> The principal issue raised is the effect of a post-issuance change in use from a qualifying use to a nonqualifying use on the exclusion from gross income of interest on exempt facility bonds under section 103(a) of the Code where the facts show good faith reasonable expectations to use bond proceeds to provide an exempt facility, actual use of bond proceeds to provide exempt facilities and qualifying use of the exempt facilities for specified period of time, and a yield-restricted defeasance at the time of the change to a nonqualifying use. The proposed Defeasance, yield restriction, and bond redemption requirements will reduce, to a reasonably-practical extent, the benefit of tax exemption and the burden on the tax-exempt market for bonds no longer being used for their exempt governmental purpose.

Thus, the answer for pre-1986 bonds is that under certain special circumstances a change in use will not cause loss of the tax exempt status of the bonds. The ruling also considers the effect of the change in use on post-1986 bonds. It reads as follows:

> With respect to certain tax-exempt private activity bonds issued after the effective date of Section 150(b)(4) of the Code, certain collateral federal income tax consequence[s] occur upon certain changes in use of bond-financed facility. Section 150(b)(4) of the Code provides, in part, that if a facility financed by the proceeds of any private activity bond is not used for a purpose for which a tax exempt bond could be issued on the date of such issue, no deduction shall be allowed on such financing which accrues during the period of non-qualified use of the facility. Thus, in the instant case, no deduction would be allowable for the interest expense attributable to interest paid or accruing on the 1986 bonds...

Thus, section 150 works as a loophole closer and requires that use be determined on an ongoing basis.

6. <u>Allocations</u>

A. In General

As in many issues affecting exempt organizations, the ultimate determination of a bond question may depend on allocations. The available guidance to performing allocations is minimal. The short answer is that an allocation is determined by any reasonable method. In the bond context, the principal allocation will be between private use and use by the governmental unit or by an exempt organization. Allocations will also be required between mixed use or mixed financing of a facility [tax exempt bond financed portions and conventionally financed portions].

B. Pre 1986 Regulations

Regs. 1.103-7(c) which interpreted the 25% test, provide some interesting examples. The old regulations should be good guidance unless specifically made obsolete by the 1986 TRA. In Example 6(b) of the regulations, the allocation was based on the percentage of rooms rented for a nongovernmental use. Example 7 provides "Such costs, whether attributable to the acquisition of land or the construction of the building, were allocated to leased space in the same proportion that the reasonable rental value of such leased space bears to the reasonable rental value of the entire building. From the facts and circumstances presented, it is determined that such allocation was reasonable." Thus, in Example 7 the allocation was based on the reasonable rental value of the leased space as opposed to the entire bond financed facility. Example 7(b) reads as follows, "Y will lease 4 floors, and the costs allocated to these floors are in excess of the 25 percent of the D's investment in the land and building." In Example 7(b) the allocation was based on cost and the relationship between cost and investment [cost of acquisition]. What is clear from the regulations is that the standard is reasonableness and there are a number of ways of calculating reasonableness.

C. Examples

Allocation Between Two Types of Use

PLR 8626047 concerns an allocation question under pre-1986 law. In this case the bond under consideration was a "small issue bond". The bonds could be used for hotel construction but more than 25% of the bond proceeds could be used for recreational facilities such as pools, bars and restaurants, and health club facilities. The project to be built was a 60 room hotel with restaurant, swimming

pool, sauna and fitness center. The issue is whether the recreational facilities were financed with more than 25% of the bond proceeds.

> The restaurant and bar, along with the common areas allocable to them, will comprise less than 20% of the square footage of the hotel building and less than 20% of the cost of the hotel building. Revenues from the hotel rooms are expected to provide at least 80 percent of total revenues...
>
> Because no more than 25 percent of the bond proceeds are allocable to portions of the facility which will be used primarily for retail food or beverage service or for the provision of recreation or entertainment, we conclude that the primary purpose of the hotel building and 1.31 acre site is for the provision of lodging for the hotel guests. Therefore, the proceeds of the bonds will not be used to provide a facility the primary purpose of which is retail food and beverage services or the provision of recreation or entertainment, nor will any portion of the proceeds be used to provide a country club or hot tub facility with the meaning of section 103(b)(6)(O) of the Code.

The private letter ruling provides the following information:

> 1. The restricted recreational facilities were aggregated with the common areas allocable to them. This would include building equipment such as air conditioning, heating, and plumbing. It would also include parking facilities, and hallways.
>
> 2. In this ruling letter the allocation was based on three different allocation methods. There was an allocation on the basis of square footage, an allocation based on cost, and an allocation based on percent of total revenue. The ruling letter does not disclose whether all three methods were necessary to the conclusion but it does not reject any method. This is understandable when the variety of methods utilized in the regulations are considered.

An Unusual Allocation Problem

PLR 9125050 presents an unusual situation which called for an unusual allocation method. The private letter ruling concerns a research foundation. The foundation wished to build a new research facility. The foundation admitted private use but professed difficulty in ascertaining the correct method of allocation. In addition to its government sponsored research, it planned to have "sponsored research contracts".

> These activities [sponsored research contracts] give rise to private business use of the facilities devoted to research pursuant to the Sponsored

Research Contracts. The Foundation estimates, however, that the gross revenues from the Sponsored Research Contracts are, and will continue to be, less than 15 percent of its gross research revenues.

You intend to treat the Facility as a mixed-use facility and finance construction of only the governmental portion of the Facility with tax exempt bonds.

The question to be determined is what is the governmental portion? It apparently can not be easily determined because the sponsored research is not severable from the permitted research.

You represent that both governmental and nonqualifying private research will take place simultaneously in all laboratories within the Facility. Moreover, all laboratory equipment will be available continuously for use by workers who will perform research pursuant to the governmental sources of funding as well as the Sponsored Research Contracts...As a result, you represent that it is impossible to allocate revenues precisely to any particular research effort...You state that the Foundation cannot possibly allocate the governmental and nongovernmental use of the laboratories and equipment on a square-foot, fair-market value or per-procedure basis. Therefore, in lieu of these other allocation methods, you suggest that the only available reasonable method is a revenue allocation test based on comparing qualified research revenue with gross research revenue from the entire research effort of the Foundation to determine the portion of the cost of the facility eligible to be financed with the Bonds...In addition, the Foundation proposes to bolster the revenue allocation test to ensure that sponsored research revenue will not exceed the permissible percentage. The Foundation will incorporate a margin of error in calculating the qualified portion of the Facility, so that the amount of sponsored research revenue can rise over several years without reaching its maximum allowable amount under the revenue allocation test.

The Report on the Committee of Ways and Means of the House of Representatives on H.R. 3838, H.R. Rept. No. 426, 99th Cong., 1st Sess. 538 (1985), 1986-3 (Vol. 2) 538 (the "House Report"), states as follows:

The committee understands that certain facilities eligible for financing with section 501(c)(3) organization bonds may comprise part of a larger facility otherwise ineligible for such financing or that portions of a section 501(c)(3) organization facility may be used for activities of persons other than section 501(c)(3) organizations. The committee intends that the treasury Department may adopt rules for allocating the costs of such mixed use facilities (including common elements) according to any reasonable method that properly reflects the proportionate benefit to be derived, directly or indirectly, by the various users of the facility. Only the portions of such mixed use facilities owned and used by a

section 501(c)(3) organization may be financed with bonds for such organizations.

An allocation of the proceeds of the Bonds based on either the physical areas in the Facility that will be used by private research sponsors or the amount of time each worker devotes to privately sponsored research is unworkable and unreasonable. Both the laboratories and the workers could be used or working on, as the case may be, research applicable to more than one project. Moreover, there is no way to separate either laboratory space, which is fungible, or the actual basic or clinical research, which may be applicable to several projects.

In this instance, because those other methods are unworkable, the revenue allocation method is reasonable. Allocating, the portion of the Facility that may be financed with the Bonds in the same proportion as the qualified research revenue bears to the Foundation's gross research revenue is a reasonable method of allocating the cost of the Facility to the governmental use. This allocation properly reflects the proportionate benefit to be derived, directly or indirectly, by the Foundation from the governmental use.

We stress that this approach is acceptable only because the Foundation could not have used a method with a clearer relation to actual use, such as a square-footage, fair-market-value or per-procedure method. It is clear from the wording of the ruling that this permitted method was only acceptable because this was a very unusual situation. The taxpayer was able to demonstrate that the traditionally reasonable methods of allocation would have been unreasonable. Allocations based on time, such as hours spent in an activity, should be carefully scrutinized because of the ability to manipulate the allocation.

7. The $150,000,000 Cap

A. In General

The cap contained in IRC 145(b) is a cap on the amount of outstanding bonds any particular IRC 501(c)(3) organization can have issued on its behalf. The basic rule is that no IRC 501(c)(3) organization can have more than $150,000,000 in bonds outstanding. That may sound like a lot, but it may not be because of expansive aggregation rules in the Code section and the legislative history. The following is a discussion of the technical rules of IRC 145(b).

B. Test Period Beneficiary

A test period beneficiary is defined in IRC 145(b)(3) by reference to IRC 144(a)(10), but the definition in the Blue Book is a little easier to understand. Test

period beneficiaries are all the owners and principal users of bond financed facilities. Each is allocated that portion of the facilities they own or use. Thus one bond issue can be allocated to more than one IRC 501(c)(3) organization. The following is an excerpt from the General Explanation of the Tax Reform Act of 1986, The "Blue Book" which explains the administration of the $150,000,000 limitation.

> The $150-million limitation generally is to be administered in a manner similar to the continuing $40-million limitation for beneficiaries of small-issue bonds. For example, bonds generally are to be allocated only among those section 501(c)(3) organizations who are test-period beneficiaries of the bonds in question. Test-period beneficiaries are defined as owners or other principal users of the facilities being financed by the issue at any time during the three-year period beginning on the later of (1) the date such facilities are placed in service, or (2) the date of issue. No portion of an issue generally is allocated to persons other than owners and principal users during this three year test period.
>
> As under the $40-million limitation, all owners of bond-financed facilities during the three-year test period are allocated that portion of the issue that is equivalent to the portion of the facilities that they own. Additionally, all principal users of the facilities during the three-year test period are allocated a portion of the face amount of the issue equivalent to that portion of the facility used by them. (In certain cases, this may result in all or part of an issue being allocated to more than one section 501(c)(3) organization.)

C. Aggregation Rules

The aggregation rule contained in IRC 145(b)(3) provides that two or more organizations under common management or control shall be treated as one organization. The Blue Book provides that an IRC 501(c)(3) organization is related to any other person if it owns 50% of the capital or profit interests. Also, two organizations are related if they have common purposes and substantial common membership or have directly or indirectly substantial common direction. The example given in the Blue Book was a local chapter and its national organization. Two organizations will be considered related if the purpose of the relationship was to avoid this section. This would prevent organization A with too many outstanding bonds from having unrelated organization B participate in bond financing on its behalf.

D. Three Year Test Period For The Beneficiary

The test period is three years from the later of the date the facilities are placed in service or the date of issue. If anytime during the three years the cap is violated, the interest on the bonds is taxable from the date of issuance. But, only that portion of the bonds exceeding the cap would be subject to this treatment.

E. How to Avoid the $150,000,000 Cap

There are two ways to avoid this cap. As provided in IRC 145(e), an IRC 501(c)(3) organization can elect out of this section if the bond issuance meets the requirements for qualification under any other provision of IRC 142 through IRC 144. Qualified residential rental project bonds described in IRC 142(a)(7) may be encountered. But a principal method of avoiding the IRC 145(b) volume cap is by meeting the special hospital requirements of IRC 145(c).

F. 145(c) Special Treatment for Hospital Bonds

IRC 145(c) contains special rules for qualified hospital bonds. Qualified bonds are exempt from the IRC 145(b) cap if 95% of the issue is used in respect to a hospital. One has to turn to the Blue Book again, for the definition of a hospital. In order to be exempt from the IRC 145(b) cap:

a. A hospital has to be accredited as a hospital by the Joint Commission on Accreditation of Health Care Organizations.

b. The hospital is primarily used to provide diagnostic services and therapeutic services for medical diagnosis, treatment, and care of injured, disabled or sick persons as hospital inpatients under the supervision of physicians.

c. Each patient has to be under the care of a physician.

d. It has to provide 24 hour nursing services rendered or supervised by a registered professional nurse and has a licensed practical nurse or registered nurse on duty at all times. The report makes it clear that the term "hospital" does not include rest homes, nursing homes, day care centers, medical school facilities, research laboratories, or ambulatory surgicenters.

G. Examples

Aggregation Rules

In PLR 8822043 the aggregation rules contained in the Blue Book were interpreted in the context of a system with a national council and local councils.

The relationship between the national and the locals was examined in some detail. The issue was whether the system as a whole was limited to the $150,000,000 cap. The ruling relies on the following law and analysis.

Section 103(a) of the Code provides that gross income does not include interest on any state or local bond. Section 103(b)(1) provides that this exclusion does not apply to any private activity bond which is not a qualified bond (within the meaning of section 141). Section 141(d) provides that the term qualified bond includes private activity bonds which are qualified 501(c)(3) bonds. Section 145 defines the term qualified 501(c)(3) bonds.

Section 145(b) of the Code limits the amount of qualified 501(c)(3) bonds (other than qualified hospital bonds) from which a single 501(c)(3) organization may benefit to $150 million. Section 145(b)(3) provides that two or more organizations under common management or control shall be treated as one organization.

There are two tests that we believe are appropriate in determining whether two or more organizations are under common management or control. The first test is whether the two organizations would be considered related to each other within the meaning of section 144(a)(3) of the Code. The second test is whether the two organizations have either (a) significant common purposes and substantial common membership or (b) directly or indirectly, substantial common direction. H.R. Rept. No. 426, 99th Cong., 1st Sess. 539-540, 1986-3 C.B.

Section 144(a)(3) of the Code provides that a person is related to another person if (A) the relationship between such persons would result in a disallowance of losses under section 267 or 707(b) or (B) such persons are members of the same controlled group of corporations (as defined in section 1563(a), except that more than 50 percent shall be substituted for at least 80 percent each place it appears therein).

Section 267(b) of the Code treats as related persons a person and an organization to which section 501 applies and which is controlled directly or indirectly by such person. Section 1.267(b)-1(a)(3) of the Income Tax Regulations provides that control of certain educational and charitable organizations exempt from tax under section 501 includes any kind of control, direct or indirect, by means of which a person in fact controls such an organization, whether or not the control is legally enforceable and regardless of the method by which the control is exercised or exercisable.

Section 1563(a) of the Code, provides a definition of the term "controlled group of corporations."

> Under the control tests set forth in section 267(b)(9) of the Code, and the legislative history of section 145(b)(3) the fact that Local X, other Locals, the Groups, Regions and the National Council have a general common goal of promoting world-wide fellowship with a particular religious worldview does not constitute common management or control. In this case, although Local X receives substantial benefits from its membership in the National Council, its selection of programs, activities, and staff persons is not subject to the control of the National Council, Regions, Groups or other Locals. Further, Local X's financial resources are derived from membership fees, program fees, and contributions from the area it serves, and less than one percent of the revenues are remitted to the National Council. Additionally, although the National Council may terminate Local X's membership in the National Council for failing to observe the seven membership criteria, the National Council may not dissolve Local X and cannot require Local X to distribute its assets to any particular organization upon dissolution. The endowment of Local X belongs only to Local X and neither another Local nor the National Council have any claim on Local X's endowment. Further, the selection of Local X's board of director's is not subject to the approval of any other Local, Group, Regions or the National Council. Finally, the rules of section 1563(a) do not literally apply in this case because neither Local X nor the National Council is a stock corporation.
>
> Accordingly, we conclude, based on the information submitted and representations made, that neither the National Council nor any other Local will be treated as an organization with which Local X is under common management or control within the meaning of section 145(b)(3) of the Code.

It is important to be aware that this private letter ruling interpreting the aggregation rules for purposes of the $150,000,000 cap presented a unique affiliation arrangement. While the system was joined together by common beliefs, it did not have common management, control, or membership.

Outpatient Facilities and the Hospital Exception

The principal exception to the $150,000,000 cap is the exception for bonds used for hospitals. The term "hospital" has been defined in the legislative history. There was concern by a number of hospitals that outpatient facilities that were part of a legitimate hospital operation might cause the bonds to be ineligible for the hospital bond exception. In the both ruling letters, the Service concluded that the hospital met the criteria of a hospital established in the legislative history. The facilities were principally inpatient. The ruling stated that no further allocation would be necessary between the use of bond funds for inpatient and outpatient facilities. The bonds would not be limited by the $150,000,000 cap.

PLR 9226062 concerns the hospital exception to the $150,000,000 limitation. The main issue is whether the hospital facility is primarily used to provide inpatient care, as required in the definition from the Conference Report. The ruling sets up certain criteria useful in determining whether a hospital facility is primarily used on an inpatient basis.

> The legislative history provides no test for determining whether a facility is primarily used to provide services to inpatients. However, we believe Z is primarily used to provide services to persons as hospital inpatients because (1) it has a principal, rather than an incidental, purpose to serve inpatients, (2) it has a substantial portion of its revenues derived from and a substantial portion of its area devoted to inpatients; (3) it has well-established facilities to accommodate on-site scheduled inpatients; and (4) it has well-established facilities to accommodate on-site a recipient of outpatient services who is immediately converted to an inpatient either when complications result from any outpatient services rendered or when a qualified health-care professional considers it medically prudent. Thus, at the present time, Z is primarily used to provide services to inpatients.
>
> We conclude that Z is presently a hospital within the meaning of sections 145(b) and (c) of the Code. However, we express no opinion on the following questions: (1) whether Z and Project will continue to meet the definition of a hospital if there are changes in any of the four specified characteristics; (2) whether the proposed allocation of New Bonds' proceeds for purposes of section 145 is reasonable; and (3) whether the New Bonds would cause the $150 million limitation of section 145(b)(1) to be exceeded. In addition, we express no opinion on the proposed transaction under any other provisions of the Code.

8. 145(d) Residential Real Property

A. The Code

The last major portion of IRC 145 is IRC 145(d) which concerns residential real property. The purpose of IRC 145(d) is to make the rules of IRC 142(d) for qualified residential real property apply to bonds issued on behalf of IRC 501(c)(3) organizations. The rules of IRC 142(d) are modified for purposes of IRC 145(d). In other words, a qualified 501(c)(3) bond that is used to provide residential rental housing must meet IRC 145(d) in addition to all other requirements.

1.145(d)(1) The Exclusion

IRC 145(d)(1) takes all residential rental housing bonds out of IRC 145, so the bonds would not be qualified 501(c)(3) bonds, but IRC 145(d)(2) puts three categories of bonds back in.

IRC 145(d)(1) provides that a bond which is part of an issue shall not be a qualified 501(c)(3) bond if any portion of the net proceeds of the issue are to be used directly or indirectly to provide residential rental property for family units.

2.145(d)(2) The Inclusion

IRC 145(d)(2) provides that IRC145(d)(1) shall not apply to any bond issued for:

(a) a residential rental property for family units if the first use of such property is pursuant to such issue (exception for NEW facilities);

(b) qualified residential rental projects where a specified portion of the housing is occupied by low or moderate income tenants (142(d) exception); or

(c) property which has been substantially rehabilitated (as defined in IRC 145(d)(4)) within the two year period ending one year after the date of the acquisition of such property (Substantial Rehabilitation Exception).

This section means that a bond used for residential rental units will not be a qualified 501(c)(3) bond unless the facility is new, substantially rehabilitated, or meets the low income rules of 142(d).

B. 145(d)(3) Expands Definition of New

IRC 145(d)(3) was enacted by the Omnibus Budget Reconciliation Act (OBRA) of 1989. It is a special addition to the normal definition of new for purposes of IRC 145(d). Property is new if the first use is pursuant to the financing, there is a reasonable expectation that taxable financing would be replaced with tax exempt financing, and it is replaced in a reasonable time. If, when the property was first used there was no State or local program for tax exempt bond financing, it will be considered new with the first use after tax exempt bond financing.

C. Continuing Care Facilities

IRC 145(d) was enacted by the Technical and Miscellaneous Revenue Act (TMRA) of 1988. The Conference Committee Reports provide that 145(d) is also

to be applied to the residential care facilities of a continuing care facility. This has direct application in the exempt organizations area because exempt organizations frequently purchase existing residential care facilities for the elderly. IRC 145(d) requires that the provisions of IRC 142 be complied with. IRC 142 requires that at least 20% of the housing units must be occupied by tenants having incomes of 50 percent or less of area median income or 40% of the housing units in the project must be occupied by tenants having incomes of 60% or less of the area median income for the qualified project period, generally 15 years.

For example, an exempt organization purchases an elderly care facility with separate apartment units. The facility was not new nor was it substantially rehabilitated within the meaning of IRC 145(d)(2). The facility would have to meet the special needs of the elderly for exemption under IRC 501(c)(3). In addition, it would have to comply with the low income housing requirements (the 20%/40% test) in order for the bonds to be qualified 501(c)(3) bonds. This is substantially different than exempt organization rules for elderly housing projects.

D. Housing Unit Defined

The Conference Report defines housing unit for purposes of IRC 145(d). The definition would apply to both low income housing projects and residential care facilities for the elderly. The property must be comprised of housing units which contain separate and complete facilities for living, sleeping, eating, cooking and sanitation. Hotels, motels, dormitories, fraternity and sorority houses, rooming houses, hospitals, nursing homes, sanitariums, rest homes and trailer parks for use on a transient basis are not residential rental property. Most residential care facilities would be considered housing units under this definition. Although they provide communal meals, they usually have cooking facilities in the apartments.

E. Example

Housing Unit

PLR 8609041 is a pre-Tax Reform Act private letter ruling which is useful for its interpretation of the term "housing unit" for purposes of the old residential property rules of IRC 103(b)(4)(A). Its guidance should still be valid for purposes of IRC 145(d). The property to be bond financed will consist of living units for 44 persons. The rooms will be unfurnished with each tenant being expected to provide furnishings. The rooms will not contain kitchen type appliances, such as stoves, refrigerators and sinks. Tenants will be permitted to provide such appliances as

refrigerators and microwave ovens. The facility will contain a common dining room, card rooms, reading rooms, and other communal activity spaces. The monthly charge under the lease will include the availability of all meals in the common dining room. The failure to provide separate kitchen facilities led to the conclusion that the units were not housing units.

> Section 1.103-8(b) of the Income Tax Regulations provides in part that a residential rental project is a building or structure together with any functionally related and subordinate facilities, containing one or more similarly constructed units which are used on other than a transient basis and which satisfy the requirements of section 1.103-8(b)(5)(i) and are available to members of the general public in accordance with section 1.103-8(a)(2). Section 1.103-8(b)(4) further provides that substantially all of each project must contain such units and functionally related and subordinate facilities. Section 1.103-8(b)(4) states that hotels, motels, dormitories, fraternity and sorority houses, rooming houses, hospitals, nursing homes, sanitariums, rest homes, and trailer parks and courts for use on a transient basis are not residential rental projects. Section 1.103-8(b)(8)(i) of the regulations provides that the term 'unit' means any accommodation containing separate and complete facilities for living, sleeping, eating, cooking and sanitation. Such accommodations may be served by centrally located equipment, such as air conditioning or heating. Thus, for example, an apartment containing a living area, a sleeping area, bathing and sanitation facilities, and cooking facilities equipped with a cooking range, refrigerator and sink, all of which are separate and distinct from other apartments, would constitute a unit.
>
> Based on the above, we conclude that the failure to provide separate and complete cooking facilities prevents the rooms from constituting units within the meaning of section 1.103-8(b)(8)(i) of the regulations and therefore prevents the facility from qualification as residential rental property under section 103(b)(4)(A) of the Code.

9. Changes Effecting A Bond As It Matures

Bonds typically have a 20 to 30 year maturity. Many events can occur which will effect the tax exempt status of the bonds. In addition, there are events which will trigger bondholder tax liability. The liability is not limited to a denial of the interest deduction. This section discusses four situations.

A. Restructuring of a Public Hospital

PLR 8951058 concerns a public hospital. Improvements on the hospital were financed by tax exempt bonds in 1966 and 1987. When the 1987 bonds were issued the hospital was experiencing losses although a feasibility study projected a turn

around. The turn around did not materialize. The hospital proposed to merge with one hospital unit of a 501(c)(3) hospital system. The newly merged hospitals would be part of a newly created entity, New Entity. The question to be addressed was whether the change would effect the tax exempt status of the bonds. The bonds had been considered government bonds but after the merger, a 501(c)(3) organization will be the user of the facility. The change caused the post-1986 bonds to be reevaluated according to the private activity rules.

Based on Rev. Rul. 77-416, 1977-2 C.B. 34, it was concluded that the change would not effect the tax status of the 1966 bonds.

> Rev. Rul. 77-416 provides that interest on tax-exempt municipal bonds issued to finance a city's electric generation, transmission, and distribution system will continue to be exempt after the sale of the system to a private utility company.

The result was reached because the change from governmental ownership of the facility to an IRC 501(c)(3) organization owning the facility should not cause any change to the 1966 bonds because the pre-1986 Code treated 501(c)(3) organizations similarly to governmental units.

This is not the case for post-1986 bonds because 501(c)(3) use is treated as private use, and the bonds would not be tax exempt unless they were "qualified" within the meaning of IRC 145. The ruling letter concludes as follows.

> Under the facts previously stated, should the hospitals merge, we believe the tax-exempt status of the 1966 Bonds will not be affected by the use of the facility by the New Entity...However, we believe the tax-exempt status of the 1987 Bonds must be redetermined to take into account the use of the facility by the New Entity, a section 501(c)(3) hospital. Thus the interest on the 1987 Bonds will remain exempt from federal income taxes provided the 1987 Bonds, which will become private activity bonds, qualify as qualified 501(c)(3) bonds.
>
> However, with compliance with section 148(f) [arbitrage rebate provisions] and with section 147 [various requirements such as notice and the 120% rule] of the Code, the 1987 Bonds will be a 'qualified 501(c)(3) bond' within the meaning of section 145(c) of the Code.

B. Sale of A Bond Financed Facility

PLR 8630023 is an example of one way to sell a bond financed facility when the bonds are still outstanding. The bonds could not be redeemed without payment

of a premium. This provision protects the bondholders from having the bonds redeemed early if interest rates go down.

> The bonds were issued in 1971 by the City of finance a seafood processing business and ship repair yard facility. Subsequently, the initial user and later users had financial difficulties and the facility was eventually purchased directly or through foreclosure by a succession of five companies. The City has retained legal title of the facility. The Company, the current owner of the facility, wishes to defease the bondholder's lien on the facility to facilitate sale of the facility and discharge the current user's obligation to the bondholders. The sale proceeds will be deposited under an indenture of trust and invested in United States government securities, State and Local Government Series, with interest rates and maturity dates sufficient to pay the interest and principal on the Bonds when they become due. The City will retain legal title to the facility until the Bonds are paid in full. The City is obligated to make payment on the Bonds to the extent it receives payment from the Company. The current user would be liable for payment of a premium if the Bonds are redeemed at any time prior to maturity. Upon termination of the Company's obligation to pay debt service and establishment of the escrow account, the City will be legally obligated to ensure that payments are made by the trustee of the trust to the bondholders.
>
> Based solely on the above and assuming the original issuance of the Bonds was proper and the interest thereon was exempt from federal income taxation at the time of issuance, the defeasance of the lien of the Bonds in accordance with the aforementioned facts will not result in the interest from the Bonds being taxable.

In this instance, the bondholders could not be paid off with the proceeds from the sale. The purchaser would have had to pay a premium for defeasing the bonds prior to maturity. The escrow account and guaranteed payments by the City gave the bondholders the same type of security they had when the payments were dependent upon operation of the facility.

C. Bond Default

PLR 8602038 is an interesting pre-Tax Reform Act case because it illustrates the effect of bond default on the bonds and on the bondholders. A public authority issued bonds to be used for hospital improvements and a parking garage by the Corporation. In a particular year the Corporation failed to pay the trustee the amount due under the sublease, creating an event of default under the bond indenture. In a subsequent year the trustee declared all the Bonds due and payable. Following this acceleration, the Corporation filed for bankruptcy. The following is the proposed plan of reorganization.

(a) Bondholders will receive all cash held by the trustee, less $500,000.00.

(b) Corporation will pay the trustee for the benefit of the Bondholders, the difference between $M Million and the amount held by the trustee over an approximately 10 1/2 year period at the rate of $50,000 per month. Bondholders will receive principal payments, pro rata, on October 1 and April 1 of each year. [These payments are the new securities, issued by the trustee not by the authority.]

(c) The $ 500,000.00 retained by the trustee will be used toward the final principal payment on the Bonds. Any interest on this reserve that is not used to cover the trustee's expenses will be distributed to the Bondholders with the final payment.

The ruling relies on the following law an analysis. It is important to be aware of the ramifications of a bond default and bankruptcy reorganization on the individual bondholders who had not participated in the actions leading up to the default. The new bonds are taxable because the trustee is the issuer. In addition, the default of the bonds are a taxable event. The bondholder will have gain or loss depending on the basis.

Section 1001 of the Code provides that gain or loss from the sale or other disposition of property will be determined by reference to the amount realized and the adjusted basis of such property. Section 1.1001-1(a) of the Income Tax Regulations states that the gain or loss realized from the exchange of property for other property differing materially either in kind or in extent is treated as income or loss sustained.

Rev. Rul. 73-160, 1973-1 C.B. 365, states that the income tax liability resulting from a transaction involving a change in the terms of outstanding securities is not controlled entirely by the mechanical means used for the accomplishment of the change. When the changes are so material as to amount virtually to the issuance of a new security, the same income tax consequences should follow as if the new security were actually issued. Each case of this nature must be governed by its own facts.

In situations where the maturity date and interest rate of an obligation have been substantially changed, it has been held that a taxable transaction has occurred pursuant to Code section 1001...

Section 1272(a)(1) of the Code provides that there shall be included in the gross income of the holder of any debt instrument having original issue discount issued after July 1, 1982, an amount equal to the sum of the daily portions of the

original issue discount for each day during the taxable year on which such holder held such debt instrument.

Section 1273(a)(1) of the Code provides that the term "original issue discount" means the excess (if any) of the stated redemption price at maturity, over the issue price...

In Rev. Rul. 81-281, 1981-2 C.B. 18, the Service concluded that where the terms of an obligation where substantially altered, including a change in interest rate, in principal amount, in terms to maturity, and a reduction in principal to be repaid, a new obligation had been created for purposes of section 103 of the Code.

In the present case, the Plan will eliminate interest on the Bonds and extend or accelerate the Bonds' maturity dates. These changes will result in materially different bond terms and will result in the creation of new obligations for federal income tax purposes. From all the information submitted, the Bonds and new obligations appear to meet the trading requirements of section 1273(b)(3) of the Code. Further, the new obligations are of a type offered to the public. The obligations will have a term of more than one year and are not described in section 163(f)(2)(B) of the Code. Finally, the new obligations will not be in registered form.

Therefore, based upon the information submitted and the foregoing discussion we conclude:

1. The Plan will cause material differences in the terms of the Bonds thereby creating new obligations for federal income tax purposes. Therefore, a taxable exchange will result under section 1001 of the Code.

2. The amount realized by the Bondholders for purpose of section 1001 of the Code will be determined in accordance with the provisions of section 1273(b)(3) of the Code.

3. A Bondholder will recognize gain or loss on the exchange determined with reference to the amount realized and the Bondholder's adjusted basis.

4. Bondholders will be required to recognize original issue discount pursuant to Code section 1272 on the new obligations created by the Plan. The issue price for such obligations shall be determined pursuant to Code section 1273(b)(3).

5. The new obligations created by the Plan will be registration-required obligations within the meaning of section 103(j) of the Code.

6. The interest on the new obligations will not be excluded from federal income tax by reason of subsection 103(a) of the Code [because the government is not the issuer].

Any changes of this type should be referred to the National Office.

D. Change in Bond Terms

PLR 9043060 concerns the effect of a change in the terms of issued bonds. When the terms of issued bonds are changed, new bonds will be considered as having been issued if the change was considered material. If the bonds are considered new, their tax exempt status would have to be determined according to current rules. Also, there may be tax consequences to the bondholders. PLR's 8913005 and 9037009 also address this issue.

In PLR 9043060 a town issued bonds to assist a corporation in financing the cost of constructing a manufacturing facility. The project was to be completed in three phases but phase three was not built because of a downturn in the economy. Abandonment of the third phase resulted in excess bond proceeds. The excess will be applied as prepayment on the bond proceeds. Because the bond payments were fixed, this would result in the bonds being fully paid for early which hurts bondholders. The Town proposes to amend the principal repayment schedule provided for the Bond in order to spread payment of the remaining principal amount over the originally intended term. The ruling concludes that this change is not material.

> Section 103(a) of the Code provides that gross income does not include interest on any state or local bonds.
>
> In general, section 1001 of the Code provides that gain or loss from the sale or other disposition of property will be determined by reference to the amount realized and the adjusted basis of such property. Section 1.1001-1(a) of the Income Tax Regulations provides that the gain or loss realized from the exchange of property differing materially either in kind or in extent is treated as income or loss sustained. Where changes in terms of outstanding securities are so material as to amount virtually to the issuance of a new security, the same income tax consequences should follow as if a new security were actually issued. With respect to whether such material changes, have been, or will be made, each case must be governed by its own facts. See Rev. Rul. 73-160, 1973-1 C.B. 365.
>
> In Rev. Rul. 73-160, the Service held that the mere extension of the maturity date of certain notes accompanied by an agreement of some of the

noteholders not to resort to the underlying security until other noteholders had been paid, did not constitute, in substance, the exchange of the notes for new and materially different notes.

In this case, we conclude that the proposed modification to the Bond regarding the adjustment downward of the fixed monthly principal payment is not so material to result in a deemed exchange of the outstanding bond for a new and materially different bonds. Therefore, based strictly on the facts submitted and the representations made, we conclude that the proposed modification to the Bond will not constitute a reissuance of the Bond under sections 1001, 103, and 141-150 of the Code.

10. IRC 147

A. IRC 147(b)-The 120% Rule

1. In General

IRC 147(b) provides that a private activity bond will not be a qualified bond if the average maturity of the bonds issued exceeds 120% of the average reasonably expected economic life of the facility. Where the maturity date of the bonds significantly exceeds the economic life of the facility being financed, this is indicative that an overfunding of the facility may have occurred. This provision would be particularly relevant when an exempt organization is purchasing an existing facility but it also applies to the purchase of new facilities. PLR 8822063 interprets these provisions as they apply to bonds issued on behalf of an IRC 501(c)(3) organization. The issue in the ruling is the effect of the refunding of taxable bonds with tax exempt bonds for purposes of 120% rule.

Example

Average Maturity of Bonds	= 30 yearsAverage
Economic Life of Facility	= 20 years
120% of 20 years	= 24 years

The bonds would be taxable because their average maturity (30 years) exceeds the average economic life of the facility (20 years).

2. PLR 8822063

The developer, a IRC 501(c)(3) organization, was building a retirement lifecare facility in three phases. The first phase was built and was financed by taxable bonds floated by the organization. In an effort to reduce its financial burden, it approached a county and the county agreed to issue bonds on the organization's behalf.

Section 147(b)(1) of the Code provides, generally, that a private activity bond is not a qualified bond if it is issued as part of an issue in which the average maturity of the bonds issued as part of such issue exceeds 120 percent of the average reasonably expected economic life of the facilities being financed with the net proceeds of such issue.

Section 147(b)(2) of the Code provides that for purposes of section 147(b)(1), (A) the average maturity of any issue shall be determined by taking into account the respective issue prices of the bonds issued as part of such issue, and (B) the average reasonably expected economic life of the facilities being financed with any issue shall be determined by taking into account the respective cost of such facilities.

Section 147(b)(3) of the Code provides that the reasonably expected economic life of any facility shall be determined as of the later of (i) the date on which the bonds are issued, or (ii) the date on which the facility is placed in service (or expected to be placed in service.)

In this case, the proceeds of the Taxable Bonds were used, in part, to finance start-up and construction costs associated with phase I of the Project. The bonds will be used, in part, to refinance a portion of the start-up and construction costs of phase I of the Project originally financed through the issuance of the Taxable Bonds. That portion of the net proceeds of the Bonds used to refinance the Taxable Bonds will be treated as being used to provide those facilities originally financed by that portion of the Taxable Bonds for purposes of section 147(b) of the Code. [Thus, the portion of the facility originally financed by taxable bonds will be considered financed by the new tax exempt bonds which refunded the original taxable bonds.]

The economic life of the portion of the facilities treated as financed by the Bonds is computed by using the economic life of each such asset based on the facts and circumstances in existence at the time such assets were placed in service. The economic life of each such asset is then reduced by the amount of time between the date the asset was placed in service and the date of issue of the Bonds. This result is the remaining economic life of each asset treated as financed by the Bonds as of the date of issue of the Bonds.

B. IRC 147(f)-Public Approval

1. In General

IRC 147(f) requires that there be public approval of the qualified private activity bond either by "applicable elected representative" after a public hearing or by voter referendum. The governmental unit that must obtain the approval is the issuing unit or unit on whose behalf the bonds will be issued. If the site of the facility is not in the same jurisdiction as the issuer, the host jurisdiction must also follow IRC 147(f). If bonds are to be issued that will effect a number of counties, any county can obtain public approval or the state can. If the original issue met the public approval requirement, under most circumstances, it can be currently refunded [not advance refunded, see part 12, Question 5 for discussion of advance refundings] without additional approval.

2. The Code

IRC 147(f)(2)(E) defines the term "applicable elected representative".

IRC 147(f)(2)(E)(i)provides that term applicable elected representative means with respect to any governmental unit-

(I) an elected legislative body of such unit, or

(II) the chief elected executive officer, the chief elected State legal officer of the executive branch, or any other elected official of such unit designated for purposes of this paragraph by such chief elected executive officer or by State law.

(ii) If a governmental unit has no applicable elected representative, the applicable elected representative for purposes of clause (i) shall be the applicable elected representative of the governmental unit which is the next higher governmental unit with such a representative from which the authority of the governmental unit with no such representative is derived.

3. Temporary Regulations

The elected official must give approval after a public hearing which was held after reasonable notice. Reasonable notice was not defined in the statute but there are temporary regulations.

> Temp. Regs. 5f.103-2(g)(3) provides that reasonable public notice means published notice which is reasonably designed to inform residents of the affected governmental units, including residents of the issuing unit and the governmental unit where a facility is to be located, of the proposed issue. The notice must state the time and place of the hearing and contain the information contained in paragraph (f)(2) of this section. Notice is presumed reasonable if published no fewer than 14 days before the hearing. Except in the locality of the facility, publication is presumed to be reasonably designed to inform residents of the approving governmental unit if given in the same manner and same locations as required of the approving governmental unit for any other purposes for which applicable State or local law specified a notice of public hearing requirement (including laws relating to notice of public meetings of the governmental unit). Notice is presumed reasonably designed to inform affected residents in the locality of the facility only if published in one or more newspapers of general circulation available to residents of that locality or if announced by radio or television broadcast to those residents."

Temp. Regs. 5f.103-2(f) provides the information that must be contained in the notice of public hearing.

> A facility is within the scope of an approval if the notice of hearing (when required) and the approval contain-
>
> (i) A general, functional description of the type and use of the facility to be financed (e.g. "a 10,000 square foot machine shop and hardware manufacturing plant," "dock facility for supertanker"),
>
> (ii) The maximum aggregate face amount of obligations to be issued with respect to the facility,
>
> (iii) The initial owner, operator, or manager of the facility,
>
> (iv) The prospective location of the facility by its street address or, if none, by a general description designed to inform readers of its specific location.

4. Examples

Mistake in Address

PLR 8831046 concerns the problem of mistakes in the published notice. The street address of the subject property was misprinted. The actual site and the advertised site where within one city block of each other. It does not seem like a significant question until you consider that failure to publish appropriate notice would result in the bonds not being qualified and the interest being taxable to the bondholders.

> Section 5f.103-2(f)(2) of the Temporary Income Tax Regulations provides that an approval is valid for the purposes of the public approval provisions with respect to any issue used to provide publicly approved facilities, notwithstanding insubstantial deviations with respect to (a) the maximum aggregate face amount of the bonds issued under the approval for the facility, (b) the name of its initial owner, manager, or operator, or (c) the type or location of the facility from that described in the approval. An approval or notice of public hearing will not be considered to be adequate if any items in (a) through (c) above with respect to the facility to be financed are unknown on the date of the approval or the date of the public notice.
>
> The purpose of the public notice requirement is to inform members of the general public who might be affected by a bond financed project of the location of the project, the owner, manager, or operator of the project, or the nature and size of the project. The deviation in this instance misplaced the location of the property by one city block in a homogeneously commercial area. The error, although somewhat misleading, was not so substantial as to fail to put members of the public on notice in the general vicinity of the project. The error was also of a nature to cause a question of whether there was a mistake in the street address numbering because of the current status of the Advertised Site and the Actual Site.
>
> Based on the facts submitted and the representations made we conclude that, the numbering error constitutes an 'insubstantial deviation' within the meaning of section 5f.103-2(f)(2) of the Temporary Income Tax Regulations. Accordingly, the notice and approval given meet the requirements of section 147(f)(2) of the Code.

Applicable Public Official

PLR 9123058 concerns the issue of who is the "applicable public official" for purposes of IRC 147(f). Two counties entered into a joint powers agreement to form an authority. The purpose of the authority was to provide financing for projects to be undertaken by IRC 501(c)(3) organizations. It was planned that the obligations, in this case certificates of participation, were to be approved by a representative who had been "elected at-large" by the voters of one county.

Section 5f.103-2(c)(2) of the temporary regulations provides that the governmental unit which will issue the obligations or on behalf of which the issue is to be issued must approve the issue (issuer approval"). However, in the case of an issuer which issues obligations on behalf of more than one governmental unit (e.g. an authority which acts for two counties), any one of such unit may give the issuer approval required by this paragraph.

Section 5f.103-2(c)(3) of the temporary regulations provides that each governmental unit with geographic jurisdiction over the site of a facility to be financed by the issue must approve the issue ('host approval".

Paragraph 5f.103-2(e) of the temporary regulations provides that the applicable elected representative of a governmental unit means (i) its elected legislative body, (ii) its chief elected executive officer, (iii) in the case of a State, the chief elected legal officer of the State's executive branch of government, or, (iv) any official elected by the voters of the unit and designated for purposes of this section by the unit's chief elected executive officer or by State or local law to approve issues for the unit. If multiple elected legislative bodies of a governmental unit have independent legislative authority, however, the body with the more specific authority relating to the issue is the only legislative body described in this section.

Based solely on the information submitted, we conclude that County A's applicable elected representative is a designated agent of County A's Board of Supervisors, as provided by State law. Therefore, this representative will be an "applicable elected representative" for purposes of public approval of the Obligations under sections 147(f)(2)(A)(i) and 147(f)(2)(A)(ii) of the Code.

11. Reporting Requirements of IRC 149(e)

IRC 149(e) imposes reporting requirements. Depending on the type of bond, there are three applicable forms. The issuer (the governmental authority) of private activity bonds files Form 8038 which is due no later than the 15th day of the second calendar month following the calendar quarter in which the bonds were issued. Issuers of governmental bonds file Form 8038-G, which is due in the same time period. Form 8038-GC is a consolidated information return for issues having an issue price of less than $100,000. It is filed annually by February 15 of the calendar year following the calendar year in which the small issues were issued. If the reporting requirements are not satisfied, the bonds are not tax exempt. All Forms 8038 are filed at the Philadelphia Service Center.

IRC 149(e)(3) provides that the Secretary may grant an extension of time for the filing of any statement required under paragraph (2) if the failure to file in a timely fashion was not due to wilful neglect.

Temp. Regs. 1.149(e)-1T(d)(2)(ii) provides that the Commissioner may grant an extension of time to file any form (or attachment) required under this section if the Commissioner determines that the failure to file in a timely manner was not due to willful neglect. Such determination may be made with respect to an issue or a class of issues. There are numerous private letter rulings granting extensions pursuant to these provisions. Because willful neglect is the standard, extensions are granted in cases constituting negligence such as inadvertent failure to file, failure to mail, and incorrect mailing.

12. Questions and Answers

We have been asked a number of technical questions by EO specialists who are examining exempt organizations. The organizations have been the beneficiaries of bond financing. The following answers are in response to those questions. The answers are intended to provide general guidance.

1. Discuss the different rules pertaining to the amount of private use or unrelated business use permitted for pre-1986 and post-1986 bonds.

The rule for post-1986 501(c)(3) bonds is that 5% of the net proceeds can be used in an unrelated trade or business or for private use. Included in the 5% is the issuance cost. Net proceeds equals proceeds minus the 10% reserve fund. The rule for pre-1986 501(c)(3) bonds is 25% of proceeds. The post-1986 rule for government bonds is that no more than 10% of the proceeds can be for a private use. The rule for pre-1986 government bonds was 25% of proceeds.

In addition to determining the correct rule to apply, it is fundamental to determine what law applies (either pre or post 1986 law). The post-1986 laws are generally effective for obligations issued after August 15, 1986. There is a general transitional rule for binding contracts and started construction. These bonds are exempt from the new rules if they were described in an inducement resolution or other comparable approval issued before September 26, 1985, and the original use of which begins with the beneficiary and the construction, reconstruction, or rehabilitation of which began before September 26, 1985, and was completed on or after such date, or the original use of which begins with the beneficiary and with respect to which a binding contract to incur more than 10% of the reasonably

anticipated costs for construction, reconstruction, or rehabilitation was entered into before September 26, 1985, or if the bond financed facilities were acquired on or after September 26, 1985, pursuant to a binding contract entered into before such date Different rules apply for refunding issues. In the case of current refundings, the law changes (other than arbitrage, rules relating to change of use limitations, issuance cost, information reporting, and certain other rules) do not apply to bonds whose proceeds are used exclusively to refund tax exempt bonds, (1) that were issued on or before January 1, 1986, and, (2) whose amount is not greater than the amount of the refunded bonds, and, (3) which may have a maturity date no later than 17 years after issue or comply with the rule requiring maturity to be no more than 120% of economic life of the financed facilities.

For rules pertaining to advance refundings, see Question 5.

2. There is concern about the correct method of allocation between private business use or unrelated business income and exempt function use. Is there a standard method of allocation? If not, what method is recommended?

Allocation must be determined by a reasonable method. Section 1.103-7(c) of the old regulations provided guidance under the 25% test. The principles established under the regulations continue to apply unless made obsolete by the 1986 TRA. In Example 6(b) the allocation was based on the percentage of rooms rented for a nongovernmental use. Example 7 provides "Such costs, whether attributable to the acquisition of land or the construction of the building, were allocated to leased space in the same proportion that the reasonable rental value of such leased space bears to the reasonable rental value of the entire building. From the facts and circumstances presented, it is determined that such allocation was reasonable." Thus, in Example 7 the allocation was based on the reasonable rental value of the leased space as opposed to the entire bond financed facility. Example 7(b) reads as follows, "Y will lease 4 floors, and the costs allocated to these floors are in excess of the 25 percent of D's investment in the land and building." In Example 7(b) the allocation was based on cost and the relationship between cost and investment [cost of acquisition]. There are other examples in the regulations. What is clear from the regulations, is that the standard is reasonableness and there are a number of ways of calculating reasonableness. Allocations based on time alone are highly questionable. Be aware that the financing of an undivided interest in a mixed use facility is not permitted. Only those portions of a mixed use facility

owned and used by a 501(c)(3) organization and not by nongovernmental users can be financed with qualified 501(c)(3) bonds. See Part 6 of the Article.

3. When is nonexempt function use determined, initially, at some point in the life of the bonds, or over the life of the bond.

The issue of change in use is currently being studied in Chief Counsel, Financial Institutions and Products. All change in use issues should be referred on Technical Advice for coordination.

PLR 912430 is a good illustration of how the pre-1986 and post-1986 rules would work. While it helps explain the issue, please note that it has been revoked for procedural reasons. In the PLR a utility that was financed with bonds was sold to another system that would not qualify under the exempt facility rules of IRC 142. The seller had a number of bonds outstanding from before the Act and after the Act. The pre-1986 treatment is that under certain circumstances the interest on the bonds will still be tax exempt. The ruling relies on Rev. Rul. 77-416, Rev. Proc. 79-5 and Rev. Proc. 81-22. The conditions to be met are substantial. The ruling reads as follows:

> The principal issue raised is the effect of a post-issuance change in use from a qualifying use to a nonqualifying use on the exclusion from gross income of interest on exempt facility bonds under section 103(a) of the Code where the facts show good faith reasonable expectations to use bond proceeds to provide exempt facility, actual use of bond proceeds to provide exempt facilities and qualifying use of the exempt facilities for specified period of time, and a yield-restricted defeasance at the time of the change to a nonqualifying use. The proposed Defeasance, yield restriction, and bond redemption requirements will reduce, to a reasonably-practical extent, the benefit of tax exemption and the burden on the tax-exempt market for bonds no longer being used for their exempt governmental purpose.

Thus, the answer for pre-1986 bonds appears to be that under certain special circumstances a change is use will not cause loss of the tax exempt status of the bonds. The ruling goes on to consider the effect of change in use on post-1986 bonds. It reads as follows:

> With respect to certain tax-exempt private activity bonds issued after the effective date of Section 150(b)(4) of the Code, certain collateral federal income tax consequence[s] occur upon certain changes in use of bond-financed facility. Section 150(b)(4) of the Code provides, in part, that if a facility financed by the

> proceeds of any private activity bond is not used for a purpose for which a tax exempt bond could be issued on the date of such issue, no deduction shall be allowed on such financing which accrues during the period of non-qualified use of the facility. Thus, in the instant case, no deduction would be allowable for the interest expense attributable to interest paid or accruing on the 1986B bonds...

In addition, IRC 150 requires that use be determined on an ongoing basis.

4. Discuss the mechanics of the 150 tax.

a. When is the tax due and how is it reported?

The tax is due with the first return due after the change in use. It should be reported on the 990-T as income from an unrelated trade or business. This should be clear from the provision, which deems that certain income is unrelated trade or business income.

b. What is deductible is computing the tax?

Additional expenses such as depreciation should not be deductible. The Code should be interpreted literally. The Code creates unrelated business income equal to the fair market rental value of the portion of the facility used by private users. IRC 150(b)(3) contains an additional penalty. A deduction is denied for rent or similar expenses equal to the interest deduction on that portion of the facility that is bond financed. See Part V of the Article.

c. If part of the bond facility is used by an organization exempt from tax under a Code section other than IRC 501(c)(3) [for example, an associated 501(c)(4)] would the income generated by the IRC 501(c)(4)'s use of the bond financed facility become subject to tax by virtue of IRC 150.

There is no authority for taxing the income of the IRC 501(c)(4) organization. IRC 150(b)(3) is a substantial penalty and should not be construed broadly. In addition, the statue provides that the portion that is used by the non501(c)(3) entity be used in a trade or business. IRC 141 contains a definition of trade or business which provides that any activity of an entity other than an individual is a trade or business. Thus, if there is use by an associated non501(c)(4)

exempt organization, it would be a trade or business use that would give rise to the IRC 150(b)(3) penalties.

5. There is a lot of confusion concerning the refunding and advance refunding rules.

A distinction needs to be made between current refundings and advance refundings. In a current refunding, the refunding bonds are used to immediately pay off the refunded bonds. There will only be one set of bonds outstanding. Sometimes, the original bonds cannot be refunded immediately because they have a call date in the future. Advance refunding bonds are issued but they can not pay off the original bonds immediately. So there will be two sets of bond proceeds outstanding on one facility. The advance refunding bonds will be held, pending the call date of the refunded bonds. There are special arbitrage rules to control the investment of the refunding bond's proceeds. The Tax Reform Act of 1986 permits limited advance refundings for only governmental bonds and qualified 501(c)(3) bonds.

Historically there have been three principal regulatory definitions of "refunding issue." Section 1.103-14(e)(2)(i), which was generally the operative definition prior to the 1986 Act, defined refunding issue by reference to whether the issuer of the refunded and refunding issue are the same. Section 1.148-8T(f)(2) defined refunding issue more broadly as any issue used to discharge another issue. The current definition at 1.148-11(b) defines refunding issue by reference to whether the obligor of the refunded and refunding issues are the same.

> (b) Definitions of refunding issue and prior issue. For purposes of this section, the following definitions apply:
>
> > (1) Refunding issue. Except as provided in paragraph (b)(2) of this section, "refunding issue" means an issue of obligation debt service (as defined in paragraph (c)(1) of this section) on another issue (a "prior issue," as more particularly defined in paragraph (b)(5) of this section) or to finance issuance costs, accrued interest, capitalized interest on the refunding issue, a reserve or replacement fund, or similar costs properly allocable to the issue.
> >
> > (2) Exceptions and special rules. For purposes of paragraph (b)(1) of this section, the following exceptions and special rules apply:
> >
> > > (i) Payment of certain interest. An issue is not a refunding issue if the proceeds of the issue are used to pay

> any debt service (as defined in paragraph (c)(1) of this section) on another issue that is described as follows—
>
> > (A) Interest that accrues on the other issue during a one-year period including the date of issue of the issue that finances the interest;
> >
> > (B) Interest that is a "capital expenditure" (as defined in 1.150-1(h)); or
> >
> > (C) Interest that is a working capital expenditure (as defined in 1.148-4(d)(3)(ii)).
>
> (ii) Certain issues with different obligors--(A) In general. An issue is not a refunding issue to the extent that the obligor (as defined in paragraph (b)(2)(ii) (B) of this section) of one issue is neither the obligor of the other issue nor a related party (as defined in paragraph (b)(2)(ii) (C) of this section) with respect to the obligor of the other issue.

The consequences of refunding bonds are generally as follows:

1. Upon the application of the refunding bonds' proceeds to the discharge of the prior bonds, proceeds of the prior bonds become "transferred proceeds" effectively allocated to the new refunding bonds. This is true whether the refunding bonds are current refunding bonds or advance refunding bonds.

2. Proceeds treated as "transferred proceeds" are also therefore treated as gross proceeds of the refunding bonds, subject to rebate rules and are subject to the yield limitations of the refunding bonds.

Advance refunding bonds are issued in advance of maturity or the call date of refunded bonds generally to accomplish a debt service saving for the issuer. Depending upon the technique used, it may be to remove onerous covenants or to take advantage of interest rate changes. The proceeds of the advance refunding bonds are typically invested in an escrowed trust account (the "escrow account,") until required to repay the prior issue. Pending the repayment, the cash flow from the investment of bond proceeds is applied to payment of debt service on the refunded bonds.

Under the new law, advance refunding bonds are those issued more than 90 days before the refunded bonds are redeemed. Refundings before January 1, 1986 are treated as advance refunding only if the refunding bonds were not redeemed within 180 days of the issuance of the refunding bonds. Only qualified 501(c)(3) bonds and government bonds can be advance refunded and only under the following circumstances.

> Bonds originally issued before January 1, 1986 can be advance refunded 2 times with a transitional rule permitting one additional advance refunding after March 14, 1986 if the bonds were advance refunded 2 or more times before May 15, 1986. Bonds originally issued after December 31, 1985 can be advance refunded only once.

In the case of advance refundings of bonds originally issued after December 31, 1985, that produce debt service savings, the refunded bonds must be redeemed no later than the first date on which their call is not prohibited.

In the case of bonds originally issued before January 1, 1986, and advance refunding that may produce debt service savings, the refunded bonds must be redeemed no later than the first date on which the issue may be called at a premium of 3% or less.

The new advance refunding rules generally apply to advance refunding bonds issued after August 15, 1986.

6. There is confusion concerning the broader meaning of private use particularly in the hospital setting.

a. The use of the hospital by attending physicians.

The answer would depend on the purpose served by the physicians. If the physicians are there to minister to the needs of the hospital's patients or to administer the hospital's programs, their use of the facilities would not be private use. If the physicians are there to care for their private practice patients, the use could be private use.

b. Departments of the hospital that are controlled by private physicians such as the radiology department.

The issue here would be those issues presented in Rev. Procs. 82-14 and 82-15. Note that Rev. Proc. 82-14 and 82-15 only establish safe harbors. They do not set forth examination guidelines. Upon examination, control will be determined from the facts. It boils down to the control exercised by the physicians over the department. If the physicians hire, fire, set rates, or have other indicia of control private use could result.

c. The lease or condominium ownership of a bond financed medical office building.

Medical office buildings used by private physicians were unfavored by Congress in the 1986 Tax Act. The congressional history makes it clear specifically that these types of arrangements should be considered private use.