

## TEB Phase II - Lesson 10

### Change in Use Rules for Private Activity Bonds

#### Overview

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|                     |                                                                                                                                                                                                                         |
|---------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Introduction</b> | In Phase I Lesson 7, you learned how changes in use affects governmental and § 501(c)(3) bonds. This lesson discusses post-issuance events and how they affect the tax-exempt status of certain private activity bonds. |
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| <b>Objectives</b> | After completing this lesson, you will be able to: <ul style="list-style-type: none"><li>• Determine if proper remedial action has taken place</li><li>• Determine if the §150(b) change in use disallowance applies to a transaction</li><li>• Explain how disallowances affect the owners and users of the tax-exempt bond-financed property</li></ul> |
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| <b>Typical Changes Which May Affect the Bond's Status</b> | <p>A typical change which may affect the status of tax-exempt bonds involves the failure to spend the proceeds as required by the Code.</p> <p>This scenario jeopardizes the tax-exempt status of bonds if the required percentage of the net proceeds of the bonds is not spent on qualifying expenditures. This type of post-issuance event can cause the bonds, issued as tax-exempt bonds, to become taxable private activity bonds.</p> |
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## Overview, Continued

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**Example 1** City X issues bonds and loans the proceeds to the Airport Authority of City X to fund the expansion of a new hanger and terminal to be used by Fly Me Airlines. Due to an unexpected economic downturn, Fly Me Airlines no longer has the need for the new hanger and will not proceed with the planned construction. The construction of the terminal will result in the allocation of only 65 percent of the net bond proceeds to the airport facility. Therefore, the tax-exempt status of the bonds is in jeopardy.

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**Effect of Change of Use** When a change in use occurs, the bonds are usually considered taxable as of **the date of issuance**. This is because the issuer failed to properly use the proceeds of the bonds after the issuance date causing the bonds to be taxable.

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**History** Regulation § 1.103-8(a)(1) required that substantially all of the proceeds of an issue be used to provide one or more of the exempt facilities listed in § 103(b)(4) of the 1954 Code. Regulation § 1.103-10(b)(1)(ii) required that substantially all the proceeds of an issue described in § 103(b)(6) of the 1954 Code be used for qualifying expenditures. Revenue Procedure 79-5, 1979-1 C.B.485, as amplified by Revenue Procedure 81-22, 1981-1 C.B. 692, provided that unexpended bond proceeds will not be considered in computing whether substantially all of the bond proceeds were used to provide exempt facilities when such unexpended bond proceeds are used or are placed in escrow to be used to redeem outstanding bonds. Revenue Procedure 93-17, 1993-1 C.B. 507 set forth additional remedial actions for changes in use.

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## Overview, Continued

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**Current Rules** This lesson covers the current change in use rules which are generally effective for certain private activity bonds issued on or after May 16, 1997. These rules are contained in Regulations §§ 1.142-2, 1.144-2, 1.147-2 and 1.150-4.

Many of the rules may also be applied in whole, but not in part, to bonds issued before, but were still outstanding on, May 16, 1997.

(See Regulation § 1.141-16 for specific information.)

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**Contents** This lesson contains the following topics:

| Topic                                   | See Page |
|-----------------------------------------|----------|
| Overview                                | 1        |
| Section 1 – Change in Use Remedies      | 5        |
| Section 2 – Change in Use Disallowances | 19       |
| Summary                                 | 27       |

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# Section 1, Change in Use Remedies

## Overview

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### Introduction

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

The test for qualified private activity bonds considers the actual use of the proceeds of the issue. Even though an issuer reasonably expects on the issuance date to use the bond proceeds for a qualifying purpose throughout the life of the bonds, unexpected events may occur that impact the actual use. These unexpected events can result in a deliberate action by the issuer that can change the intended use of the proceeds of the issue; and consequently, can affect the taxability of the interest on the bonds from the issuance date, even though the events may occur much later.

The regulations provide for certain actions, which, if properly taken by issuers, will preserve the tax exemption of the bonds starting from the issuance date. This section explains the conditions the issuer must meet to avail itself of these remedial actions.

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### Content

This section contains the following topics:

| Topic                         | See Page |
|-------------------------------|----------|
| Overview                      | 5        |
| Exempt Facility Bonds         | 6        |
| Mortgage Revenue Bonds        | 10       |
| Qualified Small Issue Bonds   | 11       |
| Qualified Redevelopment Bonds | 12       |
| Qualified Student Loan Bonds  | 13       |
| Closing Agreement             | 14       |
| Section 147                   | 17       |
| Exhibit A – Applicability     | 18       |

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## Exempt Facility Bonds

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### **Remedial Action Introduction**

In Lesson 6, you learned that exempt facility bonds are private activity bonds for which 95 percent or more of the net proceeds of the issue are to be used to finance certain facilities specified by law.

Regulation § 1.142-2 provides that if less than 95 percent of the net proceeds are actually used to provide an exempt facility (other than bonds for qualified residential rental projects or local furnishing of electric energy or gas), the issue will be treated as meeting the use of proceeds requirement if the issue meets one condition and takes the appropriate remedial action.

The remedial action provisions, if properly undertaken, will prevent a use violation from causing an issue to fail to be a qualified exempt facility bond.

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### **Required Condition**

Regulation § 1.142-2 requires that the issuer must have reasonably expected on the issue date that 95 percent of the net proceeds of the issue would be used to provide an exempt facility and for no other purpose for the entire term of the bonds.

To meet this condition, the amount of the issue must have been based on reasonable estimates about the cost of the facility.

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## Exempt Facility Bonds, Continued

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|                                                       |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |
|-------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Action</b>                                         | If the issuer reasonably expected to provide an exempt facility at the issue date but failed to use bond proceeds as required by the regulations, the issuer may remediate by redeeming all nonqualified bonds at the earliest call date after the date on which the failure to properly use proceeds occurs.                                                                                                                                                                                                                                                                                                                           |
| <b>Failure to Use Proceeds</b>                        | <p>Failure to use proceeds occurs:</p> <ul style="list-style-type: none"><li>• As a result of unspent proceeds, on the earlier of the date on which the issuer reasonably determines that the financed facility will not be completed or the date on which the financed facility is placed in service</li><li>• As the result of spent proceeds, on the date on which an action is taken that causes the bonds not to be used for the qualifying purpose for which the bonds were issued</li><li>• Demolition is NOT a change in use (PLR 200928018)</li></ul>                                                                          |
| <b>Redemption or Defeasance of Nonqualified Bonds</b> | <p>Regulation § 1.142-2(c) provides that the redemption or defeasance of nonqualified bonds is met if all of the nonqualified bonds of the issue:</p> <ul style="list-style-type: none"><li>• Are redeemed within 90 days of the deliberate action, or</li><li>• If not redeemed, a defeasance escrow must be established within 90 days of the failure to properly use proceeds (the first call date cannot be more than 10.5 years from the date of issuance).</li></ul> <p>Proceeds of tax-exempt bonds (other than those described in Regulation § 1.142-2(d)(1)) must not be used to redeem or defease the nonqualified bonds.</p> |

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## Exempt Facility Bonds, Continued

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### Notice of Defeasance

Regulation § 1.142-2(c)(2) requires that the issuer must provide written notice to the Commissioner of the establishment of the defeasance escrow within 90 days of the date the defeasance escrow is established.

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

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### Special Rule for Disposition of Personal Property

Regulation § 1.142-2(c)(4) provides that for the disposition of personal property exclusively for cash, the redemption or defeasance requirements are met if the issuer expends the disposition proceeds within six months of the date of the disposition to acquire replacement property for the same qualifying purpose of the issue under § 142.

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### Nonqualified Bonds

In order to remediate, the issuer must determine the amount of nonqualified bonds and allocate the nonqualified bonds to the outstanding bonds of the issue. Regulation § 1.142-2(e)(1) defines nonqualified bonds as the portion of the outstanding bonds in an amount that, if the remaining bonds were issued on the date on which the failure to properly use the proceeds occurs, at least 95 percent of the net proceeds of the remaining bonds would be used to provide an exempt facility.

**If no proceeds have been spent to provide an exempt facility, all of the outstanding bonds are nonqualified bonds.**

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## Exempt Facility Bonds, Continued

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### Allocation of Nonqualified Bonds

Allocation of the nonqualified bonds must be made on a pro rata basis. However, an issuer may allocate the nonqualified bonds of an issue to any bonds of the same issuance as the nonqualified bonds as long as the weighted average maturity of the outstanding bonds (on the date of redemption) after the removal of the nonqualified bonds is less than the weighted average maturity (on the date of redemption) of the outstanding bonds before redemption of the nonqualified bonds. (See § 1.142-2(e)(2).)

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### Example 1

On March 1, 2015 City X issued \$10 million of tax-exempt bonds under § 142(a)(1), for the expansion of a passenger terminal for the Airport of City X. Airport revenues were used to pay the costs of issuance. On April 2, 2016, City X leased space financed with \$1,000,000 of the bond proceeds to Fly Me Airlines for use as its corporate headquarters. As of April 2, 2016, \$9,700,000 of bonds were outstanding. The issuer would like to remediate the non-exempt facility use by redeeming the nonqualified bonds.

#### Calculation of the Percentage of Nonqualified Bonds:

The percentage of nonqualified bonds is computed by dividing the percentage of the facility used for the exempt facility by the minimum amount of use required and subtracting the resulting percentage from 100 percent.

|                                            |                  |
|--------------------------------------------|------------------|
| % of proceeds used for the exempt facility | 90% (\$9M/\$10M) |
| ÷ Minimum use required                     | ÷ 95%            |
|                                            | -----            |
|                                            | 94.74%           |
|                                            | - 100.00%        |
|                                            | -----            |
| % of nonqualified bonds                    | 5.26%            |
|                                            | =====            |

5.26% X \$9,700,000 bonds outstanding = \$510,220 nonqualified bonds

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# Mortgage Revenue Bonds

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**Remedial  
Action  
Introduction**

In Lesson 8, you learned that under § 143, mortgage revenue bonds are private activity bonds that require all of the proceeds of the bonds (exclusive of issuance costs and a reasonably required reserve) to be used to finance owner occupied residences.

Furthermore, § 143(a)(2)(D) requires that the proceeds be used within the 42-month period beginning on the date of issuance of the issue.

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**42-Month  
Spending  
Requirement**

Unlike exempt facility bonds, there is not a specific provision in the regulations that discusses remedial actions for mortgage revenue bonds. However, per § 143(a)(2)(D)(i)(I), if the proceeds have not been used to finance single family housing within the 42-month period, such proceeds must be used to redeem bonds of the issue.

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**Redemption**

If the issuer fails to spend the bond proceeds to finance owner-occupied residences, to the extent not used, the issuer must redeem bonds with those proceeds within the 42-month period.

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# Qualified Small Issue Bonds

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**Remedial  
Action  
Introduction**

In Lesson 5, you learned that qualified small issue bonds are private activity bonds issued for which 95 percent or more of the net proceeds of the issue are to be used for the acquisition, construction, reconstruction or improvement of land or property of a character subject to depreciation; specifically, a manufacturing facility or certain farm property.

Remedial action provisions are provided in Regulation § 1.144-2. Thus, the issue will be treated as meeting the use of proceeds requirement if the issuer takes the appropriate action.

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**Regulation  
§ 1.144-2**

Regulation § 1.144-2 provides that the remedial action rules of Regulation § 1.142-2 (exempt facility) apply to qualified small issue bonds.

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**Required  
Condition and  
Remedial  
Action**

Regulation § 1.142-2, applied to qualified small issue bonds, requires that the issuer must have reasonably expected on the issue date that 95 percent of the net proceeds of the issue would be used to provide the facility and for no other purpose for the entire term of the bonds. If this condition is met, then the issuer may remediate a use problem by the redemption or defeasance of the nonqualified bonds on the earliest call date after the date on which the failure to properly use the proceeds occurs.

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**Limitation on  
Remedial  
Actions**

There are no remedial action provisions to address post issuance compliance violations concerning § 144(a)(4) relating to the limitation on capital expenditures, or § 144(a)(10) dealing with the aggregate limit of tax-exempt bonds per taxpayer.

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## Qualified Redevelopment Bonds

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**Section 144(c)  
Qualified  
Redevelop-  
ment Bonds**

Qualified redevelopment bonds means any bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used for one or more redevelopment purposes in any designated blighted area.

The remedial action provisions related to qualified redevelopment bonds parallel those of the exempt facility bonds.

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**Regulation  
§ 1.144-2**

Regulation § 1.144-2 provides that the remedial action rules of Regulation § 1.142-2 (exempt facility) apply to qualified redevelopment bonds.

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**Required  
Condition and  
Remedial  
Action**

Regulation § 1.142-2, applied to qualified redevelopment bonds, requires that the issuer must have reasonably expected on the issue date that 95 percent of the net proceeds of the issue would be used for redevelopment purposes as defined in § 144(c)(3) and for no other purpose for the entire term of the bonds. If this condition is met, then the issuer may remediate a use problem by the redemption or defeasance of the nonqualified bonds on the earliest call date after the date on which the failure to properly use the proceeds occurs.

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## Qualified Student Loan Bonds

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**Qualified  
Student Loan**

Section 144(b) requires that either 90 percent or 95 percent of the net bond proceeds (depending on the type of program) must be used to make or finance student loans in order to be a qualified student loan bond.

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**No Remedial  
Action  
Provisions**

There are no remedial actions under the regulations that the issuer may take to remedy a failure to properly use proceeds of a student loan bond.

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## Closing Agreement

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### **Closing Agreement**

Application of remedial action provisions may not be possible for issuers in some cases. Regulation § 1.141-12(h) provides that the Commissioner may provide for additional remedial actions through publication. Pursuant to this authority, the Internal Revenue Service released Rev. Proc. 97-15, 1997-1 C.B. 635, on February 3, 1997.

Under this provision, bonds for which it has been determined do not meet the use requirements and did not meet the remediation provisions, may retain their tax-exempt status through a closing agreement. This program is a compliance program but is not based upon an examination of an issue of bonds by the Service.

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

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### **Provisions of Rev. Proc. 97-15**

Revenue Procedure 97-15 permits an issuer to enter into a closing agreement to prevent interest on the bonds: from becoming taxable due to a deliberate action which causes the bonds to fail to meet certain requirements of §§ 141-150.

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## Closing Agreement, Continued

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**Required Issuer  
Actions**

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

- The requirements of Regulations §§ 1.142-2, 1.144-2, 1.147-2 and 1.150-4 as applicable, relating to conditions for remedial action must be satisfied, AND

The issuer must:

- Submit a proper request for a closing agreement which describes the subsequent action and explains computation of the proposed closing agreement amount within 180 days of the subsequent action,
- Agree to redeem the bonds at the next call date,
- Notify the bondholders that the bonds will be redeemed on the next redemption date, and if not redeemed, the bonds will be nonqualified private activity bonds,
- Not make any closing agreement payment from tax-exempt bond proceeds,
- Sign a disclosure consent authorizing the Service to make certain documents relating to the agreement public if the bonds are not redeemed in accordance with the terms of the agreement, AND
- Pay the full amount due upon execution of the closing agreement.

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## Closing Agreement, Continued

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### **Voluntary Closing Agreement Program (VCAP)**

The VCAP program is designed for tax-advantaged bonds and provides a process for issuers to resolve compliance violations when existing remedial actions for self-correction are not available. TEB's Compliance and Program Management (CPM) oversees the VCAP program.

VCAP is NOT available when the:

- Bond issue is under exam,
- Tax favored status is at issue in any federal court, IRS office of Appeals, or any other proceedings, or
- Violation was due to willful neglect.

See Notice 2008-31 and IRM Sections 7.2.3 and 4.81.6 for program requirements and administrative processes for VCAP request.

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## Section 147

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**General Rule**

Regulation § 1.147-2 provides that the exempt facility remedial action rules of Regulation § 1.142-2 apply to certain rules in § 147 for qualified private activity bonds. These rules are:

- § 147(c)(3) land for environmental purposes
- § 147(d)(2) and (3) use of proceeds for certain rehabilitations
- § 147(e) skyboxes, airplanes, gambling establishments and similar facilities
- § 147(f) public approval

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**Application**

For the purpose of applying the remedial action rules under Regulation § 1.142-2 to the above, the qualified private activity bonds subject to the rules of § 147 are treated as exempt facility bonds and the qualified purposes for those bonds as an exempt facility.

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## Exhibit A. Applicability

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

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

## Section 2, Change in Use Disallowances

### Overview

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

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**Example 1** On January 1, 2010, City X issued bonds in the principal amount of \$50M. On that date, the bonds satisfied all of the requirements for tax-exempt facility bonds under §142(a)(2). Corporation Y borrowed the proceeds and used them to finance construction and renovation of its wharf, fund a debt service reserve fund, and pay costs of issuance. Five years later, Corporation Y proposed to sell the land and facility to a local developer for private use.

Absent appropriate remedial action, the bonds would become nonqualified private activity bonds on date of the sale of the financed facility and land. The interest on the bonds would be taxable retroactive to the issuance date, and § 150(b)(3) would apply.

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**Content** This section contains the following topics:

| Topic                                                          | See Page |
|----------------------------------------------------------------|----------|
| Overview                                                       | 19       |
| Mortgage Revenue Bonds                                         | 22       |
| Qualified Residential Rental Projects                          | 23       |
| Facilities Required to be Owned by Governmental Units          | 24       |
| Exempt Facility Bonds and Small Issue Bonds                    | 25       |
| Small Issue Bonds Exceeding the Capital Expenditure Limitation | 26       |

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## Overview, Continued

|                                    |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
|------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Purpose</b>                     | <p>Section 150(b) affects the users of tax-exempt private activity bond-financed facilities who fail to use the facilities for a qualifying purpose. The change in use disallowances are generally separate and distinct from any retroactive or prospective loss of exemption of bond interest that may result if applicable Code requirements are not met.</p> <p>The disallowances were enacted in response to the concern that the proper use of bond-financed facilities was generally under the control of the users of such facilities, and that such users should be penalized for any misuse.</p>                     |
| <b>Effective Date</b>              | <p>Section 150(b) was added to the Code in 1986 and generally applies to changes in use of bond-financed property occurring after August 15, 1986, with respect to financing provided after that date.</p>                                                                                                                                                                                                                                                                                                                                                                                                                     |
| <b>Applicability</b>               | <p>The provisions of §§ 150(b) and (c) apply only to the following types of qualified private activity bonds:</p> <ul style="list-style-type: none"><li>• Mortgage revenue bonds (§ 143)</li><li>• Qualified residential rental projects (§ 142(d))</li><li>• Qualified 501(c)(3) bonds (§ 145)</li><li>• Exempt facility bonds (§ 142(a) other than 142(a)(7))</li><li>• Qualified small issue bonds (§ 144(a))</li><li>• Bonds financing facilities required to be owned by governmental units (§§ 142(a)(1), (2), (3), and (12))</li></ul> <p>The provisions do NOT apply to property financed with governmental bonds.</p> |
| <b>Exception and Special Rules</b> | <p>Section 150(c) provides an exception and several special rules which relate to § 150(b). The exception is discussed below. The special rules concern:</p> <ul style="list-style-type: none"><li>• The treatment of amounts payable for the use of a facility that are not interest, (such as leases), AND</li><li>• Allocations where only a portion of a facility is used for private use (See Regulation § 1.150-4(c).)</li></ul>                                                                                                                                                                                         |

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## Overview, Continued

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**Effect of Remedial Action**

Regulation § 1.150-4(b)(1) provides generally that the rules of §§ 150(b)(3) through (5) and 150(c) apply even if the issuer takes a remedial action described in Regulations §§ 1.142-2, 1.144-2 or 1.145-2.

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**Exceptions**

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

- Redemption within 90 days of the deliberate action under Regulation § 1.145-2 or within 90 days of the date on which a failure to properly use proceeds occurs under Regulation § 1.142-2 or 1.144-2,
- An alternative qualifying use of a bond-financed facility under Regulation § 1.145-2 and 1.141-12(f), OR
- An alternative use of disposition proceeds under Regulation § 1.145-2, 1.141-12(e), 1.142-2(c)(4), or 1.144-2

(See Regulation § 1.150-4(b)(2) for specific rules.)

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**Note**

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

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# Mortgage Revenue Bonds

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## General Rule

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

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

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

## Disallowance

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

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## Qualified Residential Rental Projects

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|                     |                                                                                                                                   |
|---------------------|-----------------------------------------------------------------------------------------------------------------------------------|
| <b>General Rule</b> | Section 150(b)(2) applies when a bond-financed qualified residential rental project no longer meets the requirements of § 142(d). |
|---------------------|-----------------------------------------------------------------------------------------------------------------------------------|

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|                          |                                                                                                         |
|--------------------------|---------------------------------------------------------------------------------------------------------|
| <b>Applicable Events</b> | If the project does not meet the residency test elected by the issuer under § 142(d), the rule applies. |
|--------------------------|---------------------------------------------------------------------------------------------------------|

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|                     |                                                                                              |
|---------------------|----------------------------------------------------------------------------------------------|
| <b>Disallowance</b> | No deduction shall be allowed for interest on the financing which accrues during the period: |
|---------------------|----------------------------------------------------------------------------------------------|

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

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|                  |                                                                                                                                                                                                                                                                                                                                                                                                                                       |
|------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Example 2</b> | <p>The issuer elected, at the time of issuance, that during the qualified project period 20 percent or more of the units would be occupied by individuals whose income is 50 percent or less of the area median gross income. Eight years later, during the qualified project period, less than 20 percent of the residents met the income qualifications. In year 10, 20 percent of the residents met the income qualifications.</p> |
|------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

No deduction for interest is allowed for the 2-year period that the 20 percent requirement was not met.

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

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## Facilities Required to be Owned by Governmental Units

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**General Rule** Section 150(b)(5) provides for a denial of interest deduction when property financed by tax-exempt bonds is required to be owned by a governmental unit, and there is a change in ownership to an organization which is other than a governmental unit.

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**Applicable** This provision applies to bonds issued under the following Code sections of § 142(a):

- (1) airports
- (2) docks and wharves
- (3) mass commuting facilities
- (12) environmental enhancements of hydro-electric generating facilities

This provision also applies to bonds issued under the exception for volume cap for government-owned solid waste disposal facilities under §146(h)(1).

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

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

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## Exempt Facility Bonds and Small Issue Bonds

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|                     |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |
|---------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>General Rule</b> | Section 150(b)(4) applies when a facility is not used for a purpose for which a tax-exempt bond could be issued on the date of the issue.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
| <b>Disallowance</b> | No deduction is allowed for interest on such financing which accrues during the period beginning on the date such facility is not so used and ending on the date such facility is so used.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                            |
| <b>Example 3</b>    | <p>City Z issues \$25M principal amount of bonds and loans the proceeds to a Private Transit Company X to build, own, and operate a high-speed intercity rail facility, as described in § 142(i). After a few years of operation, public ridership declined. Company X decided to give Business ABC discounted fares and a special schedule for ABC's employees such that the requirements of § 142 are no longer met.</p> <p>As a result of the arrangement with Business ABC, the bonds are no longer qualified bonds. In addition to the interest on the bonds becoming taxable to the bondholders, Company X is not entitled to a deduction for interest on the loan from City Z (not to exceed the amount of bond interest).</p> |

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## Small Issue Bonds Exceeding the Capital Expenditure Limitation

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|                     |                                                                                                                                                                                                                             |
|---------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>General Rule</b> | Section 150(b)(6) provides that when a small issue bond becomes nonqualified because the capital expenditure limitation is exceeded, the owner is denied a deduction for interest during the time the bond is nonqualified. |
|---------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

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|                  |                                                                                                                                                                                                                                                                                                                          |
|------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Example 4</b> | County Z issued \$8M of qualified small issue bonds under § 144(a) and loaned the proceeds to Corporation X. Upon examination by the Internal Revenue Service, it is determined that Corporation X exceeded the capital expenditures limitation of § 144(a)(4)(A)(ii) in the third year following issuance of the bonds. |
|------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

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

Remember, too, that no remedial action can cure this violation.

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## Summary

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### **Review of Lesson 10**

Lesson 10 discussed the change in use rules included in Regulations §§ 1.142-2, 1.144-2, 1.147-2; and the change in use disallowances provided by §§ 150(b) and (c) and the accompanying regulations.

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

Any failure to properly use the proceeds of the bonds is significant. Bonds are issued as tax exempt based on reasonable expectations on the date of issue. Although these expectations might be reasonable on the issuance date, circumstances might change resulting in a change in the use of the proceeds.

When a change in use occurs it can result in the bond issue becoming a nonqualified issue retroactive to the issuance date if a proper remedial action is not taken.

The regulations provide remedial action provisions which, if properly performed by the issuer, will prevent the bonds from becoming taxable. In addition to meeting all of the requirements of the specific remedial action, the issuer must also meet certain conditions. If accomplished correctly, then the failure to properly use the proceeds of the bonds will not cause the interest to become taxable.

The change in use disallowances apply only to certain types of qualified private activity bonds. These rules apply whenever a subsequent deliberate action has caused the bonds to become nonqualified, but their effects are not limited by the remedial action that is taken.

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*Continued on next page*

## Summary, Continued

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**Preview of  
Lesson 11**

Lesson 11 introduces qualified tax credit bonds. Qualified tax credit bonds are bonds issued under § 54A that are 1) issued as taxable bonds and provide a credit to the holder of such bond, or 2) issued as taxable bonds and under § 6431(f) elect in lieu of a tax credit a direct pay refundable credit to the issuer of such bonds. In addition to satisfying certain conditions applicable to tax-exempt bonds, qualified tax credit bonds have their own unique conditions which you will explore in Lesson 11.

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