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October 11, 2012

Mr. Sergio Cruz
County of Hidalgo
Edinburg, Texas

Re: Memorandum Regarding Private Use of Property Financed with Proceeds of Tax Exempt Obligations

Background Facts:

Hidalgo County has proposed to lease a 1280+ acre tract of land, originally acquired for purposes of developing a landfill, for private agricultural purposes. The land was acquired with proceeds of the County's tax-exempt, Series 2004 Certificates of Obligation and an additional 300+ acres were acquired via Hidalgo County tax-exempt, Series 2009 Certificates. The bond proceeds for each series were \$32,250,000 and \$24,280,000, respectively. The County used \$2,094,791.37 of the Series 2004 proceeds and \$1,691,548.84 of the Series 2009 Certificates to acquire approximately 1280 acres of land in total. At the time of the issuance of the bonds, the County reasonably expected that the bonds would not meet the tax-exempt regulations' private activity bond tests for the entire bond issues and so certified on the date of issuance in its No-Arbitrage Certificate.

The land has been lying fallow and there is now the opportunity to lease the property for terms not exceeding one year until the property can be improved for County purposes. It is anticipated that the annual revenue generated by the lease (on a

competitively bid rental) could be between \$30,000 to \$40,000.

Legal Issues:

May the County lease the property to a private person? If so, what conditions are imposed on the lease under the federal tax exempt regulations?

Summary Opinion:

The lease will not pass the 10% "private use" test. Therefore, the County may lease the property to a private person. Further, lease payments will not meet the "private security" test because (1) the County will allocate all lease revenue to past and on-going maintenance and operations costs relating to the leased property, and (2) the payments of debt service on the two series of obligations will be paid exclusively through a County debt tax.

Discussion:

The County may lease the property to a private person, but must be aware of Internal Revenue Service regulations relating to use of bond proceeds or property acquired with bond proceeds by a "nongovernmental persons". Certain deliberate actions taken by the Issuer of governmental bonds (such as the County) may cause the bonds to take on the character of private activity bonds, in which case the interest would become taxable retroactive to the date of issuance. Bonds may be issued as governmental bonds, but analysis of the use of the proceeds or the facility financed with bond proceeds may reveal that they are actually private activity bonds.

Federal regulations outline tests that, if satisfied, render a bond issue a "private activity bond". To be considered a private activity bond, the bond issue must meet (1) the "private business use test" *and* the "private security or payment test", or (2) the private loan financing test. 26 USC § 141(a)(1) and (a)(2).

Note that the circumstances which cause the bond to satisfy the private activity tests must also be the result of a deliberate action by the Issuer of the bonds. If unforeseen circumstances beyond the control of the Issuer cause the bonds to meet the private activity tests, the bonds will not be considered private activity bonds if the Issuer reasonably believed that at the time of issuance the tests would not be met. 26 CFR §1.141-2(d)(3). Under current circumstances, the County would be taking a deliberate act.

In cases of non-deliberate actions, certain remedial measures can be taken to cure violations of the private activity tests under the Final Private Activity Bond ("PAB") Regulations, 26 CFR Section 1.141-12. These remedial measures would include "calling" or redeeming the Bonds allocable to the sale, or using the proceeds of the sale or lease for a "governmental use."

Private Business Use Test

The Private Business Use test is satisfied if more than 10% of the proceeds of a bond issue are used for any non-governmental, private business use. 26 CFR § 1.141-3(a)(1). This would include use of property financed by bonds. A use by the Federal government would also be considered a nonqualified private use.

Note that an indirect private use, such as through a lease to a non-governmental person or entity, would cause the bond issue to satisfy the Private Business Use test if the 10% threshold is crossed. *Id.* §1.141-3(a)(2). Indirect uses could also include management contracts with compensation based on profits from the property, certain research contracts, or other beneficial uses of the land. *Id.* § 1.141-3(b). Generally, the Private Business Use test is met if only if a nongovernmental person has special legal entitlements to use the financed property under an arrangement with the Issuer of the bonds. Section 1.141-3(a)(2) The lease of financed property to a nongovernmental person is a private use. Any arrangement that is properly characterized as a lease for Federal income tax purposes is treated as a lease. Section 1.141-3(b)(3)

Exceptions to Private Business Use test

There are various exceptions to the Private Business Use test. Use of bond-financed

property by the general public does not constitute a private business use. Section 1.141-3(c). A use by a private person in their trade or business will be treated as a public use if the property is also reasonably available to members of the general public not engaged in their trade or business. Certain arrangements for private use of the land which last less than 100 days will not give rise to a private use of the land if the use would be treated as a public use but for the application of certain uniform rates not available to people not engaged in trade or business, and if the property was not financed originally for the purpose of benefitting the private person. Section 1.141-3(d)(3)(i). Also, arrangements lasting less than 50 days would not give rise to a private use if the arrangement is arrived at through arm's length negotiations and the property was not financed originally for the purpose of benefitting the private person. Section 1.141-3(d)(3)(ii). Also certain incidental uses or temporary use by developers would not cause the Private Business Use test to be met. Section 1.141-3(d)(4) and (d)(5).

Calculating private business use

The calculation of private business use can be fairly complex under the Federal statutes. The determination is made during the "measurement period," which begins on the *later* of the issue date of the bonds *or* the date the property is placed in service, and ends on the *earlier* of the last date of reasonable economic life expectancy of the property *or* the latest maturity date of any bond of the issue financing the property. Section 1.141-3(g)(2)

The amount of private business use resulting from ownership by a nongovernmental person is the greatest percentage of business use in any one-year period. Section 1.141-3(g)(2)(iv). The average percentage of private business use is the average of the percentages of private business use during the one-year periods within the measurement period. Section 1.141-3(g)(3) If the private business use is reasonably expected to have a greater fair market value than the government use than the government use, the average amount of private business use must be determined according to the relative reasonably expected fair market values of use rather than another measure. Section 1.141-3(g)(4)(v)

Applying the facts we know to the situation at hand, less than 10% of proceeds from each of the series of bonds were used to purchase the properties at issue. There is no doubt that the lease will result in a private use of a bond-financed property. However,

because the amount of bond proceeds allocated to the property is less than 10 percent of the bonds proceeds, it does not reach the 10% threshold required to meet the Private Business Use test. Therefore, according to our analysis, the Private Business Use test has not been met, and the bonds will not acquire a private activity character by virtue of the lease.

As noted above, even if the Private Business Use test is met, the bond issue must also satisfy the Private Security or Payment test before the bonds are considered private activity bonds. 26 USC §141(a)(1)

Private Security or Payment Test

The Private Security or Payment test is met if more than 10% of the payment of principal or interest on the bond issue is either made or secured (directly or indirectly) by payments or property used, or to be used, for a private business use. 26 CFR §1.141-4.

In determining whether an issue meets the Private Security or Payment test, the present value of the payments or property taken into account is compared to the present value of the debt service to be paid over the term of the issue. §1.141-4(b)(2) For example, if on the date of issuance, the Issuer reasonably believes that the present value of the lease payments will be less than 10% of the present value of the total debt service of the bonds, the Private Security or Payment test is not satisfied and the bonds are considered governmental bonds. This would be true even if subsequent events beyond the control of the Issuer causes the present value of lease payments to exceed 10% of the present value of the actual total debt service on the bonds.

Private payments

Both direct and indirect payments made by any nongovernmental person that is treated as using proceeds of the issue are taken into account as "private payments" to the extent allocable to the proceeds used by that person. §1.141-4(c)(2). Payments are taken into account only to the extent that they are made for the period of time that proceeds are used for a private business use. *Id.* Private payments include payments made with respect to property financed by bond proceeds, even if such payments are not made by the private business user of bond proceeds. However, such payments are not taken into

account to the extent that they are reasonably allocable to other property being used by the person making the payment. *Id.* Ordinary and necessary expenses properly allocable to the operation and maintenance of the financed property would not be considered a payment for the use of proceeds allocable to that space. Section 1.141-4(c)(2)(C).

According to the information that you have provided us, the County is not planning on paying any portion of the debt service on the bonds, directly or indirectly, with proceeds from the lease. Instead, revenues to pay debt service will be raised via a generally applicable tax. Pursuant to the Code of Federal Regulations, a generally applicable tax is an enforced contribution exacted pursuant to legislative authority in the exercise of taxing power that is imposed and collected for the purpose of raising revenue or to be used for governmental purposes. A generally applicable tax must have a uniform tax rate that is applied to all persons of the same classification within the jurisdiction and a generally applicable manner of determination and collection. §1.141-4(e)(2). For purposes of the Private Security or Payment test, generally applicable taxes are not considered payments from a nongovernmental person, and are not considered payments in respect of property used for a private business use. Section 1.141-4(e)(1).

Therefore, the Private Payment and Security test is not met, and the bonds remain classified as governmental bonds. This would be true even if the Private Business Use test had been met (which we do not believe to be the case, based upon the foregoing analysis in the previous paragraph). As previously noted, both the Private Business Use and Private Payment or Security tests must be met in order for the bonds to have acquired a private activity character.

Private Loan Financing Test

The Private Loan Financing is an alternative to the two-pronged "Private Business Use" test and "Private Payment or Security" test. If those two tests are not met, but the bonds otherwise satisfy the Private Loan Financing test, the bonds are still considered private activity bonds. This test is satisfied if the amount of proceeds of the bond issue which is to be used (directly or indirectly) to make or finance loans to persons other than governmental entities exceeds the lesser of 5% of such proceeds, or Five Million dollars.

26 CFR Section 1.141-5(a).

Under the Federal regulations any transaction that is generally characterized as a loan for Federal income tax purposes counts as a loan for purposes of the Private Loan Financing test. A loan might also arise from direct lending of the bond proceeds or from a transaction in which indirect benefits that are the economic equivalent of a loan are conveyed. A lease might be considered a loan, but only if the business arrangement transfers tax ownership of the property to a nongovernmental person. Section 1.141.5(c)

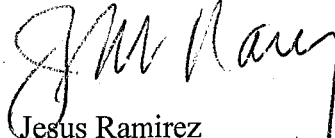
In the case at bar, there is no transaction that could be considered a loan for Federal income tax purposes, nor is there any transaction in which indirect benefits convey the economic equivalent of a loan. The lease, as we understand the facts, will not transfer tax ownership of the property to the lessee. This is a simple lease, a transaction distinct from a loan. Therefore, since the proposed Hidalgo County transaction does not contemplate a loan, this test never comes into play into our analysis of whether the bonds at issue constitute private activity bonds.

Conclusion:

The proposed lease would constitute a "private use" under the Federal "Private Business Use" test, if proceeds of the bonds in excess of 10% are set aside for a private use. This clearly does not appear to be the case. However, even if we assume that the Private Business Use test has been met, that alone does not make the proposed transaction objectionable as long as none of the lease proceeds are used to pay debt service on the bonds, according to the "Private Payment or Security" test. The "Private Loan Financing" test is not applicable. Therefore, we need not consider the remedial measures caused from violations of the private business activity tests if the County does not intend to use lease proceeds to pay debt service on the bonds.

We recommend that the foregoing analysis be undertaken on every occasion that renewals of the current lease or new leases are contemplated for this property.

Very truly yours,



Jesus Ramirez

Excerpts of relevant statutes

26 USC 141 - Sec. 141. Private activity bond; qualified bond

(a) Private activity bond For purposes of this title, the term "private activity bond" means any bond issued as part of an issue - (1) which meets - (A) the private business use test of paragraph (1) of subsection (b), and (B) the private security or payment test of paragraph (2) of subsection (b), or (2) which meets the private loan financing test of subsection (c).

(b) Private business tests

(1) Private business use test Except as otherwise provided in this subsection, an issue meets the test of this paragraph if more than 10 percent of the proceeds of the issue are to be used for any private business use.

(2) Private security or payment test Except as otherwise provided in this 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.

[...]

(c) Private loan financing test

(1) In general

An issue meets the test of this subsection if the amount of the proceeds of the issue which are to be used (directly or indirectly) to make or finance loans (other than loans described in paragraph (2)) to persons other than governmental units exceeds the lesser of—

(A) 5 percent of such proceeds, or

(B) \$5,000,000.

26 CFR § 1.141-2

Private activity bond tests.

(a) Overview. Interest on a private activity bond is not excludable from gross income under section 103(a) unless the bond is a qualified bond. The purpose of the private activity bond tests of section 141 is to limit the volume of tax-exempt bonds that finance the activities of nongovernmental persons, without regard to whether a financing actually transfers benefits of tax-exempt financing to a nongovernmental person. The private activity bond tests serve to identify arrangements that have the potential to transfer the benefits of tax-exempt financing, as well as arrangements that actually transfer these benefits. The regulations under section 141 may not be applied in a manner that is inconsistent with these purposes.

(b) Scope. Sections 1.141-0 through 1.141-16 apply generally for purposes of the private activity bond limitations under section 141.

(c) General definition of private activity bond. Under section 141, bonds are private activity bonds if they meet either the private business use test and private security or payment test of section 141(b) or the private loan financing test of section 141(c). The private business use and private security or payment tests are described in §§ 1.141-3 and 1.141-4. The private loan financing test is described in § 1.141-5.

(d) Reasonable expectations and deliberate actions— (1) In general. An issue is an issue of private activity bonds if the issuer reasonably expects, as of the issue date, that the issue will meet either the private business tests or the private loan financing test. An issue is also an issue of private activity bonds if the issuer takes a deliberate action, subsequent to the issue date, that causes the conditions of either the private business tests or the private loan financing test to be met.

(2) Reasonable expectations test— (i) In general. In general, the reasonable expectations test must take into account reasonable expectations about events and actions over the entire stated term of an issue.

[...]

(3) Deliberate action defined— (i) In general. Except as otherwise provided in this paragraph (d)(3), a deliberate action is any action taken by the issuer that is within its control. An intent to violate the requirements of section 141 is not necessary for an action to be deliberate.

(ii) Safe harbor exceptions. An action is not treated as a deliberate action if—

(A) It would be treated as an involuntary or compulsory conversion under section 1033; or

(B) It is taken in response to a regulatory directive made by the federal government. See § 1.141-7(g)(4).

26 CFR § 1.141-3

Definition of private business use.

(a) General rule— (1) In general. The private business use test relates to the use of the proceeds of an issue. The 10 percent private business use test of section 141(b)(1) is met

if more than 10 percent of the proceeds of an issue is used in a trade or business of a nongovernmental person. For this purpose, the use of financed property is treated as the direct use of proceeds. Any activity carried on by a person other than a natural person is treated as a trade or business. Unless the context or a provision clearly requires otherwise, this section also applies to the private business use test under sections 141(b)(3) (unrelated or disproportionate use), 141(b)(4) (\$15 million limitation for certain output facilities), and 141(b)(5) (the coordination with the volume cap where the nonqualified amount exceeds \$15 million).

(2) Indirect use. In determining whether an issue meets the private business use test, it is necessary to look to both the indirect and direct uses of proceeds. For example, a facility is treated as being used for a private business use if it is leased to a nongovernmental person and subleased to a governmental person or if it is leased to a governmental person and then subleased to a nongovernmental person, provided that in each case the nongovernmental person's use is in a trade or business. Similarly, the issuer's use of the proceeds to engage in a series of financing transactions for property to be used by nongovernmental persons in their trades or businesses may cause the private business use test to be met. In addition, proceeds are treated as used in the trade or business of a nongovernmental person if a nongovernmental person, as a result of a single transaction or a series of related transactions, uses property acquired with the proceeds of an issue.

(3) Aggregation of private business use. The use of proceeds by all nongovernmental persons is aggregated to determine whether the private business use test is met.

(b) Types of private business use arrangements— (1) In general. Both actual and beneficial use by a nongovernmental person may be treated as private business use. In most cases, the private business use test is met only if a nongovernmental person has special legal entitlements to use the financed property under an arrangement with the issuer. In general, a nongovernmental person is treated as a private business user of proceeds and financed property as a result of ownership; actual or beneficial use of property pursuant to a lease, or a management or incentive payment contract; or certain other arrangements such as a take or pay or other output-type contract.

(2) Ownership. Except as provided in paragraph (d)(1) or (d)(2) of this section, ownership by a nongovernmental person of financed property is private business use of that property. For this purpose, ownership refers to ownership for federal income tax purposes.

(3) Leases. Except as provided in paragraph (d) of this section, the lease of financed property to a nongovernmental person is private business use of that property. For this purpose, any arrangement that is properly characterized as a lease for federal income tax purposes is treated as a lease. In determining whether a management contract is properly characterized as a lease, it is necessary to consider all of the facts and circumstances, including the following factors—

(i) The degree of control over the property that is exercised by a nongovernmental person; and

(ii) Whether a nongovernmental person bears risk of loss of the financed property.

(4) Management contracts— (i) Facts and circumstances test. Except as provided in paragraph (d) of this section, a management contract (within the meaning of paragraph (b)(4)(ii) of this section) with respect to financed property may result in private business use of that property, based on all of the facts and circumstances. A management contract with respect to financed property generally results in private business use of that property if the contract provides for compensation for services rendered with compensation based, in whole or in part, on a share of net profits from the operation of the facility.

(ii) Management contract defined. For purposes of this section, a management contract is a management, service, or incentive payment contract between a governmental person and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility. For example, a contract for the provision of management services for an entire hospital, a contract for management services for a specific department of a hospital, and an incentive payment contract for physician services to patients of a hospital are each treated as a management contract.

(iii) Arrangements generally not treated as management contracts. The arrangements described in paragraphs (b)(4)(iii)(A) through (D) of this section generally are not treated as management contracts that give rise to private business use.

(A) Contracts for services that are solely incidental to the primary governmental function or functions of a financed facility (for example, contracts for janitorial, office equipment repair, hospital billing, or similar services).

(B) The mere granting of admitting privileges by a hospital to a doctor, even if those privileges are conditioned on the provision of de minimis services, if those privileges are available to all qualified physicians in the area, consistent with the size and nature of its facilities.

(C) A contract to provide for the operation of a facility or system of facilities that consists predominantly of public utility property, if the only compensation is the reimbursement of actual and direct expenses of the service provider and reasonable administrative overhead expenses of the service provider.

(D) A contract to provide for services, if the only compensation is the reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties.

(iv) Management contracts that are properly treated as other types of private business use. A management contract with respect to financed property results in private business use of that property if the service provider is treated as the lessee or owner of financed property for federal income tax purposes, unless an exception under paragraph (d) of this section applies to the arrangement.

(5) Output contracts. See § 1.141-7 for special rules for contracts for the purchase of output of output facilities.

(6) Research agreements— (i) Facts and circumstances test. Except as provided in paragraph (d) of this section, an agreement by a nongovernmental person to sponsor

research performed by a governmental person may result in private business use of the property used for the research, based on all of the facts and circumstances.

(ii) Research agreements that are properly treated as other types of private business use. A research agreement with respect to financed property results in private business use of that property if the sponsor is treated as the lessee or owner of financed property for federal income tax purposes, unless an exception under paragraph (d) of this section applies to the arrangement.

(7) Other actual or beneficial use— (i) In general. Any other arrangement that conveys special legal entitlements for beneficial use of bond proceeds or of financed property that are comparable to special legal entitlements described in paragraphs (b)(2), (3), (4), (5), or (6) of this section results in private business use. For example, an arrangement that conveys priority rights to the use or capacity of a facility generally results in private business use.

(ii) Special rule for facilities not used by the general public. In the case of financed property that is not available for use by the general public (within the meaning of paragraph (c) of this section), private business use may be established solely on the basis of a special economic benefit to one or more nongovernmental persons, even if those nongovernmental persons have no special legal entitlements to use of the property. In determining whether special economic benefit gives rise to private business use it is necessary to consider all of the facts and circumstances, including one or more of the following factors—

(A) Whether the financed property is functionally related or physically proximate to property used in the trade or business of a nongovernmental person;

(B) Whether only a small number of nongovernmental persons receive the special economic benefit; and

(C) Whether the cost of the financed property is treated as depreciable by any nongovernmental person.

(c) Exception for general public use— (1) In general. Use as a member of the general public (general public use) is not private business use. Use of financed property by nongovernmental persons in their trades or businesses is treated as general public use only if the property is intended to be available and in fact is reasonably available for use on the same basis by natural persons not engaged in a trade or business.

(2) Use on the same basis. In general, use under an arrangement that conveys priority rights or other preferential benefits is not use on the same basis as the general public. Arrangements providing for use that is available to the general public at no charge or on the basis of rates that are generally applicable and uniformly applied do not convey priority rights or other preferential benefits. For this purpose, rates may be treated as generally applicable and uniformly applied even if—

(i) Different rates apply to different classes of users, such as volume purchasers, if the differences in rates are customary and reasonable; or

(ii) A specially negotiated rate arrangement is entered into, but only if the user is prohibited by federal law from paying the generally applicable rates, and the rates established are as comparable as reasonably possible to the generally applicable rates.

(3) Long-term arrangements not treated as general public use. An arrangement is not treated as general public use if the term of the use under the arrangement, including all renewal options, is greater than 200 days. For this purpose, a right of first refusal to renew use under the arrangement is not treated as a renewal option if—

(i) The compensation for the use under the arrangement is redetermined at generally applicable, fair market value rates that are in effect at the time of renewal; and

(ii) The use of the financed property under the same or similar arrangements is predominantly by natural persons who are not engaged in a trade or business.

(4) Relation to other use. Use of financed property by the general public does not prevent the proceeds from being used for a private business use because of other use under this section.

(d) Other exceptions—(1) Agents. Use of proceeds by nongovernmental persons solely in their capacity as agents of a governmental person is not private business use. For example, use by a nongovernmental person that issues obligations on behalf of a governmental person is not private business use to the extent the nongovernmental person's use of proceeds is in its capacity as an agent of the governmental person.

(2) Use incidental to financing arrangements. Use by a nongovernmental person that is solely incidental to a financing arrangement is not private business use. A use is solely incidental to a financing arrangement only if the nongovernmental person has no substantial rights to use bond proceeds or financed property other than as an agent of the bondholders. For example, a nongovernmental person that acts solely as an owner of title in a sale and leaseback financing transaction with a city generally is not a private business user of the property leased to the city, provided that the nongovernmental person has assigned all of its rights to use the leased facility to the trustee for the bondholders upon default by the city. Similarly, bond trustees, servicers, and guarantors are generally not treated as private business users.

(3) Exceptions for arrangements other than arrangements resulting in ownership of financed property by a nongovernmental person—(i) Arrangements not available for use on the same basis by natural persons not engaged in a trade or business. Use by a nongovernmental person pursuant to an arrangement, other than an arrangement resulting in ownership of financed property by a nongovernmental person, is not private business use if—

(A) The term of the use under the arrangement, including all renewal options, is not longer than 100 days;

(B) The arrangement would be treated as general public use, except that it is not available for use on the same basis by natural persons not engaged in a trade or business because generally applicable and uniformly applied rates are not reasonably available to natural persons not engaged in a trade or business; and

(C) The property is not financed for a principal purpose of providing that property for use by that nongovernmental person.

(ii) Negotiated arm's-length arrangements. Use by a nongovernmental person pursuant to an arrangement, other than an arrangement resulting in ownership of financed property by a nongovernmental person, is not private business use if—

(A) The term of the use under the arrangement, including all renewal options, is not longer than 50 days;

(B) The arrangement is a negotiated arm's-length arrangement, and compensation under the arrangement is at fair market value; and

(C) The property is not financed for a principal purpose of providing that property for use by that nongovernmental person.

(4) Temporary use by developers. Use during an initial development period by a developer of an improvement that carries out an essential governmental function is not private business use if the issuer and the developer reasonably expect on the issue date to proceed with all reasonable speed to develop the improvement and property benefited by that improvement and to transfer the improvement to a governmental person, and if the improvement is in fact transferred to a governmental person promptly after the property benefited by the improvement is developed.

(5) Incidental use— (i) General rule. Incidental uses of a financed facility are disregarded, to the extent that those uses do not exceed 2.5 percent of the proceeds of the issue used to finance the facility. A use of a facility by a nongovernmental person is incidental if—

(A) Except for vending machines, pay telephones, kiosks, and similar uses, the use does not involve the transfer to the nongovernmental person of possession and control of space that is separated from other areas of the facility by walls, partitions, or other physical barriers, such as a night gate affixed to a structural component of a building (a nonpossessory use);

(B) The nonpossessory use is not functionally related to any other use of the facility by the same person (other than a different nonpossessory use); and

(C) All nonpossessory uses of the facility do not, in the aggregate, involve the use of more than 2.5 percent of the facility.

(ii) Illustrations. Incidental uses may include pay telephones, vending machines, advertising displays, and use for television cameras, but incidental uses may not include output purchases.

(6) Qualified improvements. Proceeds that provide a governmentally owned improvement to a governmentally owned building (including its structural components and land functionally related and subordinate to the building) are not used for a private business use if—

(i) The building was placed in service more than 1 year before the construction or acquisition of the improvement is begun;

- (ii) The improvement is not an enlargement of the building or an improvement of interior space occupied exclusively for any private business use;
 - (iii) No portion of the improved building or any payments in respect of the improved building are taken into account under section 141(b)(2)(A) (the private security test); and
 - (iv) No more than 15 percent of the improved building is used for a private business use.
- e) **Special rule for tax assessment bonds.** In the case of a tax assessment bond that satisfies the requirements of § 1.141-5(d), the loan (or deemed loan) of the proceeds to the borrower paying the assessment is disregarded in determining whether the private business use test is met. However, the use of the loan proceeds is not disregarded in determining whether the private business use test is met.

26 CFR § 1.141-4

Private security or payment test.

(a) **General rule— (1) Private security or payment.** The private security or payment test relates to the nature of the security for, and the source of, the payment of debt service on an issue. The private payment portion of the test takes into account the payment of the debt service on the issue that is directly or indirectly to be derived from payments (whether or not to the issuer or any related party) in respect of property, or borrowed money, used or to be used for a private business use. The private security portion of the test takes into account the payment of the debt service on the issue that is directly or indirectly secured by any interest in property used or to be used for a private business use or payments in respect of property used or to be used for a private business use. For additional rules for output facilities, see § 1.141-7.

2) **Aggregation of private payments and security.** For purposes of the private security or payment test, payments taken into account as private payments and payments or property taken into account as private security are aggregated. However, the same payments are not taken into account as both private security and private payments.

(3) **Underlying arrangement.** The security for, and payment of debt service on, an issue is determined from both the terms of the bond documents and on the basis of any underlying arrangement. An underlying arrangement may result from separate agreements between the parties or may be determined on the basis of all of the facts and circumstances surrounding the issuance of the bonds. For example, if the payment of debt service on an issue is secured by both a pledge of the full faith and credit of a state or local governmental unit and any interest in property used or to be used in a private business use, the issue meets the private security or payment test.

(b) **Measurement of private payments and security— (1) Scope.** This paragraph (b) contains rules that apply to both private security and private payments.

(2) Present value measurement— (i) Use of present value. In determining whether an issue meets the private security or payment test, the present value of the payments or property taken into account is compared to the present value of the debt service to be paid over the term of the issue.

(ii) Debt service— (A) Debt service paid from proceeds. Debt service does not include any amount paid or to be paid from sale proceeds or investment proceeds. For example, debt service does not include payments of capitalized interest funded with proceeds.

(B) Adjustments to debt service. Debt service is adjusted to take into account payments and receipts that adjust the yield on an issue for purposes of section 148(f). For example, debt service includes fees paid for qualified guarantees under § 1.148-4(f) and is adjusted to take into account payments and receipts on qualified hedges under § 1.148-4(h).

(iii) Computation of present value— (A) In general. Present values are determined by using the yield on the issue as the discount rate and by discounting all amounts to the issue date. See, however, § 1.141-13 for special rules for refunding bonds.

(B) Fixed yield issues. For a fixed yield issue, yield is determined on the issue date and is not adjusted to take into account subsequent events.

(C) Variable yield issues. The yield on a variable yield issue is determined over the term of the issue. To determine the reasonably expected yield as of any date, the issuer may assume that the future interest rate on a variable yield bond will be the then-current interest rate on the bonds determined under the formula prescribed in the bond documents. A deliberate action requires a recomputation of the yield on the variable yield issue to determine the present value of payments under that arrangement. In that case, the issuer must use the yield determined as of the date of the deliberate action for purposes of determining the present value of payments under the arrangement causing the deliberate action. See paragraph (g) of this section, *Example 3*.

(iv) Application to private security. For purposes of determining the present value of debt service that is secured by property, the property is valued at fair market value as of the first date on which the property secures bonds of the issue.

(c) Private payments— (1) In general. This paragraph (c) contains rules that apply to private payments.

(2) Payments taken into account— (i) Payments for use— Both direct and indirect payments made by any nongovernmental person that is treated as using proceeds of the issue are taken into account as private payments to the extent allocable to the proceeds used by that person. Payments are taken into account as private payments only to the extent that they are made for the period of time that proceeds are used for a private business use. Payments for a use of proceeds include payments (whether or not to the issuer) in respect of property financed (directly or indirectly) with those proceeds, even if not made by a private business user. Payments are not made in respect of financed property if those payments are directly allocable to other property being directly used by the person making the payment and those payments represent fair market value compensation for that other use. See paragraph (g) of this section, *Example*

4 and *Example 5*. See also paragraph (c)(3) of this section for rules relating to allocation of payments to the source or sources of funding of property.

(B) Payments not to exceed use. Payments with respect to proceeds that are used for a private business use are not taken into account to the extent that the present value of those payments exceeds the present value of debt service on those proceeds. Payments need not be directly derived from a private business user, however, to be taken into account. Thus, if 7 percent of the proceeds of an issue is used by a person over the measurement period, payments with respect to the property financed with those proceeds are taken into account as private payments only to the extent that the present value of those payments does not exceed the present value of 7 percent of the debt service on the issue.

(C) Payments for operating expenses. Payments by a person for a use of proceeds do not include the portion of any payment that is properly allocable to the payment of ordinary and necessary expenses (as defined under section 162) directly attributable to the operation and maintenance of the financed property used by that person. For this purpose, general overhead and administrative expenses are not directly attributable to those operations and maintenance. For example, if an issuer receives \$5,000 rent during the year for use of space in a financed facility and during the year pays \$500 for ordinary and necessary expenses properly allocable to the operation and maintenance of that space and \$400 for general overhead and general administrative expenses properly allocable to that space, \$500 of the \$5,000 received would not be considered a payment for the use of the proceeds allocable to that space (regardless of the manner in which that \$500 is actually used).

(ii) Refinanced debt service. Payments of debt service on an issue to be made from proceeds of a refunding issue are taken into account as private payments in the same proportion that the present value of the payments taken into account as private payments for the refunding issue bears to the present value of the debt service to be paid on the refunding issue. For example, if all the debt service on a note is paid with proceeds of a refunding issue, the note meets the private security or payment test if (and to the same extent that) the refunding issue meets the private security or payment test. This paragraph (c)(2)(ii) does not apply to payments that arise from deliberate actions that occur more than 3 years after the retirement of the prior issue that are not reasonably expected on the issue date of the refunding issue. For purposes of this paragraph (c)(2)(ii), whether an issue is a refunding issue is determined without regard to § 1.150-1(d)(2)(i) (relating to certain payments of interest).

(3) Allocation of payments— (i) In general. Private payments for the use of property are allocated to the source or different sources of funding of property. The allocation to the source or different sources of funding is based on all of the facts and circumstances, including whether an allocation is consistent with the purposes of section 141. In general, a private payment for the use of property is allocated to a source of funding based upon the nexus between the payment and both the financed property and the source of funding. For this purpose, different sources of funding may include different tax-exempt issues,

taxable issues, and amounts that are not derived from a borrowing, such as revenues of an issuer (equity).

(ii) Payments for use of discrete property. Payments for the use of a discrete facility (or a discrete portion of a facility) are allocated to the source or different sources of funding of that discrete property.

(iii) Allocations among two or more sources of funding. In general, except as provided in paragraphs (c)(3)(iv) and (v) of this section, if a payment is made for the use of property financed with two or more sources of funding (for example, equity and a tax-exempt issue), that payment must be allocated to those sources of funding in a manner that reasonably corresponds to the relative amounts of those sources of funding that are expended on that property. If an issuer has not retained records of amounts expended on the property (for example, records of costs of a building that was built 30 years before the allocation), an issuer may use reasonable estimates of those expenditures. For this purpose, costs of issuance and other similar neutral costs are allocated ratably among expenditures in the same manner as in § 1.141-3(g)(6). A payment for the use of property may be allocated to two or more issues that finance property according to the relative amounts of debt service (both paid and accrued) on the issues during the annual period for which the payment is made, if that allocation reasonably reflects the economic substance of the arrangement. In general, allocations of payments according to relative debt service reasonably reflect the economic substance of the arrangement if the maturity of the bonds reasonably corresponds to the reasonably expected economic life of the property and debt service payments on the bonds are approximately level from year to year.

(iv) Payments made under an arrangement entered into in connection with issuance of bonds. A private payment for the use of property made under an arrangement that is entered into in connection with the issuance of the issue that finances that property generally is allocated to that issue. Whether an arrangement is entered into in connection with the issuance of an issue is determined on the basis of all of the facts and circumstances. An arrangement is ordinarily treated as entered into in connection with the issuance of an issue if—

(A) The issuer enters into the arrangement during the 3-year period beginning 18 months before the issue date; and

(B) The amount of payments reflects all or a portion of debt service on the issue.

(v) Allocations to equity. A private payment for the use of property may be allocated to equity before payments are allocated to an issue only if—

(A) Not later than 60 days after the date of the expenditure of those amounts, the issuer adopts an official intent (in a manner comparable to § 1.150-2(e)) indicating that the issuer reasonably expects to be repaid for the expenditure from a specific arrangement; and

(B) The private payment is made not later than 18 months after the later of the date the expenditure is made or the date the project is placed in service.

(d) Private security— (1) In general. This paragraph (d) contains rules that relate to private security.

(2) Security taken into account. The property that is the security for, or the source of, the payment of debt service on an issue need not be property financed with proceeds. For example, unimproved land or investment securities used, directly or indirectly, in a private business use that secures an issue provides private security. Private security (other than financed property and private payments) for an issue is taken into account under section 141(b), however, only to the extent it is provided, directly or indirectly, by a user of proceeds of the issue.

(3) Pledge of unexpended proceeds. Proceeds qualifying for an initial temporary period under § 1.148-2(e)(2) or (3) or deposited in a reasonably required reserve or replacement fund (as defined in § 1.148-2(f)(2)(i)) are not taken into account under this paragraph (d) before the date on which those amounts are either expended or loaned by the issuer to an unrelated party.

(4) Secured by any interest in property or payments. Property used or to be used for a private business use and payments in respect of that property are treated as private security if any interest in that property or payments secures the payment of debt service on the bonds. For this purpose, the phrase any interest in is to be interpreted broadly and includes, for example, any right, claim, title, or legal share in property or payments.

(5) Payments in respect of property. The payments taken into account as private security are payments in respect of property used or to be used for a private business use. Except as otherwise provided in this paragraph (d)(5) and paragraph (d)(6) of this section, the rules in paragraphs (c)(2)(i)(A) and (B) and (c)(2)(ii) of this section apply to determine the amount of payments treated as payments in respect of property used or to be used for a private business use. Thus, payments made by members of the general public for use of a facility used for a private business use (for example, a facility that is the subject of a management contract that results in private business use) are taken into account as private security to the extent that they are made for the period of time that property is used by a private business user.

(6) Allocation of security among issues. In general, property or payments from the disposition of that property that are taken into account as private security are allocated to each issue secured by the property or payments on a reasonable basis that takes into account bondholders' rights to the payments or property upon default.

(e) Generally applicable taxes— (1) General rule. For purposes of the private security or payment test, generally applicable taxes are not taken into account (that is, are not payments from a nongovernmental person and are not payments in respect of property used for a private business use).

(2) Definition of generally applicable taxes. A generally applicable tax is an enforced contribution exacted pursuant to legislative authority in the exercise of the taxing power that is imposed and collected for the purpose of raising revenue to be used for governmental or public purposes. A generally applicable tax must have a uniform tax rate

that is applied to all persons of the same classification in the appropriate jurisdiction and a generally applicable manner of determination and collection.

26 CFR 1.141-5 - Private loan financing test

(a) In general. Bonds of an issue are private activity bonds if more than the lesser of 5 percent or \$5 million of the proceeds of the issue is to be used (directly or indirectly) to make or finance loans to persons other than governmental persons. Section 1.1412(d) applies in determining whether the private loan financing test is met. In determining whether the proceeds of an issue are used to make or finance loans, indirect, as well as direct, use of the proceeds is taken into account.

(b) Measurement of test. In determining whether the private loan financing test is met,

the amount actually loaned to a nongovernmental person is not discounted to reflect the present value of the loan repayments.

(c) Definition of private loan(1) In general. Any transaction that is generally characterized as a loan for federal income tax purposes is a loan for purposes of this section. In addition, a loan may arise from the direct lending of bond proceeds or may arise from transactions in which indirect benefits that are the economic equivalent of a loan are conveyed. Thus, the determination of whether a loan is made depends on the substance of a transaction rather than its form. For example, a lease or other contractual arrangement (for example, a management contract or an output contract) may in substance constitute a loan if the arrangement transfers tax ownership of the facility to a nongovernmental person. Similarly, an output contract or a management contract with respect to a financed facility generally is not treated as a loan of proceeds unless the agreement in substance shifts significant burdens and benefits of ownership to the nongovernmental purchaser or manager of the facility.