

Tax-Exempt Bond Update: IRS Releases Remedial Action Guidance

On April 11, 2018, the Internal Revenue Service released Revenue Procedure 2018-26, expanding the availability of certain remedial actions for tax-exempt and tax-advantaged bonds.

Bonds that are tax-exempt or otherwise tax-advantaged (such as tax credit and direct pay bonds) are subject to various requirements with respect to the expenditure of bond proceeds and the on-going use of any facilities financed with bond proceeds. If a change in use of a bond-financed facility results in “nonqualified use” of bond proceeds, existing Regulations provide remedial actions to cure the nonqualified use in certain situations. These Regulations apply generally to bonds issued for the benefit of governmental entities and 501(c)(3) organizations. Existing remedial actions include:

1. Redemption or defeasance of nonqualified bonds
2. Alternative use of disposition proceeds
3. Alternative use of facility

In most cases, disposition proceeds must be treated as proceeds of the bonds for arbitrage purposes (i.e. must be yield restricted until spent).

Remedial Action for Long Term Leases. One remedial action available under current Regulations is expenditure of proceeds of a sale, exchange or other disposition of property (“disposition proceeds”) for an alternative use meeting the requirements of the Code. For example, if a building financed with tax-exempt bond proceeds (“Building A”) is later sold to a private entity, the issuer may use the proceeds of that sale to acquire another building (“Building B”) that will be used for governmental purposes. If the requirements of the Regulations are met, bond proceeds will be allocated to the acquisition of Building B, and the nonqualified use of Building A can be ignored. However, if an issuer entered into a long-term lease of Building A rather than a sale, the alternative use of disposition proceeds was not available. Revenue Procedure 2018-26 expands the availability of this remedial action, with some modifications, to eligible leases.

Under the Revenue Procedure, if the consideration for the lease of Building A consists exclusively of cash lease payments and the term of the lease either (i) is at least

equal to the lesser of 20 years or 75% of the economic life of the leased property or (ii) runs through the end of the measurement period (the earlier of the last date of the reasonably expected economic life of the property or the latest maturity date of any bond of the issue financing the property), then the lease is an “eligible lease,” and the lease amount (described below) can be treated as disposition proceeds, Building A can be treated as transferred property, and the disposition proceeds can be allocated to an alternative use (Building B) during the term of the lease. For purposes of the remedial action, disposition proceeds are equal to the lease amount, which is defined as the present value of all the lease payments required to be made under the eligible lease (using the yield on the bonds as a discount rate).

Remedial Action for Direct Pay Bonds. Current regulations do not provide remedial actions for tax credit and direct pay bonds. The Revenue Procedure provides a new remedial action for issuers of direct pay bonds, such as Build America Bonds designated under Section 6431 of the Code. Under the Revenue Procedure, the issuer may cure a nonqualified use simply by reducing the amount of the refundable Federal tax credit to eliminate the amount allocable to the nonqualified bonds and by treating disposition proceeds as proceeds of the bonds for certain purposes. The Revenue Procedure provides instructions for using this remedial action.

Other Remedial Actions for Tax-Advantaged Bonds. The Revenue Procedure also allows issuers to cure a nonqualified use (including a failure to spend proceeds) of tax credit or direct pay bonds by redeeming or defeasing nonqualified bonds or by using disposition proceeds for an alternative use. The Revenue Procedure also clarifies that establishment of a defeasance escrow for purposes of remedial action will not trigger a reissuance of the bonds.

Contact Information. For further information regarding remedial actions, please consult any of our public finance attorneys:

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