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Tax-Exempt Bonds: General Tax Considerations for Tax-Exempt Financing of Utility Facilities

Introduction

State and local governments, including municipal utilities and public utility districts, often turn to tax-exempt bonds as a means of financing infrastructure such as water, wastewater, stormwater, solid waste, electric and natural gas enterprise systems. Tax-exempt bonds can be a low cost financing tool for capital projects, but issuers must be prepared to comply with the various requirements with respect to the investment and use of proceeds, as well as the use of the bond-financed facilities.

Eligible Expenditures and Reimbursement

With some limited exceptions, proceeds of tax-exempt bonds must be used primarily to finance "capital expenditures." A capital expenditure is any cost of a type that is properly chargeable to a capital account (or would be so chargeable with a proper election) under general federal income tax principles. Examples of capital expenditures for utilities include generation, transmission and distribution facilities for public power systems; collection, storage, treatment, processing or final disposition facilities for solid waste or sewage; and storage, treatment and distribution facilities for water systems. In addition, in some cases, prepayment of natural gas or electricity and prepayment of water supply are considered capital expenditures that may be financed with tax-exempt bond proceeds.

Issuers of tax-exempt bonds may allocate all or a portion of the proceeds of such bonds to the reimbursement of expenditures made prior to the date of issuance if certain rules are followed. These "reimbursement bonds" may be issued to reimburse capital expenditures that (A) were paid no earlier than 60 days before the date the issuer adopted a declaration of intent to reimburse such expenditures from the proceeds of obligations, and (B) are reimbursed no later than 18 months after the later of the date the expenditure was paid or the date the project is placed in service (but no later than three years after the expenditure is paid). Reimbursement bonds may also be issued to reimburse certain costs of issuance, certain preliminary capital expenditures (like architect or engineering fees) or certain *de minimus* costs (not exceeding the lesser or $100,000 or 5% of the proceeds of the bonds).

Arbitrage Bonds

Under Section 148 of the Internal Revenue Code of 1986, as amended (the "Code"), in order for the interest on the bonds to be exempt from federal income taxes, the bonds must not be "arbitrage bonds." Bonds will be arbitrage bonds if either (a) any proceeds of the bonds are reasonably expected to be used, or are intentionally used, directly or indirectly, to acquire investments that have a materially higher yield than the yield on the bonds ("higher yielding investments"), or to replace funds that are used to acquire higher-yielding investments, or (b) any applicable arbitrage rebate amounts are not paid when due to the United States, all except as permitted by the Code and related Treasury Regulations.

Subject to certain exceptions, investment earnings allocable to gross proceeds must be rebated to the United States in an amount equal to the difference between the amount actually earned and the amount that would have been earned if those investments had a yield equal to the yield on the issue.

For more information on arbitrage and rebate, see "Tax-Exempt Bonds: A Quick Guide to Yield Restriction and Rebate Exceptions" available [here].

Private Activity Bonds

When a governmental entity issues tax-exempt bonds to finance a project, there are a variety of rules that apply to use of the project throughout the life of the bonds. One of those rules is that, unless specially qualified as an "Exempt Facility Bond" (described below), a tax-exempt bond issued to finance capital costs of a utility cannot be a "private activity bond." A bond is a private activity bond if the issuer of the bond reasonably expects on the issue date that the bond issue will meet the "Private Business Tests" or the "Private Loan Test." The Private Business Tests are met if (a) there is more than the lesser of 10% or $15 million of private business use of the proceeds of an issue and (b) there is more than the lesser of 10% or $15 million of private payments or private security interest. The Private Loan Test is met if more than 5% (or $5 million if less) of the proceeds is treated as being loaned to nongovernmental entities. A bond can also become a private activity bond after issuance if the use of the project changes and as a result of the change the bonds meet either the Private Business Tests or the Private Loan Test.

A summary of the private use provisions of the Private Business Tests are provided below. To the extent that facilities are financed with bonds and "qualified equity," the qualified equity can reduce the total amount of private business use allocable to the bonds and allow for additional flexibility for use of the financed facility. For a more detailed description of how private use and qualified equity apply to utilities, see "Tax-Exempt Bonds: An Introduction to Private Business Use of Bond-Financed Utility Facilities" available [here].

Private Business Use

Speaking generally, private business use is use of property financed with tax-exempt bonds in a trade or business carried on by a person other than a "qualified user" (a state or local government entity using the property for governmental purposes). Private business use can arise from a lease, output contract, management contract, sponsored research agreement or any other arrangement that gives any private entity, other than a qualified user, special legal entitlements to use the project. The federal government is not a qualified user and use by the federal government generally constitutes private business use.

Use by the general public (including use of the output of a project) generally does not constitute private business use. Use by an entity in a trade or business can constitute "general public use" if the project is also available for use by natural persons and any charges for use are pursuant to a generally applicable rate or fee schedule. Rates may be treated as generally applicable and uniformly applied even if different rates apply to different classes of users, such as volume purchasers, if the differences in rates are customary and reasonable. For example, if a city's electric utility provides electricity to residences

and to private businesses and all customers are charged pursuant to generally applicable rate schedules (which may include separate residential and commercial rate schedules), electrical usage by the residences and private businesses will constitute use by members of the general public.

Output contracts

The Regulations define "output facility" to mean electric and gas generation, transmission, distribution, and related facilities, and water collection, storage, and distribution facilities. Bond-financed output facilities are subject to special rules regarding private business use of their output. If any private entities (or the federal government) purchase output but do not pay pursuant to a generally applicable rate or fee schedule, that use may constitute private business use of the output facility. Contracts with non-qualified users of output for resale (wholesale contracts), for the purchase of all of the output of a facility (take contracts), for a certain amount of output whether or not the facility can provide it (take or pay contracts), and for all of the user's output requirements (requirements contracts) need to be analyzed under the special rules for output facilities in Treasury Regulation §1.141-7.

Management Contracts

A private management, operating or service contract ("Management Contract") with respect to a bond-financed project can result in private business use of the property if (a) the contract gives the service provider an ownership or leasehold interest in the financed facility (or an interest in the nature of an ownership or leasehold interest), or (b) the contract provides for compensation for services based, in whole or in part, on a share of net profits from the operation of the financed facility. In Revenue Procedure 2017-13, the IRS established safe harbors for Management Contracts that, if satisfied, will prevent the Management Contract from generating private business use.

For more information on the safe harbors for Management Contracts, see "Tax-Exempt Bonds: A Quick Guide to Management Contracts" available [here].

Exempt Facility Bonds

As noted above, a tax-exempt bond cannot be a "private activity bond" unless it is specially qualified. Under Section 142 of the Code, qualified private activity bonds may include bonds issued for the furnishing of water, for sewage facilities, for solid waste disposal facilities, and for facilities for the local furnishing of electric energy or gas. Bonds issued as qualified private activity bonds are not subject to the Private Business Tests or the Private Loan Tests described above; however, at least 95% of the bond proceeds must be used on capital costs of the exempt facility and each type of exempt facility must meet specific requirements set forth in Section 142. In addition, all qualified private activity bonds are subject to public hearing and approval ("TEFRA") and volume cap requirements, as well as additional restrictions on the use of proceeds.

If you have any questions regarding the use of tax-exempt bonds to finance utility infrastructure, please contact any of our public finance attorneys.

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