PACIFICA
LAW GROUP

Tax-Exempt Bonds: An Introduction to Private Business Use of Bond-Financed Utility Facilities

Introduction

For over a hundred years, tax-exempt bonds have been a critical tool of municipalities, utility districts and other governmental entities (each, an "Issuer") for financing capital improvements for utilities, such as electric, gas, water and wastewater systems. Issuers generally issue tax-exempt "governmental bonds" that are subject to restrictions on the ownership and use of the bond-financed improvements under Section 141 of the Internal Revenue Code, as amended (the "Code"). Issuers must comply with the restrictions on private use of the financed projects or the bonds may be private activity bonds that do not qualify for tax exemption.

General Rule

Bonds will be characterized as taxable private activity bonds if the Issuer reasonably expects, as of the issue date, that the issue of bonds will meet either the private business tests or the private loan financing tests. The bonds will also be 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.

Private Business Tests

For purposes of the private business tests, use of the project financed with bond proceeds is treated as a direct use of bond proceeds, and indirect use of a project, such as leasing or ownership rights or certain output arrangements, may also be treated as private business use. The private business tests consist of a "private business use test" and a "private security or payment test."

The private business use test is satisfied if more than 10% of the proceeds of bonds (or $15,000,000 if less) is used for a private business use. The private security or payment test relates the direct or indirect source of payment of or security for the bonds. With some exceptions, if that security or payment relates to a private business use of the property financed or refinanced with the bonds and if the amount of security or payment exceeds 10% of the debt service on the bonds then the test is satisfied. If a private business use is not related to the governmental use of the proceeds or is related but is disproportionate to the governmental use then the 10% use and payment threshold is reduced to 5%.

If both the private business use test and the private security or payment test are satisfied, then bonds will be private activity bonds. If either the private business use test or the private security or payment test is not satisfied, then bonds will be not be private activity bonds unless the private loan financing test discussed below is met.

Private Loan Financing Test
Even though the private business tests are not satisfied, bonds may be private activity bonds if the private loan financing test is satisfied. The private loan financing test is satisfied if more than the lesser of 5% or $5,000,000 of the proceeds is used, directly or indirectly, to make or finance loans to any person other than a state or local governmental unit.

Measurement
Private business use is measured annually and is then averaged over the "Measurement Period" for a tax-exempt bond issue to determine compliance. As a general rule, the "Measurement Period" for a project begins on the later of the issue date of the bonds or the date the financed facility is placed in service and ends on the earlier of the last maturity date of the bonds or the last date of the reasonably expected economic life of the financed facility. Special rules applicable to the measurement of private business use of output facilities are described below.

Private Business Use

Speaking generally, private business use is use of tax-exempt bond financed property 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 or any other arrangement that gives anyone (other than a qualified user) special legal entitlements to use the project. Note that the federal government is not a qualified user and use by the federal government generally constitutes private business use.

In addition to use by a state or local government, categories of unlimited (or "good") use of a bond-financed project include:

- Use by the general public; and
- Use meeting an IRS safe harbor.

General Public Use
The following constitutes allowable general public use and not private business use:

- Use by natural persons not engaged in a trade or business.
- Use by nongovernmental persons in their trades or businesses if the financed facility is reasonably available to use on the same basis by natural persons not engaged in a trade or business. 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.

Many projects for utilities meet the general public use exception because use of the projects by residential, industrial and commercial customers is pursuant to generally applicable and uniformly applied rates. 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

PACIFICA
LAW GROUP

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.

Contracts with industrial and commercial customers containing specially negotiated rates, priority rights or preferential benefits should be carefully reviewed for private use implications.

Qualified Management Contracts

A private management or service contract ("Management Contract") with respect to financed property generally results 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. The safe harbor includes requirements relating to: (a) general financial terms, (b) term of the contract, (c) control of the property, (d) risk of loss, (e) consistent tax positions, and (f) exercise of rights, and is applicable to contracts entered into or materially modified after August 18, 2017. Structuring Management Contracts to meet the safe harbor requirements is particularly important because a project subject to a nonqualified Management Contract will be treated as entirely used for private business use.

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

Private Security or Payments

The private security or payment test is broader than most Issuers expect. Private payments include direct and indirect payments made by nongovernmental persons using a bond-financed project for any period of time that the project is used for a private business use, even if the payments are not made by a private business user. For example, if a project for an electrical utility is managed pursuant to a non-qualified Management Contract, the project is considered entirely used for private business use (as described above) and payments made by any electrical customers relating to that project are treated as private payments. The private security test takes into account the payment of the debt service on the bonds 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. Therefore, if a bond issue is secured by revenues of the utility, then payments made by utility customers with respect to a project that is privately used generally constitute private security for the bonds.

Special Rules for Output Facilities

The Regulations define "output facility" to mean electric and gas generation, transmission, distribution, and related facilities, and water collection, storage, and distribution facilities. Output facilities are subject to the same private business use restrictions as other projects (such as limitations on leasing and

management contracts); however, the IRS has also adopted some special rules applicable only to output facilities.

Private Business Use and Output Contracts

In 2002, the IRS released final regulations (the "Output Contract Regulations") with respect to whether certain arrangements for the purchase of output from an output facility cause an issue of bonds to meet the private business tests. Generally speaking, an output contract will meet the private business use tests if the contract has the effect of transferring the benefits of owning the facility and the burdens of paying the debt service on bonds used (directly or indirectly) to finance the facility (the "benefits and burdens" test). If an output contract results in private business use, the amount of private business use generally is measured by the amount of output purchased under the contract.

Benefits and Burdens Test

The Output Contract Regulations apply the benefits and burdens test to several types of output contacts, as follows:

1) Take contract and take or pay contract. A take contract is an output contract under which a purchaser agrees to pay for the output under the contract if the output facility is capable of providing the output. A take or pay contract is an output contract under which a purchaser agrees to pay for the output under the contract, whether or not the output facility is capable of providing the output. A take contract or take or pay contract will generally meet the benefits and burdens test and create private business use if a nongovernmental person agrees pursuant to the contract to purchase available output (defined below) of a facility.
2) Requirements contract. A requirements contract is an output contract, other than a take contract or a take or pay contract, under which a nongovernmental person agrees to purchase all or part of its output requirements.
    a) Non-Contingent Obligation to Purchase. A requirements contract generally meets the benefits and burdens test to the extent that it contains contractual terms that obligate the purchaser to make payments that are not contingent on the output requirements of the purchaser or that obligate the purchaser to have output requirements. For example, a requirements contract with an industrial purchaser meets the benefits and burdens test if the purchaser enters into additional contractual obligations with the issuer or another governmental unit not to cease operations. A requirements contract does not meet the benefits and burdens test, however, by reason of a provision that requires the purchaser to pay reasonable and customary damages (including liquidated damages) in the event of a default, or a provision that permits the purchaser to pay a specified amount to terminate the contract while the purchaser has requirements, in each case if the amount of the payment is reasonably related to the purchaser's obligation to buy requirements that is discharged by the payment.
    b) Wholesale Requirements Contract. A requirements contract that is a sale at wholesale (i.e. a sale of output to any person for resale) may satisfy the benefits and burdens test, depending on all the facts and circumstances. Significant factors that tend to establish that a wholesale

requirements contract meets the benefits and burdens test include, but are not limited to: (1) the term of the contract is substantial relative to the term of the bond issue or issues that financed the facility; and (2) the amount of output to be purchased under the contract represents a substantial portion of the available output of the facility.

A wholesale requirements contract does not meet the benefits and burdens test if— (1) The term of the contract, including all renewal options, does not exceed the lesser of 5 years or 30% of the term of the bond issue; or (2) the amount of output to be purchased under the contract (and any other requirements contract with the same purchaser or a related party with respect to the facility) does not exceed 5% of the available output of the facility.

c) Retail Requirements Contract. Except as otherwise described above, a requirements contract that is not a sale at wholesale (a "retail requirements contract") does not meet the benefits and burdens test.

Available Output

The "available output" of a facility financed by an issue is determined by multiplying the number of units produced or to be produced by the facility in one year by the number of years in the Measurement Period of that facility for that issue.

a) Generating facilities. The number of units produced or to be produced by a generating facility in one year is determined by reference to its nameplate capacity or the equivalent (or where there is no nameplate capacity or the equivalent, its maximum capacity), which is not reduced for reserves, maintenance or other unutilized capacity.
b) Transmission and other output facilities.
   i) In general. For transmission, distribution, cogeneration, and other output facilities, available output must be measured in a reasonable manner to reflect capacity.
   ii) Electric transmission facilities. Measurement of the available output of all or a portion of electric transmission facilities may be determined in a manner consistent with the reporting rules and requirements for transmission networks promulgated by the Federal Energy Regulatory Commission (FERC).
c) The Output Contract Regulations provide special rules for measuring available output of facilities with significant unutilized capacity and for facilities with a limited source of supply.

Measurement of Private Use from Output Contracts

The amount of private business use of an output contract generally is measured by the amount of available output purchased under the contract over the Measurement Period. The Measurement Period begins on the later of the issue date of the bonds financing the output facility or the date the property is placed in service and ends on 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 (determined without regard to any optional redemption dates). In general, the reasonably expected economic life of the property for this purpose is based on reasonable expectations as of the issue date.

The following example from the Output Contract Regulations illustrates the measurement of private business use of an output contract: City J issues 20-year bonds to acquire an electric generating facility having a reasonably expected economic life substantially greater than 20 years and a nameplate capacity of 100 MW. The available output of the facility is approximately 17,520,000 MWh (100 MW x 24 hours x 365 days x 20 years). On the issue date, J enters into a contract with T, an investor-owned utility, to provide T with all of its power requirements for a period of 10 years, commencing on the issue date. J reasonably expects that T will actually purchase an average of 30 MW over the 10-year period. The contract is taken into account under the private business tests because the term of the contract is substantial relative to the term of the issue and the amount of output to be purchased is a substantial portion of the available output. The amount of reasonably expected private business use under this contract is approximately 15% (30 MW x 24 hours x 365 days x 10 years, or 2,628,000 MWh) of the available output. Accordingly, the issue meets the private business use test.

Safe Harbors

Under the Output Contract Regulations, the following types of contracts do not result in private business use:

a) Small purchases of output. An output contract for the use of a facility is not taken into account under the private business tests if the average annual payments to be made under the contract do not exceed 1% of the average annual debt service on all outstanding tax-exempt bonds issued to finance the facility, determined as of the effective date of the contract.
b) Swapping and pooling arrangements. An agreement that provides for swapping or pooling of output by one or more governmental persons and one or more nongovernmental persons does not result in private business use of the output facility owned by the governmental person to the extent that:
    i) The swapped output is reasonably expected to be approximately equal in value (determined over periods of three years or less); and
    ii) The purpose of the agreement is to enable each of the parties to satisfy different peak load demands, to accommodate temporary outages, to diversify supply, or to enhance reliability in accordance with prudent reliability standards.
c) Short-term output contracts. An output contract with a nongovernmental person is not taken into account under the private business tests if:
    i) The term of the contract, including all renewal options, is not longer than 3 years;
    ii) The contract either is a negotiated, arm's-length arrangement that provides for compensation at fair market value, or is based on generally applicable and uniformly applied rates; and
    iii) The output facility is not financed for a principal purpose of providing that facility for use by that nongovernmental person.
d) Certain conduit parties disregarded. A nongovernmental person acting solely as a conduit for the exchange of output among governmentally owned and operated utilities is disregarded in

determining whether the private business tests are met with respect to financed facilities owned by a governmental person.

Lower Private Use Limitation

As stated above, for most governmental bonds the private business use test is satisfied if more than 10% of the proceeds of bonds (or $15 million if less) is used for a private business use. However, the Code provides an additional limitation for certain output facilities. For a bond issue financing an output facility (other than a facility for the furnishing of water), the $15 million limitation is further reduced by the aggregate nonqualified amounts with respect to all outstanding prior tax-exempt issues 5% or more of the proceeds of which are or will be used with respect to such facility (or any other facility which is part of the same project).

For purposes of applying the special $15 million limitation, the Output Contract Regulations specify that facilities that are functionally related and subordinate to a project are treated as part of that same project. Facilities having different purposes or serving different customer bases are not ordinarily part of the same project. For example, the following are generally not part of the same project: (i) generation, transmission and distribution facilities; (ii) separate facilities designed to serve wholesale customers and retail customers; and (iii) a peaking unit and a baseload unit (regardless of the location of the units). In addition, facilities that are not owned by the same person are not part of the same project.

The Regulations further provide that:

1) In the case of generation and related facilities, a project means property located at the same site. Separate generating units are not part of the same project if one unit is reasonably expected, on the issue date of each issue that finances the units, to be placed in service more than 3 years before the other.
2) In the case of transmission or distribution facilities, project means functionally related or contiguous property. Separate transmission or distribution facilities are not part of the same project if one facility is reasonably expected, on the issue date of each issue that finances the facilities, to be placed in service more than 2 years before the other.
3) An improvement to generation, transmission or distribution facilities that is not part of the original design of those facilities (the original project) is not part of the same project as the original project if the construction, reconstruction, or acquisition of that improvement commences more than 3 years after the original project was placed in service and the bonds issued to finance that improvement are issued more than 3 years after the original project was placed in service. An improvement to transmission or distribution facilities that is not part of the original design of that property is not part of the same project as the original project if the issuer did not reasonably expect the need to make that improvement when it commenced construction of the original project and the construction, reconstruction, or acquisition of that improvement is mandated by the federal government or a state regulatory authority to accommodate requests for wheeling.

4) Property that replaces existing property of an output facility is treated as part of the same project as the replaced property unless the need to replace the property was not reasonably expected on the issue date or the need to replace the property occurred more than 3 years before the issuer reasonably expected (determined on the issue date of the bonds financing the property) that it would need to replace the property, and the bonds that finance (and refinance) the output facility have a weighted average maturity that is not greater than 120% of the reasonably expected economic life of the facility.

Allocating Qualified Equity to Offset Private Business Use

To the extent that facilities are financed with bonds and "qualified equity" (as defined below), 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. Final private activity bond regulations issued on October 26, 2015 (the "Final Mixed Use Regulations"), apply the "undivided portion method" to eligible mixed-use projects of governmental and 501(c)(3) issuers. Under the Final Mixed Use Regulations, a "project" is defined as one or more facilities or capital projects, including land, buildings, equipment or other property, financed in whole or in part with proceeds of the bonds. An "eligible mixed-use project" is a project financed with governmental bonds and with qualified equity pursuant to the same plan of financing. Generally, an eligible mixed-use project must be wholly owned by one or more governmental persons or by a partnership in which at least one governmental person is a partner; however, if an output facility has multiple undivided ownership interests (respectively owned by governmental persons or by both governmental and nongovernmental persons), each owner's interest in the facility is treated as a separate facility for purposes of the Final Mixed Use Regulations, provided that all owners of the undivided ownership interests share the ownership and output in proportion to their contributions to the capital costs of the output facility.

"Qualified equity" includes proceeds of bonds that are not tax-advantaged and funds that are not derived from proceeds of a borrowing (grants, revenues, etc.) that finance a project under the same plan of financing as the bonds. To constitute the same plan of financing, the equity generally must have been expended for costs no earlier than the start of the reimbursement period for the bonds and no later than the date the project is placed in service. Qualified equity is first allocated to all private business use, with any remaining qualified equity then allocated to governmental use on an annual basis. As a result, if the percentage of the project financed with qualified equity is greater than the percentage of private business use of the project, all of the qualified equity is allocated to private business use, resulting in 0% private business use allocated to the bonds for that year. For example, if a project that costs $50 million is financed with $10 million in Issuer revenues constituting qualified equity and $40 million in tax-exempt bond proceeds, then up to 20% private business use of the project will be allocated to the qualified equity before any private business use is allocated to the bonds. For most facilities, this allocation of private business use will be done on an annual basis, but there is a special rule for output facilities (described below).

The Final Mixed Use Regulations provide benefits and challenges with respect to tax-exempt financing for utilities. One benefit for Issuers is that utilities often use a combination of revenues and tax-exempt debt to finance capital expenditures. One challenge for Issuers is determining how to define the "project" or "projects" for purposes of measuring private business use. Utilities often have dozens of capital facilities that may be financed with a single series or multiple series of tax-exempt bonds and those facilities may have a variety of functions (such as generation, transmission, distribution of electricity or collection, storage, treatment and distribution of water). The Final Mixed Use Regulations give Issuers flexibility in defining the "project" financed with tax-exempt bonds; however, once again, output facilities are subject to special rules.

Additional Allocation Rules for Output Facilities

The Final Mixed Use Regulations provide an example demonstrating how qualified equity is applied to private use of a mixed-use output facility. In the example, Authority A is a governmental person that owns and operates an electric transmission facility. Several years ago, Authority A used its equity to pay capital expenditures of $1 billion for the facility. Authority A wants to make capital improvements to the facility in the amount of $100 million (the project). Authority A reasonably expects that, after completion of the project, it will sell 46% of the available output of the facility, as determined under §1.141-7, under output contracts that result in private business use and it will sell 54% of the available output of the facility for governmental use. On January 1, 2017, Authority A issues $60 million of bonds (the Bonds) and uses the proceeds of the Bonds and $40 million of qualified equity (the Qualified Equity) to finance the project. The Qualified Equity is allocated to 40 of the 46% private business use resulting from the output contracts. Proceeds of the Bonds are allocated to the 54% governmental use and thereafter to the remaining 6% private business use.

Under the Output Contract Regulations, whether output sold under an output contract is allocated to a particular facility (for example, a generating unit), to the entire system of the seller of that output (net of any uses of that system output allocated to a particular facility), or to a portion of a facility is based on all the facts and circumstances. Significant factors to be considered in determining the allocation of an output contract to financed property are the following:

1) The extent to which it is physically possible to deliver output to or from a particular facility or system.
2) The terms of a contract relating to the delivery of output (such as delivery limitations and options or obligations to deliver power from additional sources).
3) Whether a contract is entered into as part of a common plan of financing for a facility.
4) The method of pricing output under the contract, such as the use of market rates rather than rates designed to pay debt service of tax-exempt bonds used to finance a particular facility.

Whether use under an output contract for transmission or distribution is allocated to a particular facility or to a transmission or distribution network is based on all the facts and circumstances, in a manner similar to what is described above. In general, the method used to determine payments under a

contract is a more significant contract term for this purpose than nominal contract path. In general, if reasonable and consistently applied, the determination of use of transmission or distribution facilities under an output contract may be based on a method used by third parties, such as reliability councils.

If you have any questions regarding private business use of bond-financed utility property, please contact any of our public finance attorneys.

Alison Benge	Alison.Benge@pacificalawgroup.com	206.602.1210
Deanna Gregory	Deanna.Gregory@pacificalawgroup.com	206.245.1716
Faith Li Pettis	Faith.Pettis@pacificalawgroup.com	206.245.1715
Stacey Lewis	Stacey.Lewis@pacificalawgroup.com	206.245.1714
Jon Jurich	Jon.Jurich@pacificalawgroup.com	206.245.1717
Will Singer	Will.Singer@pacificalawgroup.com	206.602.1216

Dated: March 31, 2019

A Note: This publication is for informational purposes and does not provide legal advice. It is not intended to be used or relied upon as legal advice in connection with any particular situation or facts. The information herein is provided as of the date it is written and the provisions described herein may be modified by future changes in the Code or guidance from the Internal Revenue Service.

Copyright © 2019 Pacifica Law Group LLP. All rights reserved.

To subscribe to our mailing list, please contact Mia Wiltse at Mia.Wiltse@pacificalawgroup.com.