

Tax-Exempt Bonds: A Quick Guide to Private Business Use

When a governmental entity issues tax-exempt bonds or other debt (referred to herein as “bonds”) to finance capital expenditures (a “Project”), there are a variety of rules and regulations that apply to use of the bond proceeds. One of those rules is that, unless the bond is specially qualified, a tax-exempt bond 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 either (a) both private business tests (the “Private Business Tests”) or (b) the private loan test (the “Private Loan Test”). The Private Business Tests are met if (a) there is more than the lesser of 10% or \$15 million private business use of the proceeds of an issue (the “Private Business Use Test”) AND (b) there is more than the lesser of 10% or \$15 million 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.

This quick guide provides some general information on the Private Business Use Test and how governmental issuers can avoid exceeding the private business use limitations that apply to a bond financed Project.

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 state or local government entity for governmental purposes (“qualified users”). Private business use can arise from a lease, management contract, sponsored research agreement or any other arrangement that gives anyone, other than a qualified user, special legal entitlements with respect to the use of the Project. Note that use by the federal government generally constitutes private business use.

Categories of unlimited (“good”) use of a bond-financed Project include:

- Use by a state or local government;
- Use by the general public under a safe harbor; and
- Use pursuant to a qualified management contract or research agreement.

Safe Harbors for General Public Use

Generally, if a lease or other arrangement with respect to a Project has a term of use that is greater than 200 days, including all renewal options, it is considered private business use and not general public use. The following safe harbors and exceptions permit the borrower to disregard what would otherwise be considered private business use, so long as the facility was not financed for the principal purpose of the private trade or business use:

- Under 200 Days General Public Use Arrangements. The Project may be used by the general public for terms of under 200 days. For this exception, use by an entity by a trade or business can still 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.
- 100 Days Limited General Public Use Arrangements. The Project may be used by any person or entity under any arrangement for use (other than as an owner) for a contract term of no longer than 100 days over the life of the contract (including renewal options), if the arrangement would

be general public use except that it is not available on the same basis for use by natural persons because generally applicable and uniformly applied rates are not reasonably available to natural persons not engaged in a trade or business.

- 50 Days Negotiated Arm's-Length Use Arrangements. The Project may be used by any person or entity under any arrangement (other than as an owner) for a contract term of no longer than 50 days over the life of the contract (including renewal options), if the arrangement is negotiated at arm's-length and the compensation paid for the use is at fair market value.
- Incidental Use Arrangements. The financed facility may be used by any person or entity where the use is incidental if the use is non-possessory (except for vending machines, pay telephones, kiosks and similar uses, for which possessory use is permitted) and the non-possessory uses do not in the aggregate exceed 2.5% of the Project.

These safe harbors measure use over the life of the relevant lease or contract and not on an annual basis. For example, a contract allowing a private entity to host a summer camp at a bond financed Project for 30 days a year for three consecutive summers does not meet the 50 day safe harbor because the total use under the contract is 90 days. While the regulations are not clear on this point, a conservative approach treats any amount of use in one day (e.g. one hour) as a day of use for purposes of these safe harbors.

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. Contracts entered into or last materially modified prior to August 18, 2017, will need to be evaluated using the prior IRS guidance.

For more information on private use, see "Tax-Exempt Bonds: A Quick Guide to Management Contracts" available [here](#).

Sponsored Research Agreements

Certain types of research agreements will give rise to private business use, but the IRS has set up a system of safe harbors in Revenue Procedure 2007-47 that turn on several factors beyond the scope of this quick summary. Issuers should exercise caution and seek appropriate counsel when evaluating research agreements with respect to private business use.

If you have any questions on this or other topics relating to municipal finance, please contact any of our public finance attorneys, listed below.

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

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