

# Notice of Proposed Rulemaking and Notice of Public Hearing

## Remedial Actions for Tax-Exempt Bonds

### REG-132483-03

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Notice of proposed rulemaking and notice of public hearing.

**SUMMARY:** This document contains proposed regulations that amend the final regulations that provide certain permitted remedial actions for tax-exempt bonds issued by state and local governments. This document also contains a notice of public hearing on these proposed regulations.

**DATES:** Written or electronic comments must be received by October 14, 2003. Outlines of topics to be discussed at the public hearing scheduled for November 4, 2003, at 10 a.m., must be received by October 14, 2003.

**ADDRESSES:** Send submissions to CC:PA:RU (REG-132483-03), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:RU (REG-132483-03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically to the IRS Internet site at [www.irs.gov/reg](http://www.irs.gov/reg). The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

**FOR FURTHER INFORMATION CONTACT:** Concerning the regulations, Gary W. Bornholdt, (202) 622-3980; concerning submissions of comments, the hearing, and requests to be placed on the building access list to attend the meeting, Sonya M. Cruse, (202) 622-7180 (not toll-free numbers).

**SUPPLEMENTARY INFORMATION:**

## Background

Section 103(a) of the Internal Revenue Code (Code) provides that, generally, interest on any State or local bond is not included in gross income. However, this exclusion does not apply to any private activity bond that is not a qualified bond.

### *A. Governmental Bonds*

Under section 141, a bond is a private activity bond if the bond is issued as part of an issue that meets either (1) the private business use test and the private security or payment test (the private business tests), or (2) the private loan financing test.

The private business use test is met if more than 10 percent of the proceeds of an issue are to be used for any private business use. Section 141(b)(6) defines private business use as use directly or indirectly in a trade or business that is carried on by any person other than a governmental unit.

The private security or payment test is met if the payment of the principal of, or the interest on, more than 10 percent of the proceeds of an issue is directly or indirectly (1) secured by an interest in property used or to be used for a private business use, (2) secured by an interest in payments in respect of such property, or (3) 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.

The private loan financing test is satisfied if more than the lesser of \$5 million or 5 percent of the proceeds of an issue are to be used to make or finance loans to persons other than governmental units.

Under §1.141-2(d) of the Income Tax Regulations, 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. Under §1.141-2(d), 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.

Section 1.141-12 sets forth certain remedial actions that prevent a deliberate action with respect to property financed by an issue from causing that issue to meet the private business use test or the private loan

financing test. Specifically, if an issuer satisfies certain conditions, an issuer may take one of the following three remedial actions to cure a deliberate action. First, the issuer may redeem or defease the nonqualified bonds. However, a defeasance is not a permitted remedial action if the period between the issue date and the first call date of the bonds is more than 10½ years (the 10½ year limitation). Second, if the deliberate action is a disposition of the bond-financed property for which the consideration is exclusively cash, and certain other requirements are met, the issuer may use the cash for an alternative qualifying use. Third, in certain cases, the facility with respect to which the deliberate action occurs may be used in an alternative qualifying manner (for example, the facility may be used for a qualifying purpose by a nongovernmental person or used by a 501(c)(3) organization rather than a governmental person). The second and third types of remedial action may cause a deemed reissuance of the nonqualified bonds (that is, a deemed issuance of new bonds to refund the nonqualified bonds) for certain purposes of the Code.

Section 1.141–12(j) provides that the percentage of outstanding bonds that are nonqualified bonds equals the highest percentage of private business use in any 1-year period commencing with the deliberate action. In addition, §1.141–12(j) provides that the determination of the bonds of an issue that are treated as the nonqualified bonds must be made on a *pro rata* basis, except that, for purposes of the remedial action that involves the redemption or defeasance of the nonqualified bonds, an issuer may treat bonds with longer maturities (determined on a bond-by-bond basis) as the nonqualified bonds.

In general, §1.141–15 provides that §1.141–12 applies to bonds issued on or after May 16, 1997, that are subject to section 1301 of the Tax Reform Act of 1986. However, issuers may apply the remedial action provisions in §1.141–12 to any bonds to which §1.141–12 does not otherwise apply.

### *B. Qualified 501(c)(3) Bonds*

Under section 141(e), a qualified 501(c)(3) bond issued under section 145 may be a qualified bond. Section 145(a)

provides that, in general, a qualified 501(c)(3) bond is any private activity bond issued as part of an issue if: (1) all of the property that is to be provided by the net proceeds of the issue is to be owned by a 501(c)(3) organization or a governmental unit; and (2) such bond would not be a private activity bond if section 501(c)(3) organizations were treated as governmental units with respect to their activities that do not constitute unrelated trades or businesses, determined by applying section 513(a). For this purpose, the private business tests are applied by using “5 percent” instead of “10 percent” each place it appears and “net proceeds” for “proceeds” each place it appears. Section 1.145–2 provides, in general, that §§1.141–0 through 1.141–15 apply to section 145(a).

### *C. Exempt Facility Bonds*

Under section 141(e), an exempt facility bond issued under section 142 may be a qualified bond. Under section 142(a), an exempt facility bond is any bond issued as part of an issue if 95 percent or more of the net proceeds are to be used to provide certain exempt facilities.

Under §1.142–2, if less than 95 percent of the net proceeds of an exempt facility bond are actually used to provide an exempt facility, and for no other purpose, the issue will be treated as meeting the use of proceeds requirement of section 142(a) if the issue meets a reasonable expectations test, and the issuer takes the remedial action described §1.142–2. The reasonable expectations test requires that the issuer must have reasonably expected on the issue date of the bonds that at least 95 percent of the net proceeds of the issue would be used to provide an exempt facility and for no other purpose for the entire term of the bonds (disregarding any redemption provisions). The remedial action provided in §1.142–2 requires that the issuer redeem or defease the nonqualified bonds of the issue. However, a defeasance is not a permitted remedial action if it does not satisfy the 10½ year limitation on defeasances.

For purposes of §1.142–2, the nonqualified bonds are a portion of the outstanding bonds in an amount that, if the remaining bonds were issued on the date on which the failure to properly use the proceeds occurs, at least 95 percent of the net

proceeds of the remaining bonds would be used to provide an exempt facility. If no proceeds have been spent to provide an exempt facility, all of the outstanding bonds are nonqualified bonds. The nonqualified bonds must be determined on a *pro rata* basis, except that an issuer may treat bonds with longer maturities (determined on a bond-by-bond basis) as the nonqualified bonds.

In general, §1.141–16 provides that §1.142–2 applies to bonds issued on or after May 16, 1997. However, §1.142–2, together with certain other regulations, may be applied in whole, but not in part, to bonds outstanding on May 16, 1997.

### *D. Prior Remedial Action Rules*

Prior to the release of §§1.141–12 and 1.142–2, Rev. Proc. 93–17 (1993–1 C.B. 507), provided remedial action rules. Rev. Proc. 93–17 does not contain the 10½ year limitation on defeasances. The preamble to the regulations that include §§1.141–12 and 1.142–2 provides that for actions that occur on or after May 16, 1997, Rev. Proc. 93–17 is obsolete.

### **Explanation of Provisions**

Comments have been received suggesting that the definition of the amount of nonqualified bonds contained in §1.141–12 be limited to the excess of the actual amount of the private business use or private loans over the permitted amount of private business use or private loans under section 141. The comments note that this approach is consistent with the statutory language of section 141, which permits certain *de minimis* amounts of private business use and private loans without jeopardizing the tax-exempt status of bonds, and with the definition of the amount of nonqualified bonds contained in §1.142–2.

The comments also suggest simplifying the rules for determining the bonds to be treated as the nonqualified bonds. The comments recommend granting an issuer greater discretion in its selection of bonds, to the extent that the issuer, through such selection, does not effectively extend the remaining weighted average maturity of the bond issue with respect to which the deliberate action occurred.

Finally, the comments request clarification of the remedial action rules applicable

to bonds issued prior to May 16, 1997. In particular, the comments request that issuers be permitted to apply §§1.141-12 and 1.142-2 to bonds issued before May 16, 1997, without regard to the 10½ year limitation on defeasances contained in those regulations. The comments indicate that it is unfair to require issuers to comply with the 10½ year limitation for bonds issued prior to the release of §§1.141-12 and 1.142-2 because issuers could not have known about the limitation when structuring those bonds.

The proposed regulations generally adopt these suggestions.

First, the proposed regulations reduce the amount of outstanding bonds that are nonqualified bonds under §1.141-12. The proposed regulations provide that the nonqualified bonds are a portion of the outstanding bonds in an amount that, if the remaining bonds were issued on the date on which the deliberate action occurs, the remaining bonds would not satisfy the private business use test or private loan financing test, as applicable. For this purpose, the amount of private business use is the greatest percentage of private business use in any one-year period commencing with the deliberate action.

Second, the proposed regulations amend the provisions of §1.141-12 relating to redemption or defeasance and the provisions of §1.142-2 relating to allocations of nonqualified bonds. Under the proposed regulations, allocations of nonqualified bonds must be made on a *pro rata* basis, except that an issuer may treat any bonds of an issue as the nonqualified bonds so long as (i) the remaining weighted average maturity of the issue, determined as of the date on which the nonqualified bonds are redeemed or defeased (determination date), and excluding from the determination the nonqualified bonds redeemed or defeased by the issuer, is not greater than (ii) the remaining weighted average maturity of the issue, determined as of the determination date, but without regard to the redemption or defeasance of any bonds (including the nonqualified bonds) occurring on the determination date.

Finally, the proposed regulations amend §§1.141-15(e) and 1.141-16(c) to provide that for bonds issued before May 16, 1997, issuers may apply §§1.141-12 and 1.142-2 without regard to the 10½

year limitation on defeasances contained in those regulations.

### Proposed Effective Dates

The proposed regulations that amend §§1.141-12 and 1.142-2 will apply to deliberate actions or failures to properly use proceeds, as applicable, that occur on or after the date of publication of final regulations in the **Federal Register**, to the extent §1.141-12 or 1.142-2, as applicable, applies to the bonds. The proposed regulations that amend §§1.141-15(e) and 1.141-16(c) will apply to bonds issued before May 16, 1997, that are subject to §§1.141-12 or 1.142-2, as applicable, for purposes of deliberate actions or failures to properly use proceeds, as applicable, that occur on or after April 21, 2003. Issuers may apply the proposed regulations to deliberate actions or failures to properly use proceeds, as applicable, that occur on or after April 21, 2003 and before the date of publication of final regulations in the **Federal Register**, to the extent (1) §1.141-12 or §1.142-2, as applicable, applies to the bonds, and (2) with respect to the amendments to §§1.141-15(e) and 1.141-16(c), the bonds were issued before May 16, 1997.

### Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments that are submitted timely (preferably a signed original and eight (8) copies) to the IRS.

The IRS and Treasury request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for November 4, 2003, at 10 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the lobby more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit written comments by October 14, 2003, and submit an outline of the topics to be discussed and the amount of time to be devoted to each topic by October 14, 2003.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Comments are requested on all aspects of the proposed regulations.

### Drafting Information

The principal authors of these regulations are Rebecca L. Harrigal and Gary W. Bornholdt, Office of Associate Chief Counsel (Tax-Exempt and Government Entities), IRS, and Bruce M. Serchuk, Office of Tax Policy, Treasury Department. However, other personnel from the IRS and Treasury Department participated in their development.

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### Proposed Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:  
Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. Section 1.141-0 is amended by adding an entry to the table for §1.141-16(d) to read as follows:

§1.141-0 Table of contents.

\* \* \* \* \*

§1.141-16 Effective dates for qualified private activity bond provisions.

\* \* \* \* \*

(d) Certain remedial actions.

\* \* \* \* \*

Par. 3. In §1.141-12, paragraphs (j) and (k) Example 8 are revised to read as follows:

§1.141-12 Remedial Actions.

\* \* \* \* \*

(j) Nonqualified bonds—(1) Amount of nonqualified bonds. The nonqualified bonds are a portion of the outstanding bonds in an amount that, if the remaining bonds were issued on the date on which the deliberate action occurs, the remaining bonds would not satisfy the private business use test or private loan financing test, as applicable. For this purpose, the amount of private business use is the greatest percentage of private business use in any one-year period commencing with the deliberate action.

(2) Allocation of nonqualified bonds. Allocations of nonqualified bonds must be made on a pro rata basis, except that, for purposes of paragraph (d) of this section (relating to redemption or defeasance), an issuer may treat any bonds of an issue as the nonqualified bonds so long as—

(i) The remaining weighted average maturity of the issue, determined as of the date on which the nonqualified bonds are redeemed or defeased (determination date), and excluding from the determination the nonqualified bonds redeemed or defeased by the issuer in accordance with this section, is not greater than

(ii) The remaining weighted average maturity of the issue, determined as of the determination date, but without regard to the redemption or defeasance of any bonds (including the nonqualified bonds) occurring on the determination date.

(k) \* \* \*

Example 8. Compliance after remedial action. In 2000, City G issues bonds with proceeds of \$10

million to finance a courthouse. The bonds have a weighted average maturity that does not exceed 120 percent of the reasonably expected economic life of the courthouse. G uses \$1 million of the proceeds for a private business use and more than 10 percent of the debt service on the issue is secured by private security or payments. In 2004, in a bona fide and arm's length arrangement, G enters into a management contract with a nongovernmental person that results in private business use of 40 percent of the courthouse per year during the remaining term of the bonds. G immediately redeems the nonqualified bonds, or 44.44 percent of the outstanding bonds. This is the portion of the outstanding bonds that, if the remaining bonds were issued on the date on which the deliberate action occurs, the remaining bonds would not satisfy the private business use test, if the amount of private business use is the greatest percentage of private business use in any one-year period commencing with the deliberate action (50 percent). This percentage is computed by dividing the percentage of the facility used for a government use (50 percent) by the minimum amount of government use required (90 percent), and subtracting the resulting percentage (55.56 percent) from 100 percent (44.44 percent). For purposes of subsequently applying section 141 to the issue, G may continue to use all of the proceeds of the outstanding bonds in the same manner (that is, for the courthouse and the private business use) without causing the issue to meet the private business use test. The issue, however, continues to meet the private security or payment test. The result would be the same if G, instead of redeeming the bonds, established a defeasance escrow for those bonds, provided that the requirement of paragraph (d)(4) of this section was met.

Par. 4. Section 1.141-15 is amended as follows:

1. Paragraph (b)(4) is added.

2. Paragraph (e) is revised.

The amendments read as follows:

§1.141-15 Effective dates.

\* \* \* \* \*

(b) Effective dates. \* \* \*

(4) Certain remedial actions. For bonds subject to §1.141-12, the provisions of §§1.141-12(j) and 1.141-12(k), Example 8, apply to deliberate actions that occur on or after the date of publication of final regulations in the Federal Register and may be applied by issuers to deliberate actions that occur on or after April 21, 2003, and before the date of publication of final regulations in the Federal Register.

\* \* \* \* \*

(e) Permissive application of certain sections — (1) In general. Except as otherwise provided in paragraph (b)(4) of this section and this paragraph (e), the following sections may each be applied by issuers to any bonds—

(i) Section 1.141-3(b)(4);

(ii) Section 1.141-3(b)(6); and

(iii) Section 1.141-12.

(2) Transition rule for pre-effective date bonds. For purposes of paragraphs (e)(1) and (h) of this section, issuers may apply §1.141-12 to bonds issued before May 16, 1997, without regard to paragraph (d)(4) thereof with respect to deliberate actions that occur on or after April 21, 2003.

\* \* \* \* \*

Par. 5. Section 1.141-16 is amended by revising paragraph (c) and adding paragraph (d) to read as follows:

§1.141-16 Effective dates for qualified private activity bond provisions.

\* \* \* \* \*

(c) Permissive application. The regulations designated in paragraph (a) of this section may be applied by issuers in whole, but not in part, to bonds outstanding on the effective date. For this purpose, issuers may apply §1.142-2 without regard to paragraph (c)(3) thereof to failures to properly use proceeds that occur on or after April 21, 2003.

(d) Certain remedial actions. For bonds subject to §1.142-2, the provisions of §1.142-2(e) apply to failures to properly use proceeds that occur on or after the date of publication of final regulations in the Federal Register and may be applied by issuers to failures to properly use proceeds that occur on or after April 21, 2003, and before the date of publication of final regulations in the Federal Register.

Par. 6. Section 1.142-0 is amended by revising the entries to the table for §1.142-2 paragraph (d), (d)(1) and (d)(2) to read as follows:

§1.142-0 Table of contents.

\* \* \* \* \*

§1.142-2 Remedial actions.

\* \* \* \* \*

(d) \* \* \* \* \*

(1) Amount of nonqualified bonds.

(2) Allocation of nonqualified bonds.

\* \* \* \* \*

Par. 7. Section 1.142-2 is amended by revising paragraph (e) to read as follows:

§1.142-2 Remedial actions.

\* \* \* \* \*

(e) *Nonqualified bonds* — (1) *Amount of nonqualified bonds*. The nonqualified bonds are a portion of the outstanding bonds in an amount that, if the remaining bonds were issued on the date on which the failure to properly use the proceeds occurs, at least 95 percent of the net proceeds of the remaining bonds would be used to provide an exempt facility. If no proceeds have been spent to provide an exempt facility, all of the outstanding bonds are nonqualified bonds.

(2) *Allocation of nonqualified bonds*. Allocations of nonqualified bonds must be

made on a *pro rata* basis, except that an issuer may treat any bonds of an issue as the nonqualified bonds so long as—

(i) The remaining weighted average maturity of the issue, determined as of the date on which the nonqualified bonds are redeemed or defeased (determination date), and excluding from the determination the nonqualified bonds redeemed or defeased by the issuer in accordance with this section, is not greater than

(ii) The remaining weighted average maturity of the issue, determined as of the determination date, but without regard to the redemption or defeasance of any

bonds (including the nonqualified bonds) occurring on the determination date.

Robert E. Wenzel,  
*Deputy Commissioner for Services and Enforcement.*

(Filed by the Office of the Federal Register on July 18, 2003, 8:45 a.m., and published in the issue of the Federal Register for July 21, 2003, 68 F.R. 43059)

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