



Tax Exempt Bonds

Phase II - Lesson 3

**Review of Government
Bonds & 501(c)(3) Bonds**



Objectives

- Distinguish a governmental bond from a private activity bond
- Apply the following tests:
 - Private business use test
 - Private security or payment test
 - Private loan financing test
 - Unrelated or disproportionate use test
- Explain the consequences, if any, for a bond that meets one or more of these tests



Governmental Bonds

- A governmental bond is used to finance typical governmental functions of a state or local government, such as:
 - Roads
 - Schools
 - Police Cars



Governmental Bonds (cont.)

Governmental Bond Defined:

- Is an obligation of a state or local government
- Meets the eligibility requirements for interest to be excludable from the gross income of the owner
- Is **not** a private activity bond



Not A Government Bond

Private activity bonds are obligations that benefit non-governmental persons, such as:

- Private businesses
- Charitable organizations
- Individuals



Private Activity Bond

- Per § 141, a bond is a private activity bond if the issuer reasonably expects, as of the issue date that the issue will meet either the:
 - Private *business tests*:
 - Private business use, **and**
 - Private security or payment **or**
 - Private *loan financing test*
- The issuer's reasonable expectations must take into account events and actions over the entire stated term of an issue Reg. § 1.141-2(d)(2).



Private Business Tests

- **Use** — If more than 10 % of the proceeds of the issue are to be used in a trade or business of a nongovernmental person, the issue meets the private business use test
- **Security/Payment** — If more than 10% of the proceeds of the issue are:
 - Secured directly or indirectly by an interest in property used for private business use or payments in respect to such property, or
 - Paid from funds in respect of property or borrowed money used or to be used for private business use



Private Business Use Test

When determining if the use test is met, consider:

- The use of bond proceeds, as well as the use of the bond-financed property (Reg. § 1.141-3(a)(1))
- Both the indirect and direct uses of bond proceeds (Reg. § 1.141-3(a)(2))



Private User

A non-governmental person is treated as a private business user as a result of:

- Ownership
- Actual or beneficial use of property pursuant to a lease
- A management or incentive payment contract
- Certain other arrangements such as a take-or-pay or other output-type contract
- A research contract



Measurement of Private Use

- Generally, the amount of private business use of property is determined according to the average percentage of private business use of that property during the measurement period.
(Reg. § 1.141-3(g)(1))
- The amount of private business use resulting from ownership by a non-governmental person is the greatest percentage of private business use in any 1-year period.



Measurement of Private Use (cont.)

Anti-abuse rule:

The Commissioner may determine the amount of private business use according to the greatest percentage of private business use in any one-year period, if an issuer establishes the term of an issue:

For a period that is longer than is reasonably necessary for the governmental purposes of the issue, or

For a principal purpose of increasing the permitted amount of private business use.



Measurement Period

- The measurement period begins on the **later** of:
 - The issue date, or
 - The date the property is placed in service.
- The measurement period 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).



Private Security/Payment Test

- The private security or payment test is the second part of the private business test.
- If **both** the private security test and the private business use test are satisfied, a bond is a private activity bond.



Private Payment

- The present value of the payments or property taken into account is compared to the present value of the debt service to be paid over the term of the issue.
- Both direct and indirect payments made by any nongovernmental person are taken into account as private payments to the extent allocable to the proceeds used by that person.



Private Payment (cont.)

- Private payments include payments made with respect to property financed with bond proceeds.
- However, such payments are not taken into account if they are reasonably allocable to other property being used by the person making the payment.



Private Security

- Property used for private business use and payments in respect of the property are treated as private security if any interest in that property or payments secures the payment of debt service on the bonds.
- Property that is the security for, or the source of payment of the debt service on an issue need not be property financed with the proceeds.



Unrelated or Disproportionate Use

An issue meets the private business tests if the amount of private business use and private security/payments attributable to **unrelated or disproportionate** private business use exceeds 5% of the proceeds of the issue.



Unrelated Use

- **Unrelated use** financed with the proceeds of an issue is determined on a case-by-case basis.
- Consider the operational relationship between the government use and the private business use.
- In general, a facility that is used for a related private business use must be located within, or adjacent to, the governmentally used facility.



Disproportionate Use

Use is disproportionate to a related government use only to the extent that the amount of proceeds used for that private business use exceeds the amount of proceeds used for the related government use.



Private Loan Financing Test

- A bond is a private activity bond if the issuer reasonably expects to meet either: **the private business tests or the private loan financing test.**
 - **Private Loan Financing Test:**

Bonds of an issue are private activity bonds if more than the lesser of five percent (5%) or \$5 million of the proceeds of the issue is to be used (directly or indirectly) to make or finance loans to persons other than governmental persons.



Private Loan Financing Test (cont.)

- Any transaction that is generally characterized as a loan for federal income tax purposes is a loan for purposes of this test.
- The determination of whether a loan is made depends on the substance of a transaction rather than its form.



501(c)(3) Bonds

The term Qualified 501(c)(3) bond means any private activity bond issued as part of an issue if:

- All property which 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
- Such bond would not be a private activity bond if 501(c)(3) organizations were treated as governmental units with respect to their activities which do not constitute unrelated trade or businesses determined by applying section 513(a) and paragraphs (1) and (2) of section 141(b) were applied by substituting “5” percent for “10” percent each place it appears and by substituting net proceeds for proceeds each place it appears.



501(c)(3) Organization

- An organization that has applied for and has received a 501(c)(3) determination letter from the Internal Revenue Service.
- The organization must maintain its 501(c)(3) status as long as the bonds are outstanding.



Modified Private Business Tests

- In order for bonds to be qualified 501(c)(3) bonds, the bonds must not be private activity bonds using § 141 as modified by § 145(a)(2).
- For purposes of applying the private business tests, a 501(c)(3) organization using facilities financed with qualified 501(c)(3) bonds in related activities is treated as a governmental unit and the use is not considered private use.



Modified Private Business Tests (cont.)

In applying the private business tests:

- 5% is substituted for the 10% limit in § 141(b), and
- **Net proceeds** are substituted for **proceeds**.



Unrelated Trade or Business

- Use of bond proceeds or bond-financed facilities by a 501(c)(3) organization in an unrelated trade or business activity is considered private business use.
- Unrelated business income is income from a trade or business, regularly carried on, that is not substantially related to the charitable, educational, or other purpose that is the basis of the organization's 501(c)(3) exemption.



Summary

Governmental	Qualified 501(c)(3)
Governmental Bond	Private Activity Bond
Private Business Test <u>10%</u> Proceeds	Private Business Test <u>5%</u> <u>Net</u> Proceeds
Proceeds benefit governmental entity	Proceeds benefit 501(c)(3) entity with determination letter from IRS