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New Safe Harbors regarding Tax-Exempt Bonds that may reduce Tax Risks and affect Negotiations with Management Firms

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I. Overview of Private Business Use (PBU)

- A. Excluded Interest - Internal Revenue Code Section 103(a) generally excludes from income interest on any state or local bond.¹
- B. Private Activity Bond - However, Section 103(a) will not apply to any private activity bond that is not a “qualified bond” under Section 141. Section 141(a)(1) defines “private activity bond” as any bond issued as part of an issue that meets both the private business use test (PBU Test) and the private security or payment test (Private Payment Test) or the private loan financing test.²
- C. PBU - An issue of governmental bonds generally meets the PBU Test if more than 10% of the proceeds of the issue are to be used for any PBU:
 - 1. PBU is generally defined to mean “use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit.”
 - 2. For purposes of the definition, use as a member of the general public is not generally taken into account.
 - 3. PBU may be created for governmental bonds if a nongovernmental person has special legal entitlements to use the financed property under an arrangement with the issuer or 501(c)(3) organization. Both actual and beneficial use by a nongovernmental person may be treated as PBU.
 - 4. Generally, a nongovernmental person is treated as a private business user as a result of (1) ownership, (2) actual or beneficial use of property pursuant to a lease or (3) a **management or incentive payment contract** (unless certain safe-harbors are met).
- D. Private Payment Test - The Private Payment Test is met if the payment of principal of, or the interest on, more than 10% of the proceeds of a governmental bond issue is directly or indirectly –

¹ Section references in this outline are to sections of the Internal Revenue Code of 1986.

² A discussion of the private loan financing test is beyond the scope of this outline.

1. Secured by any interest in property used or to be used for a PBU, or secured by payments in respect of such property, or
 2. 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 PBU.
- E. Threshold - The 10% limit is reduced to 5% if:
1. The use of the proceeds of the issue are used for PBU that is unrelated or disproportionate to government use, or
 2. Payments, property and borrowed money with respect to any use is unrelated or disproportionate to government use.
- F. Qualified Bond - The term “qualified bond” is defined as any private activity bond if:
1. Such bond is as follows: an exempt facility bond, a qualified mortgage bond, a qualified veterans’ mortgage bond, a qualified small issue bond, a qualified student loan bond, a qualified redevelopment bond, or a qualified 501(c)(3) bond,
 2. Such bond is issued as part of an issue which meets the applicable volume cap requirements, and
 3. Such bond meets the applicable requirements of section 147 (*e.g.*, TEFRA, 120% economic life test).
- G. Qualified 501(c)(3) Bond - To constitute a qualified 501(c)(3) bond, all of the financed or refinanced property must be owned by a 501(c)(3) organization or a governmental unit and the bond issue must not meet the PBU Test and Private Payment Test or the private loan financing test.
1. The PBU Test for qualified 501(c)(3) bonds requires that no more than 5% of the net proceeds of the issue be used for any PBU.³ PBU is generally defined as use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit or a 501(c)(3) organization.
 2. For purposes of this test, use by 501(c)(3) organizations in any activity which is an unrelated trade or business under federal tax law constitutes PBU.

³ This percentage is further reduced if proceeds of the bonds are used to pay costs of issuance.

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