HAWKINS ADVISORY

FINAL ALLOCATION AND ACCOUNTING REGULATIONS UNDER SECTION 141 OF THE INTERNAL REVENUE CODE

On October 27, 2015, final allocation and accounting regulations (the "**Final Regulations**") promulgated under section 141 of the Internal Revenue Code of 1986, as amended (the "**Code**"), were published in the Federal Register. These Final Regulations, generally effective for bonds sold after January 25, 2016, address situations in which facilities financed with the proceeds of tax-advantaged bonds* are used in both "**qualified**" and "**unqualified**" uses, as such terms are described below.

BACKGROUND

Tax-advantaged bonds may be issued to provide subsidized financing for certain "**qualified**" projects. Property financed with the proceeds of tax-advantaged bonds must generally be owned by or a state or local governmental unit or an organization described in Section 501(c)(3) of Code.

For an issue of governmental bonds, not more than 10% of the proceeds of the issue may be spent in respect of facilities used in a private trade or business use that is related to the governmental unit's exempt purpose and not more than 5% of the proceeds of the issue may be spent on facilities for which the private business use is either unrelated or disproportionate to the exempt governmental use. The lesser of 5% or $5,000,000 may be used to make loans to entities other than state or local governmental units.

For a qualified 501(c)(3) bond, 95% of the proceeds must be spent on projects that are to be used in a manner which is in furtherance of the 501(c)(3) organization's exempt purpose(s): a "**qualified**" use. For a qualified 501(c)(3) bond, "**unqualified**" uses include costs of issuance, instances of private trade or business use, and instances of unrelated trade or business use.

Proceeds used to fund a reasonably required reserve or replacement fund are considered used for "**neutral**" purposes in respect of both categories of bonds.

"**Use**" can take the form of a management contract, a lease, a take or pay contract, a research arrangement, a special legal entitlement, or a special economic benefit. Exceptions for certain private business uses are set forth in Treasury Regulations, Revenue Procedures and other interpretive guidance, e.g., short-term use exceptions; safe-harbor management contract guidelines; and, in certain instances, qualified building improvements. These exceptions do not apply to unrelated trade or business use in connection with qualified 501(c)(3) bonds.

Unqualified use must be accounted for during the "**measurement period**", i.e., the period that starts on the later of: (a) the issue date of the bonds or (b) the placed-in-service date of the financed asset, and ends on the earlier of (a) the maturity date of the bonds (including any refunding bonds) or (b) the end of the economic life of the financed asset.

Unqualified use occurring during the measurement period is quantified during each year of the measurement period and averaged for purposes of determining whether the allowable unqualified use limitation in respect of the bond issue has been exceeded.

*The Final Regulations are stated to apply to both tax-exempt bonds and interest subsidy bonds.

If the unqualified use limitation is exceeded, the interest paid on the tax-exempt bonds may become taxable to the investor, or, in the case of interest subsidy bonds, the issuer may lose its entitlement to the interest subsidy payment.

FINAL REGULATIONS – OPERATIONAL PROVISIONS

The final regulations define an "**eligible mixed-use project**" as a "**project financed pursuant to the same plan of finance with the proceeds of tax-exempt bonds and qualified equity**".

"**Project**" means one or more facilities or capital projects, including land, buildings, equipment or other property financed in whole or in part with proceeds of the issue.

The Project must be owned by a 501(c)(3) organization, a state or local governmental unit, or a partnership in which at least one partner is a 501(c)(3) organization or a state or local governmental unit. The amount of private business use by a non-exempt person resulting from the use of property by a partnership in which that non-exempt person is a partner is that non-exempt partner's share of the amount of use of the property by the partnership, measured by such partner's greatest percentage share of any partnership item of income, gain, loss, deduction or credit attributable to the period the partnership uses the property during the measurement period.

It should be noted that special rules apply to output facilities.

A borrower may contribute another source of funding ("**equity**") to the cost of an asset in addition to the proceeds of an issue of tax-advantaged bonds, thereby increasing the ability to use the asset in an unqualified use without negatively impacting the tax-advantaged status of the bonds. Under the Final Regulations, "**qualified equity**" does not include equity interests in real property or tangible personal property or funds used to redeem/repay tax-exempt bonds (except in the case of certain anticipatory remedial actions described below).

If two or more sources of funding (including two or more tax-advantaged bond issues) are allocated to capital expenditures for a Project, those sources are allocated throughout that Project to the exempt use and the unqualified use of the Project in proportion to the relative amounts of those sources of funding spent on the Project, the "**undivided portion allocation method**".

Except as noted above with respect to use involving a non-exempt partner, "**use**" may be measured based on cost, square footage, gross revenues, time used (excluding periods of non-use), fair market value, and any other reasonable allocation method that reflects the proportionate benefit to be derived in connection with each use of the asset.

The Final Regulations provide that the allocation of the proceeds of an issue of tax-advantaged bonds must be consistent for both rebate (§148) and use of proceeds (§141) purposes.

Treasury Regulation §1.148-6(d) permits a project cost to be allocated to funding sources other than the source that paid such cost using a specific tracing convention, provided the allocation is done timely. Allocations of the proceeds of a tax-advantaged bond to project costs may take place not later than the later of 18 months after (a) the date the asset has been placed-in-service, or (b) the date the project cost has been paid. No allocations are permitted after the date that is 5 years and 60 days after the issue date or 60 days after the issue has been retired, if earlier. These timing rules may prove to be at odds with the undivided portion allocation method applied in the Final Regulations.

The Final Regulations provide that sources of funding (tax-advantaged bond proceeds and qualified equity) allocated to capital expenditures for an eligible mixed-use project are allocated to undivided portions of the eligible mixed-use project and unqualified use such that the qualified equity is allocated first to the unqualified use and then to the governmental

use. If proceeds of more than one issue finance an eligible mixed-use Project, the proceeds of each issue are allocated ratably to the uses to which proceeds are allocated in proportion to the relative amounts of the proceeds of such issues allocated to the eligible mixed-use Project.

The undivided portion allocation method develops a ratio in respect of the facility that represents qualified use and unqualified use. The ratio must be respected each one-year period the bonds are outstanding.

In general, qualified equity will be considered to have financed a Project under the same plan of financing that includes the applicable bonds if the qualified equity pays for capital expenditures of the project on a date that is (a) no earlier than a date on which such expenditures would be eligible for reimbursement by proceeds of the applicable bonds and (b) no later than the date on which the measurement period begins.

The reimbursement bond rules establish the time-frame for a reimbursement allocation to be made; i.e., not later than 18 months after the later of (a) the date the asset to which the expenditure relates was placed-in-service and (b) the date the expenditure was paid, but in no event more than 3 years after the expenditure was paid. An exception to the foregoing applies in respect of "**preliminary expenditures**" and certain de minimis amounts, i.e., the lesser of $100,000 or 5% of the aggregate amount of proceeds applied to the project costs.

MULTIPURPOSE ALLOCATIONS

Where the issue of tax-advantaged bonds finances more than one asset, the Final Regulations contemplate multipurpose allocations of the proceeds of the bonds to the different assets. Separate purposes of a multipurpose issue include "any clearly discrete...governmental purpose reasonably expected to be financed by the issue." In general, all integrated or functionally related capital projects are treated as having a single governmental purpose.

Such allocations are to be made in accordance with the rules for allocations of proceeds to bonds for separate purposes of multipurpose issues in §1.141-13(d) of the Treasury Regulations.

Proceeds, investments, and bonds of a multipurpose issue may be allocated among the various separate purposes of the issue using any reasonable, consistently applied allocation method. Common costs (e.g., issuance costs, qualified guarantee fees, or reasonably required reserve or replacement funds) are allocated ratably among the purposes for which the proceeds are used.

An allocation is not reasonable if it achieves more favorable results than could be achieved with actual separate issues. Applicable Treasury Regulations establish a safe harbor for pro-rata allocations.

A multipurpose allocation may be made at any time, but once made, may not be changed.

Example 1: mixed use project

A issues $70x of governmental bonds (the "bonds") and finances the construction of a 10-story office building (the "project") with proceeds of the bonds and $30x of qualified equity (the "qualified equity"). To the extent that the unqualified use of the project does not exceed 30% in any particular year, the qualified equity is allocated to the unqualified use.

If the unqualified use of the project were 44% in a year, the qualified equity would be allocated to 30% ($30x) unqualified use and proceeds of the bonds would be allocated to the excess (that is 14% or $14x), resulting in unqualified use of the bonds in that year of 20% ($14x/$70x). Conversely, if unqualified use of the project were 20%, qualified equity would be allocated to that 20%. The remaining qualified equity (that is 10% or $10x) would be allocated to the qualified use in excess of the 70% to which the bond proceeds would be allocated.

ANTICIPATORY REMEDIAL ACTION

The Final Regulations include provisions for an "**anticipatory remedial action**" which may be taken in situations in which a change in use of a facility financed with the proceeds of an issue of tax-advantaged bonds is expected to occur but has not yet done so. This provision allows the remediated bonds to be considered retired (not outstanding) for purposes of applying the applicable unqualified use limitations in respect of the remaining bonds of an issue.

The issuer or conduit borrower must declare its "**official intent**" to redeem or defease all of the bonds that would become nonqualified bonds in the event of a subsequent deliberate action that would result in the bonds having unqualified use in excess of the allowable amount and redeems or defeases such bonds prior to the deliberate action.

The declaration of official intent must be adopted on or before the date on which the bonds are redeemed or defeased.

The official intent must identify the property with respect to which the anticipatory remedial action is being taken.

The official intent must describe the deliberate action (e.g., sale of the property financed with the bond proceeds).

The amount of bonds to be remediated as "**nonqualified bonds**" is the amount that results in the applicable percentage of the remaining bonds being associated with a qualified use. For this purpose, the final regulations provide the amount of unqualified use is the greatest percentage of unqualified use in any one year beginning with the one-year period in which the deliberate action occurs.

The nonqualified bonds generally represent a pro-rata allocation of the bonds then outstanding.

Any bonds may be treated as the nonqualified bonds for purposes of these provisions, however, if the remaining weighted average maturity of the remaining bonds, determined as of the defeasance/redemption date is not greater than the remaining weighted average maturity of the issue would have been had the nonqualified bonds continued to be outstanding.

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