

# Spotlight on Public Finance

BRACEWELL

## Spring 2017 Newsletter

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## FEATURED ARTICLE

### When Plans Change: Rules Regarding the Remediation of Excess Private Business Use

By Victoria Ozimek and Brian Teaff

Even the most carefully laid plans have a tendency to change. Thus, it comes as no surprise that, from time to time, an issuer (an “Issuer”) may find itself contemplating a change in use of the property that the Issuer financed with the proceeds of an issue of tax-exempt obligations (the “Bonds”). For example, an Issuer may have determined that land originally purchased with proceeds of the Bonds is no longer suited for its intended use and that it should be put on the market for sale. In another typical scenario, an Issuer may have the opportunity to earn some extra revenue by leasing a portion of a facility financed with proceeds of the Bonds.

Any time that an Issuer changes the use of bond-finance property in a way that creates private business use,<sup>1</sup> the Issuer should hit the “pause button” and consider what effect the action might have on the Bonds. If the action would have the effect of causing the Bonds to have private business use and private payments in excess of the levels allowed under section 141 of the Code (“Excess Private Business”), the Bonds could become taxable private activity bonds unless the Issuer takes action to remediate the Deliberate Act (a “Remedial Action”).<sup>2</sup>

Generally, Treas. Reg. § 1.141-12 provides that the taking of an action that creates Excess Private Business (a “Deliberate Act”) will not adversely affect the tax-exempt status of the Bonds if certain threshold requirements have been met and the Issuer (i) redeems or defeases Bonds that the Regulations identify as being related to the Excess Private Use (the “Nonqualified Bonds”), (ii) uses the entire amount of the proceeds from the Deliberate Act (the “Deliberate Act Proceeds”) for a governmental purpose within two years of the Deliberate Act or (iii) provides for an alternative use of the property for a qualifying purpose.

Historically, an Issuer could take a Remedial Actions only after a Deliberate Act had occurred. However, recent changes to the Regulations now allow, in certain cases, an Issuer to take an “anticipatory” Remedial Action. This article walks through the rules relating to Remedial Actions and identifies common pitfalls to be considered by an Issuer.

## The Threshold Requirements

First things first: in order to be eligible to take a Remedial Action, an Issuer must meet certain threshold requirements with respect to the Bonds and the Deliberate Act. The five threshold requirements are as follows:

1. Reasonable expectations test. On the original issue date of the Bonds, an Issuer cannot have reasonably anticipated that it would engage in a Deliberate Act creating Excess Private Business.
2. Maturity not unreasonably long. The term of the Bonds must not be longer than is reasonably necessary for the purposes of the issue. Generally, this requirement is met if the weighted average maturity of the Bonds is not greater than 120 percent of the average reasonably expected economic life of the financed property.
3. Fair market value consideration. The Deliberate Act must be for fair market value, taking into account any bona fide restrictions imposed on the property by the Issuer (e.g. that it must be used for a specific types of development), and the agreement relating to the Deliberate Act must have been made at arm's length.
4. Treatment of Deliberate Act Proceeds. The Issuer must treat any Deliberate Act Proceeds as "gross proceeds" for arbitrage purposes. This means that the Deliberate Act Proceeds cannot be invested at a yield that is materially higher than the yield on the Bonds.<sup>3</sup>
5. Proceeds expended. The bond proceeds affected by the Deliberate Act must have been expended on a qualified purpose (e.g., property intended for governmental use) before the date of the Deliberate Act. This requirement does not apply if the Remedial Action will be the redemption or defeasance of Nonqualified Bonds.

## Types of Remedial Actions

If the threshold requirements are met, the Issuer may take Remedial Action to "cure" the Deliberate Act. Depending on the facts of the Deliberate Act, Remedial Actions available to the Issuer are the following:

1. Redemption or Defeasance of Nonqualified Bonds. If the Deliberate Act Proceeds are exclusively cash, the cash may be used to redeem the Nonqualified Bonds on the earliest call date after the Deliberate Act. If the Bonds are not callable within 90 days of the date of the Deliberate Act, the Issuer may establish a defeasance escrow within 90 days of the Deliberate Act, but only if the Nonqualified Bonds are callable within 10 ½ years of the issue date of the Bonds and the Issuer provides the Internal Revenue Service (the "IRS") notice that the defeasance escrow has been established.

Nonqualified Bonds are a portion of the outstanding Bonds in an amount that, if the remaining Bonds were issued on the date of Deliberate Act, the remaining Bonds would not meet the private business use test. Thus, an Issuer need only remediate for the private business use over and above the permitted threshold. However, for this purpose, the amount of private business use is the greatest percentage of private business use in any one-year measurement period occurring after the Deliberate Act. (Note: This is different from the general measurement rules, which provide that the amount of private business use is the average percentage of private business use over the entire measurement period, which allows one-year periods of little or no use to bring down the overall percentage of private business use.)

Importantly, an Issuer cannot "pick and choose" the Bonds that it would be most beneficial for an Issuer to redeem (e.g. the maturities with the highest coupons). Rather, the allocation of Nonqualified Bonds must be made either (i) on a pro rata basis or (ii) in a manner that would not extend the weighted average maturity of the bond issue, determined as of the date of redemption or defeasance. As such, both the Issuer and its financial advisor must understand these limitations, as they may affect the overall cost-benefit analysis.

Finally, one important timing consideration of which Issuers should be aware is that a Deliberate Act occurs on the date an Issuer and the private party enter into a binding contract that is not subject to material contingencies. This can sometimes cause unexpected timing hiccups, as a contract for sale (which could trigger the Deliberate Act) may be signed well before the actual closing date when amounts that may be needed by the Issuer for the redemption or defeasance will be actually received.

2. Alternative Use of Deliberate Act Proceeds. If the Deliberate Act Proceeds are exclusively cash, the Issuer may also use the Deliberate Act Proceeds for an alternative governmental purpose. An Issuer must reasonably expect to expend the Deliberate Act Proceeds within two years of the date of the Deliberate Act in a manner that does not cause Excess Private Business. If an Issuer does not use all of the Deliberate Act Proceeds for an alternative governmental use within the two year period, an Issuer must use the remaining Deliberate Act Proceeds to redeem or defease Nonqualified Bonds. An Issuer should note that the IRS has taken the position that this Remedial Action requires that all of the Deliberate Act Proceeds be used for an alternative governmental purpose within the prescribed two-year period. This is true even if the amount of the Deliberate Act Proceeds is in excess of the amount of Bond proceeds used for the financed property. If then, for example, an Issuer sells bond-financed property for a large profit, the Issuer should carefully consider whether this Remedial Action is in its best interest.

3. Alternative use of facility. If the Deliberate Act results in the property being used for a qualifying purpose for another type of tax-exempt bond (e.g. an exempt facility bond), the Nonqualified Bonds may be treated as reissued as of the date of the Deliberate Act, provided that the new user does not use proceeds of another issue of tax-exempt obligations to finance their interest in the property. The Issuer must use Deliberate Act Proceeds to pay debt service on the reissued Bonds on the next available payment date or to establish a yield-restricted escrow to pay debt service.

## Anticipatory Remedial Actions

For many years, an Issuer had to wait until after it had taken a Deliberate Act to remediate bonds. This was seemingly contrary to the policy objective of taking bonds off the market as soon as possible. In 2015, the IRS rectified this incongruence by providing an Issuer with the ability to redeem or defease Nonqualified Bonds in anticipation of a Deliberate Act if the following requirements are met:

1. Declaration of Intent. Prior to taking the Anticipatory Remedial Action, an Issuer must declare an official intent (a “Declaration of Intent”) to redeem or defease all Bonds that would become Nonqualified Bonds if a subsequent Deliberate Act is taken. The Declaration of Intent must describe the anticipated Deliberate Act and identify the financed property or loan that will be affected.

2. Redemption of Nonqualified Bonds. An Issuer must in fact redeem or defease the Nonqualified Bonds prior to the date of the Deliberate Act. As with a “normal” remediation that involves a defeasance, the Nonqualified Bonds must be callable within 10 ½ years of the date the obligations were issued and an Issuer must provide the IRS with notice that the defeasance escrow has been established.

Anticipatory Remedial Actions are only an option if an Issuer plans to redeem or defease bonds, as both other Remedial Action options require that Deliberate Act Proceeds already be received. If an Issuer has enough cash on hand to redeem or defease Nonqualified Bonds, however, an anticipatory remedial action can be an attractive option for Issuers wishing to take care of remediating Bonds prior to a Deliberate Act.

## Parting Thoughts

When plans change and an Issuer is contemplating taking a Deliberate Act that would create Excess Private Business with respect to an issue of Bonds, there are Remedial Action options available that allow Issuers to safeguard against the entirety of the issue becoming taxable private activity bonds. However, there are prerequisites that must be met and structuring considerations that should be taken into account early in the process. Further, various pitfalls exist that, if not avoided, can hinder an Issuer’s ability to take advantage of one or more of the Remedial Action options or affect the Issuer’s analysis as it weighs different options. With this in mind, if an Issuer is considering a change in course, it’s best to get tax counsel on board early to help navigate through the rules.

Please contact **Victoria Ozimek** or **Brian Teaff** with any questions related to this article.

<sup>1</sup> For this purpose, “private business use” means direct or indirect use in a trade or business carried on by any person other than a state or local government. Thus, “private business use” includes use by the federal government and nonprofit organizations.

<sup>2</sup> All references herein to the “Code” are to the Internal Revenue Code of 1986, as amended. All references herein to “Treas. Reg. S” are to the referenced section of the Treasury Regulations (the “Regulations”) promulgated under the Code. Generally, an issue of bonds will have Excess Private Business Use if (i) more than 10 percent (and, in some cases 5 percent) of the proceeds of the issue are to be used for any private business use and (ii) the payment of, or the interest on, more than 10 percent (and, in some cases 5 percent) of the proceeds of such issue is directly or indirectly (A) secured by any interest in property used or to be used for a

private business use or payments in respect of such property or (B) to be derived from payments in respect of property, or borrower money, used or to be used for private business use.

<sup>3</sup> For yield restriction and rebate exception purposes, the Issuer may treat the date of receipt of the Deliberate Act Proceeds as the issue date of the obligations and disregard the receipt of the Deliberate Act Proceeds for purposes of rebate spending exception requirements that were met before the receipt of the Deliberate Act Proceeds.

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## PRACTICE FOCUS

### Government Relations

By Victoria Ozimek and Brian Teaff

The Policy Resolution Group (PRG) at Bracewell is a unique team of lawyers, lobbyists and strategic communications professionals with decades of experience operating in Washington, D.C. Recognized as the top performing lobbying/law firm in 2015 by Bloomberg Government, PRG is the only group among its competitors to make this list for the previous four consecutive years.

PRG includes a bipartisan team of former senior officials in both the legislative and executive branches, former press secretaries and journalists, as well as nationally recognized lobbyists and strategic communications practitioners. We provide services and solutions for our clients that span legislative and regulatory advocacy, comprehensive strategic communications services including crisis communications and reputation management, coalition development and management, and support for Congressional investigation.

### Tax News – What You Need to Know This Week

Curt Beaulieu, Senior Counsel at The Policy Resolution Group at Bracewell, distributes a weekly tax summary email consisting of hot topics, legislative updates and what to expect in the world of tax. He is a former Tax Counsel for the Senate Finance Committee and former Tax Counsel for the Ranking Member of the Ways and Means Committee.

In the most recent edition of The Lobby Shop podcast series, Curt Beaulieu breaks down President Trump's newly proposed tax plan while Josh Zive, a Senior Principal with PRG, addresses the speculation surrounding a NAFTA withdrawal.

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## NEW FACES



### Former SEC Official Edward Fierro Joins Bracewell's Public Finance Practice

Bracewell LLP, a leading law and government relations firm, is pleased to announce that Ed Fierro, a former official of the Securities and Exchange Commission's (SEC) Office of Municipal Securities, has joined the firm as senior counsel. Fierro will serve as bond counsel, disclosure counsel and underwriter's counsel, as part of Bracewell's public finance practice.

"Ed brings comprehensive knowledge of federal securities laws to Bracewell, further strengthening the firm's robust public finance practice," said Partner Barron F. Wallace, co-chair of the public finance practice. "His in-depth knowledge of the municipal-related issues affecting our clients is a significant asset to Bracewell."

During his career with the SEC, Fierro served as senior counsel to the director of the SEC's Office of Municipal Securities, where he was responsible for coordinating the agency's municipal securities activities and administering the rules pertaining to the municipal securities market.

Ed launched his public finance career at a law firm in New York City. Prior to practicing law, he served a combined six years in the United States Army and the California Army National Guard.

# ATTORNEYS IN ACTION

## Arbitrage and Rebate Update

May 11, San Antonio, TX

Todd Greenwalt will be speaking about current IRS examination topics at the Hilltop Securities Inc. Arbitrage and Rebate Update.

## Bond Dealers of America (BDA)

May 11, St. Louis, MO

Ed Fierro will be participating in BDA's retail fixed income roundtable and deliver a presentation on the MSRB and FINRA mark-up disclosure rules and pre-trade price transparency.

## Government Finance Officers Association (GFOA) Annual Conference

May 21-24, Denver, CO

Ed Fierro will be a panelist on the "GFOA Legislative and Regulatory Update" at the GFOA Annual Conference.

## The Bond Buyer's Midwest Municipal Market Conference

June 8, Chicago, IL

Ed Fierro will be a panelist on a regulatory panel at The Bond Buyer's Midwest Municipal Market Conference.

## Texas City Attorneys Association (TCAA)

June 14-16, South Padre Island, TX

Derrick Mitchell and Glenwood Hill will speak at the TCAA Summer Conference.

## National Association of Bond Lawyers (NABL)

October 4-6, Chicago, IL

Victoria Ozimek will be chairing the "Post-Issuance Compliance Panel" at NABL's Bond Attorney's Workshop. In addition, Todd Greenwalt will speak on the "Qualified 501(c)(3) Bonds Panel," Bill Avila will participate on the "Ethics—Professional Responsibility and Liability Panel," Ed Fierro will speak on the "Hot Topics in Municipal Securities Law Panel" and Brian Teaff will be presenting on the "Private Business Use Panel."

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## UPDATES

Since our last newsletter, our public finance team has released a number of updates regarding developments in both federal securities and tax law. If you missed them the first time or would like to refresh your memory, we have compiled the most recent of our team's updates here.

### Public Finance Update – SLGS Window Closing

March 13, 2017, Todd Greenwalt, Victoria Ozimek, and Brian Teaff

### SEC Proposes Additional Event Disclosures for Municipal Bond Issuers

March 2, 2017, Paul Maco, Britt Cass Steckman, and Sarah Rafie

### The New Issue Price Regulations: The Good, the Bad and the Ugly

February 3, 2017, Victoria Ozimek and Brian Teaff

### Management Contracts Safe Harbors Revisited – IRS Releases Updated Guidance (Again)

January 19, 2017, Victoria Ozimek and Brian Teaff

### Bracewell Webinar: Final Issue Price Regulations

January 13, 2017, Victoria Ozimek and Brian Teaff

# ATTORNEY SPOTLIGHT



## Curt Beaulieu | Senior Counsel, Washington, DC

Curt Beaulieu focuses on tax policy, providing advice on federal legislation and regulations. Curt joined PRG from Capitol Hill, where he served since 2011 as tax counsel for the Senate Finance Committee. As tax counsel, he co-wrote the Tax Reform Option Paper on energy taxes for Senate Finance Committee members, organized hearings on income distribution and oil and gas tax expenditures, including intangible drilling costs, dual capacity, and the Section 199 manufacturing deduction, and negotiated extension of expiring tax provisions involved in the “fiscal cliff,” including “tax extenders,” and the estate and gift tax. Following the financial collapse in 2008, he worked on the American Recovery and Reinvestment Act, which created several new types of tax-exempt financing.

Beaulieu has wide-ranging Capitol Hill experience working for both the Senate and the House. Prior to working on the Senate Finance Committee staff, he served as tax counsel to Senate Finance Committee Ranking Member Orrin Hatch (R-Utah) from 2008-11 and, in 2007-8, to Representative Jim McCrery (R-Louisiana), who was then ranking member on the House Ways & Means Committee. He also worked in various legislative capacities for Representative Sam Johnson (R-Texas) and Senator David Vitter (R-Louisiana).

“Curt is a dedicated professional with a proven track record in understanding the challenges and complexities of the U.S. tax code. I’ve always valued his expertise and counsel and know he’ll do well in this new endeavor,” said Senator Orrin Hatch when Curt joined Bracewell.

Beaulieu received an LL.M. from Georgetown University Law Center; a J.D. from the California Western School of Law; and a B.S. in Communications from the University of Texas.

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## DID YOU KNOW?

- The Lobby Shop gives you a rare opportunity to listen to conversations between advocates who are directly involved in the big issues of our day. The Lobby Shop is hosted by Josh Zive, a senior principal in Bracewell’s Policy Resolution Group, and includes lawyers, lobbyists, and communications experts from one of the country’s leading government relations teams discussing the substance and politics behind current policy debates.
- The MSRB has developed a free online course developed specifically for issuers of tax-exempt bonds. Register for MuniEdPro<sup>SM</sup> to take the free, 45-minute course.
- Texas still favors the cowboy. During the annual sales tax holiday, cowboy boots are exempt from sales tax, but rubber work boots are not.

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*Bracewell is a leading law and government relations firm primarily serving the energy, finance and technology industries throughout the world.*

*Our industry focus results in comprehensive state-of-the-art knowledge of the commercial, legal and governmental challenges faced by our clients and enables us to provide innovative solutions to facilitate transactions and resolve disputes*