HAWKINS ADVISORY

Rev. Proc. 2018-26 – Supplemental Remedial Action Guidelines for Changes in Use in Respect of Tax Advantaged Bonds

I. In General.

Revenue Procedure 2018-26, published in the Federal Register on April 11, 2018 (the "**Rev. Proc.**"), introduces guidelines for effecting remedial actions in connection certain categories of bonds issued under the Internal Revenue Code of 1986, as amended (the "**Code**").* These guidelines apply to nonqualified uses in respect of tax-advantaged bonds that take place on or after April 11, 2018, and may apply to such situations occurring prior to April 11, 2018.

The relevant categories of bonds are referred to herein as "**tax advantaged bonds**" and comprise :

- direct pay bonds, for which the issuer receives refundable tax credits ("**direct pay bonds**");
- tax credit bonds, for which holders receive tax credits ("**tax credit bonds**"); and
- tax-exempt bonds, for which holders receive tax-exempt interest ("**TEBs**").

II. Definitions.

"**Nonqualified use**" is (a) a use of tax-advantaged bond financed assets for a purpose other than a qualified use contemplated by the applicable Code section and (b), in connection with direct pay bonds and tax credit bonds, a failure to spend proceeds of such bonds within the applicable spending period; if any.

A nonqualified use occurs in connection with the failure to spend the proceeds of direct pay bonds and/or tax credit bonds on the earlier of (a) the first date on which the issuer fails to have a reasonable expectation to spend the proceeds for a qualified use (within the required expenditure period) or (b) the last day of the expenditure period.

A nonqualified use occurs in connection with facilities financed with the proceeds of direct pay bonds and/or tax credit bonds on the first date on which an action causes proceeds to be used for other than a qualified use.

A nonqualified use occurs in connection with facilities financed with the proceeds of TEBs on the date of a deliberate action, as described in §1.141-2(d)(3).

"**Nonqualified bonds**" means the portion of the outstanding bonds in an amount that, if the remaining bonds were issued on the date on which nonqualified use of proceeds occurs, the proceeds of the remaining bonds would be used in a timely manner for a qualified use. Allocations of nonqualified bonds are generally required to be made on a pro-rata basis.

"**Disposition proceeds**" are generally defined as any amounts (including property, such as an agreement to provide services) derived from the sale, exchange, or other disposition of property (other than investments) financed with the proceeds of an issue, plus investment earnings on such amounts. If property has been financed with different borrowings, disposition proceeds may be allocated among such different borrowings in proportion to the principal amount of the indebtedness outstanding

III. Remedial Action for Direct Pay Bonds: Reduce the Refundable Federal Tax Credit.

The Rev. Proc. allows an issuer to cure a nonqualified use in connection with an issue of direct pay bonds by reducing the amount of the refundable federal tax credit to eliminate the amount of such credit allocable to the nonqualified bonds.

For the first Form 8038-CP (Return for Credit Payment to Issuers of Qualified Bonds), or any successor form, filed for any interest payment date of the bonds after the nonqualified use occurs, the issuer must:

- write across the top of the form: "Remedial Action under Section 6 of Rev. Proc. 2018-26";
- attach an explanation for the difference in scheduled credit payment stating that a nonqualified use occurred and the date of the nonqualified use; and
- include a revised debt service schedule reflecting the exclusion of amounts allocable to the nonqualified bonds beginning with the date of the nonqualified use.

Finally, the issuer must treat the disposition proceeds as gross proceeds for purposes of the arbitrage requirements and as proceeds for purposes of the applicable Code section.

IV. General Remedial Action Rules for Tax Credit Bonds and Direct Pay Bonds.

The Rev. Proc. allows an issuer to cure a nonqualified use in connection with an issue of tax credit bonds and direct pay bonds by: (a) redeeming or defeasing nonqualified bonds or (b) applying the disposition proceeds of such bonds for an alternative qualified use.

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* Section references used herein are to applicable provisions of the Internal Revenue Code of 1986, as amended, or Treasury Regulations promulgated thereunder.

A. **Redemption or Defeasance of Nonqualified Bonds.**

The Rev. Proc. allows for excess nonqualified use in connection with an issue of tax credit bonds and direct pay bonds, including a failure to spend proceeds, to be cured if the issuer redeems or defeases the nonqualified bonds of the issue within 90 days after the date on which the nonqualified use occurs.

If the bonds may not be redeemed within the 90-day period and a defeasance escrow is established, the yield on investments held in the defeasance escrow must be restricted to the yield the defeased bonds. The Rev. Proc. allows for such yield restriction requirement to be satisfied if amounts earned on the defeasance escrow investments exceed what would have been earned had such investments been invested at the yield on the bonds, and the excess amounts are rebated to the United States at the same time and in the same manner as arbitrage rebate amounts are required to be paid. For this purpose, the first computation period begins on the date on which the defeasance escrow is established.

The issuer may not invest a defeasance escrow in any investment for which it (or a related party (as defined in § 1.150-1(b)) is the obligor.

The issuer must treat any disposition proceeds as gross proceeds for purposes of the arbitrage requirements and as proceeds for purposes of the applicable Code section.

Under this remedial action, the defeasance of the tax credit bond or the direct pay bond will not result in a reissuance of such bond.

B. **Alternative Qualified Use of Disposition Proceeds.**

The Rev. Proc. allows alternative qualified use of disposition proceeds as a remedial action in connection with a nonqualified use of tax credit bonds or direct pay bonds, if:

- the nonqualified use consists of a disposition for which the consideration is exclusively cash;
- the issuer reasonably expects to spend the disposition proceeds within two years after the date of the disposition on alternative qualified uses or, to the extent the issuer does not expect to so spend the disposition proceeds, the issuer redeems or defeases the nonqualified bonds within 90 days after the date of disposition (as described in A. above); and
- for this purpose, the issuer may treat the date of the receipt of the disposition proceeds as if it were the issue date of the nonqualified bonds in applying the temporary period and spending exceptions to the arbitrage requirements, and it may disregard the receipt of disposition proceeds for the spending exceptions for which the requirements were met before the receipt of the disposition proceeds.

If the issuer, notwithstanding its reasonable expectations, fails to spend all of the disposition proceeds within the prescribed two-year period, the remaining unspent disposition proceeds must be applied to either redeem or defease outstanding bonds within 90 days after the end of that two-year period.

The issuer is required to treat the disposition proceeds as gross proceeds for purposes of the arbitrage requirements and as proceeds for purposes of the applicable Code section.

V. Rebate Payments for TEB Defeasance Escrows.

Existing remedial action rules provide for the redemption or defeasance of nonqualified bonds within 90 days of the deliberate action as means of curing nonqualified use in connection with an issue of TEBs. Under these rules, the defeasance escrow must be invested at a restricted yield. The Rev. Proc. extends the ability to make rebate payments to effect compliance with such yield restriction requirement, as described in IV.A. above, to TEBs.

VI. Remedial Action for Certain Long-Term Leases of Property Financed with Tax Advantaged Bonds.

The Rev. Proc. allows for a modified alternative qualified use of proceeds remedial action in respect of situations involving “eligible leases”, which have the following characteristics:

- consideration for the lease consists exclusively of cash lease payments (regardless of when paid) that are not financed with proceeds of another issue of tax advantaged bonds; and
- the term of the lease--

  (a) is at least equal to the lesser of 20 years or 75 percent of the weighted average reasonably expected economic life of the leased property (determined in the same manner as under section 147(b)) as of the start of the term of the lease; or

  (b) runs through the end of the measurement period (as defined in § 1.141-3(g)(2)).

The conditions precedent of the existing remedial action rules set forth in §1.141-12(a) apply, *i.e.*, on the issue date of the tax advantaged bonds, the issuer reasonably expected that neither the private business use test nor the private loan test would be met, the principal amortization structure of the tax advantaged bonds satisfied the 120 percent test, the lease arrangement is entered into on terms that represent fair market value, the disposition proceeds are treated as gross proceeds for arbitrage purposes, and the proceeds of the tax advantaged bonds have been spent on a qualified project cost.

If the foregoing requirements are satisfied, the eligible lease is treated as a disposition exclusively for cash and the present value of all the lease payments, determined as of the start of the lease using the yield on the tax advantaged bonds as of the start of the lease as the discount rate, is treated as disposition proceeds that are required to be spent within the applicable two year period.

During the term of the lease, the leased property is treated as transferred property, and facilities financed with proceeds of the issue that are disposition proceeds hereunder are treated as the bond-financed facilities during the term of the lease only (and the proceeds are allocated to the leased property thereafter).

VII. Special Rules of Application.

For Qualified Zone Academy Bonds under § 1397E, the remedial actions under § 1.1397E-1(h)(8) continue to apply in lieu of the Rev. Proc. For tax advantaged bonds subject to § 141, except for the ability to make rebate payments in connection with higher yielding defeasance escrow investments described above, the remedial action provisions under § 1.141-12 apply in lieu of the Rev. Proc. for purposes of curing violations of the private business use and private loan restrictions.

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