

Public Finance Alert

Published Monday, September 26, 2011 6:00 am



Stephen Pugh
spugh@pjjlaw.com



Lorraine Tyson
ltyson@pjjlaw.com



Glenn Weinstein
gweinstein@pjjlaw.com

IRS Issues Final Regulations on Solid Waste Disposal Facilities

On August 18, 2011, the Internal Revenue Service (the "IRS") issued final regulations¹ (the "Final Regulations") for determining whether a facility is a "solid waste disposal facility" and therefore, eligible for tax-exempt bond financing. The Final Regulations are applicable to bonds sold on or after October 18, 2011. Issuers may elect to apply the Final Regulations in whole, but not in part, to outstanding bonds that have been sold before October 18, 2011. The Final Regulations do not need to be applied to bonds that currently refund bonds that were originally not subject to the Final Regulations as long as the weighted average maturity of the refunding bonds is no longer than the remaining weighted average maturity of the refunded bonds.

The significant provisions of the Final Regulations:

- eliminate the requirement that solid waste have "no value";
- eliminate the proposed rule that "residual material" is only solid waste if it is less than 5% of
- the material introduced into the original production process; expand the definition of solid waste disposal facilities to include facilities performing a
- "preliminary function" or that are functionally related or subordinate to a facility that processes
- solid waste;
- clarify the types of solid waste disposal processes that qualify for tax-exempt financing;
- for recycling and energy production facilities, still provide that the solid waste disposal process,
- in effect, ends at the production of the first useful product;
- eliminate the proposed rule that a function can only be treated as preliminary if more than 50%
- of the materials that result from the function are solid waste; and
- keep the rule that an entire facility is eligible for tax-exempt financing if at least 65% of the material processed is solid waste, but with a new requirement that the 65% rule be tested annually (subject to limited exceptions as described below).

Background on Solid Waste Disposal Bonds

The Internal Revenue Code (the "Code") generally restricts the amount of private business use associated with tax-exempt bond financed facilities. However, under Section 142 of the Code, certain exempt facilities that are privately used (including solid waste disposal facilities²) are eligible for tax-exempt bond financing. Under existing regulations, (1) solid waste disposal facilities are used for the collection, storage, treatment, utilization, processing, or final disposal of solid waste³ and (2) solid waste generally means garbage, refuse, and other discarded solid materials, but only if such property has no market or other value at the place where it is located (the "No-Value Test").⁴ The application of the No-Value Test has been difficult to apply in determining whether a facility can be financed with tax-exempt bonds.

In 2009, the IRS issued proposed regulations (the "2009 Proposed Regulations") relating to solid waste disposal facilities. The 2009 Proposed Regulations raised a number of interpretive issues, many of which are addressed in the Final Regulations.

Definition of Solid Waste Disposal Facility

The Final Regulations define a "solid waste disposal facility" as a facility that processes solid waste in a qualified solid waste disposal process, performs a function preliminary to such process, or is functionally related and subordinate to the facility.

Definition of Solid Waste

The Final Regulations define "solid waste" as garbage, refuse, and other solid material derived from any agricultural, commercial, consumer, governmental or industrial operation or activity if the material is reasonably expected to be introduced within a reasonable time into a qualified solid waste disposal process and is either:

- **used material**, which is any material that has been previously used and is a product of any agricultural, commercial, consumer, governmental or industrial operation or activity, or a component of any such product or activity (including animal waste produced by animals from a biological process); or
- **residual material**, which is a residual byproduct or excess raw material that results from or remains after the completion of any agricultural, commercial, consumer, governmental, or industrial production process or activity or from the provision of any service and as of the issue date of the bonds, such material is reasonably expected to have a fair market value that is lower than the value of all of the products made in that production process or lower than the value of services that produces such residual material. *(The Final Regulations eliminate the 5% test in the 2009 Proposed Regulations which would have required that residual material be less than 5% of the total material introduced into the original production process.)*

The Final Regulations also provide that (1) a material is "solid" if it is solid at ambient temperature and pressure; and (2) solid waste does not include virgin material⁵ (except to the extent it is an input into a final disposal process or residual material), solids within liquids and liquid waste,⁶ precious metals⁷ (except as input to a final disposal process or an unrecoverable trace of such material), hazardous materials⁸ and radioactive materials.⁹

Definition of Qualified Solid Waste Disposal Process

The Final Regulations provide for three eligible types of solid waste disposal processes: a final disposal process, an energy conversion process and a recycling process. The Final Regulations provide that absent an express restriction in the proposed regulations, a solid waste disposal function may employ any biological, engineering, industrial or technological method.

- A **final disposal process** means the placement of solid waste in a landfill (including, for this purpose, the spreading of solid waste over land in an environmentally compliant and safe manner with no intent to remove such solid waste), the incineration of solid waste without capturing any useful energy, or the containment of solid waste with a reasonable expectation as of the date of the issue of the bonds that the containment will continue indefinitely and that the solid waste has no current or future beneficial use.
- An **energy conversion process** means a thermal, chemical, or other process that is applied to solid waste to create and capture synthesis gas, heat, hot water, steam, or other useful energy. The energy conversion process begins at the point of the first application of such process and ends at the point at which the useful energy is first created, captured, or incorporated into the form of synthesis gas, heat, hot water, or other useful energy and before any transfer or distribution of such synthesis gas, heat, hot water or other useful energy, regardless of whether such syntheses gas, heat, hot water, or other useful energy constitutes a "first useful product" as described below.
- A **recycling process** means reconstituting, transforming, otherwise processing solid waste into a useful product. The recycling process begins at the point of the first application of a process to reconstitute or transform the solid waste into a useful product, such as decontamination, melting, re-pulping, shredding, or other processing of the solid waste to accomplish such purpose. The recycling process ends at the point of completion of production of the first useful product from the solid waste. The recycling process does not include refurbishment,¹⁰ repair or similar activities.

First Useful Product. "First useful product" means the first product produced from the processing of solid waste in a solid waste disposal process that is useful for consumption in agricultural, consumer, commercial, governmental, or industrial operation or activity and that could be sold for such use, whether or not actually sold. A useful product includes both a product useful to an individual consumer as an ultimate end-use consumer product and a product useful to an industrial user as a material or input for processing in some stage of manufacturing or production process to produce a different end-use consumer product. The determination of whether a useful product has been produced may take into account operational constraints that affect the point in production when a useful product reasonably can be extracted or isolated and sold independently. The costs of extracting, isolating, storing, and transporting the product to a market may only be taken into account as operational constraints if the product is not to be used as part of an integrated manufacturing or industrial process in the same location in which the product is produced.

Definition of Preliminary Function

A facility that performs a "preliminary function" is also a solid waste disposal facility. A preliminary function is a function to collect, separate, sort, store, treat, process, disassemble, or handle solid waste that is preliminary to and directly related to a qualified solid waste disposal process. The Final Regulations do not include a limitation contained in the 2009 Proposed Regulations that would have required more than 50% of the total materials resulting from the function be solid waste in each year that the bond issue was outstanding for a function to be treated as a preliminary function.

Mixed-Use Facilities

If a facility is used for both a qualified solid waste disposal function (including a qualified solid waste disposal process or a preliminary function) and another nonqualified function, then the costs of the mixed-use facility allocable to the qualified solid waste disposal function are determined using any reasonable method, based on all facts and circumstances. Facilities that are functionally related and subordinate to a qualified solid waste disposal function qualify only to the extent that they are functionally related and subordinate to the portion of the mixed-use facility that is used for one or more qualified solid waste disposal functions.

Mixed-Input Facilities

Mixed-input facilities are facilities that process both material that qualifies as solid waste and material that does not. The Final Regulations provide that qualifying costs of a mixed-input facility cannot exceed the average annual percentage¹¹ of solid waste processed while the bond issue is outstanding. However, the Final Regulations continue to allow an entire mixed-input facility to be financed with tax-exempt bonds if at least 65% of the materials processed (either by weight or by volume) in the facility for each year that the bond issue is outstanding (beginning with the date the facility is placed in service) are solid waste. This 65% test must be satisfied in each year after the facility is actually operating at substantially design level. However, there is a three year curative period to address extraordinary events outside the control of the operator (such as natural disasters, strikes, major utility disruptions, or governmental interventions).

For further information or for assistance in determining whether your facility can be financed with solid waste disposal facility bonds, please contact Lorraine Tyson at 312-768-7820 (ltyson@pjlaw.com) or Glenn Weinstein at 312-768-7850 (gweinstein@pjlaw.com).

Legal Notice: The information provided herein is for general information purposes only and does not claim to be comprehensive or provide legal or other advice. Emailing an attorney at Pugh, Jones & Johnson, P.C. shall not and does not create an attorney-client relationship between you and the attorney. If you do not have an existing attorney-client relationship, your email will not be privileged or confidential.

1 TD 9546.

2 26 U.S.C. §142(a)(6).

3 Treas. Reg. Section 1.103-8(f)(2)(ii)(a).

4 Treas. Reg. Section 1.103-8(f)(2)(ii)(b).

5 "Virgin material" means material that has not been processed into an agricultural, commercial, consumer, governmental, or industrial product, or a component of any such product. Material continues to be virgin material after it has been grown, harvested, mined, or otherwise extracted from its naturally occurring location and cleaned, divided into component elements, modified, or enhanced, as long as further processing is required before it becomes an agricultural, commercial, consumer or industrial product, or a component of any such product.

6 Includes any solid or dissolved material in domestic sewage or other significant pollutant in water resources, such as silt, dissolved or suspended solids in industrial waste effluents, dissolved materials in irrigation return flows or other common water pollutants, and liquid or gaseous waste.

7 Includes, gold, silver, ruthenium, rhodium, palladium, osmium, iridium, platinum, gallium, rhenium and any other precious metal material as may be identified by the IRS in future public administrative guidance.

8 Means any hazardous material that must be disposed of at a facility that is subject to the final permit requirements under subtitle C of title II of the Solid Waste Disposal Act as in effect on October 22, 1986.

9 Means any radioactive material subject to regulation under the Nuclear Regulatory Act, as in effect on the issue date of the bonds.

10 "Refurbishment" means the breakdown and reassembly of a product if such activity is done on a product-by-product basis and if the finished product contains more than 30% of its original materials or components.

11 The annual percentage of solid waste processed in a qualified solid waste disposal process or preliminary function for any year is the percentage, by weight or volume, of the total materials processed in a qualified solid waste disposal process or preliminary function that constitute solid waste for that year.