

Alert | Tax/Public Finance

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IRS Issues New Proposed Regulations on the TEFRA Public Approval Requirement

On Sept. 28, 2017, the Internal Revenue Service (IRS) issued a notice of proposed rulemaking (the 2017 Proposed Regulations) that would update and streamline public approval requirements under Section 147(f) of the Internal Revenue Code, as amended (the 1986 Code), applicable to state and local governments issuing tax-exempt private activity bonds. The 2017 Proposed Regulations withdraw two prior notices of proposed rulemaking on this topic, including the May 11, 1983, notice of proposed rulemaking released in conjunction with temporary regulations (the Existing Regulations) under the predecessor to Section 147(f), Section 103(k) of the Internal Revenue Code of 1954 (the 1954 Code), and the Sept. 9, 2008, notice of proposed rulemaking (the 2008 Proposed Regulations) that proposed to amend and supplement, but not revoke, Existing Regulations, thereby allowing the Existing Regulations to continue to apply to the extent not modified by the 2008 Proposed Regulations. Needless to say this odd history created confusion. Once final, the 2017 Proposed Regulations will contain all of the TEFRA public approval requirements because they will incorporate the 2008 Proposed Regulations with modifications in response to public comments and recent developments, and consolidate those rules with rules in the Existing Regulations to the extent not modified.

Background

Issuers of tax-exempt private activity bonds are generally required to obtain public approval under section 147(f) of the 1986 Code before issuing the bonds. This requirement, adopted as part of The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), was codified in Section 103(k) of the 1954 Code, and the Existing Regulations were issued under that statutory provision. The Existing Regulations became partially outdated, however, when the public approval requirements were extended to other bonds under

the 1986 Code, such as student loan bonds under Section 144(b) and qualified mortgage bonds under Section 143(a), for which certain provisions in the Existing Regulations were unworkable. For this reason and to simplify certain aspects of the Existing Regulations, the Department of Treasury (Treasury) issued the 2008 Proposed Regulations. Those proposed regulations were favorably received and are largely incorporated into the 2017 Proposed Regulations.

Existing Regulations

Generally, public approval means approval by the appropriate governmental unit after reasonable public notice and hearing. More specifically, the Existing Regulations provide the following:

Government Approval generally means approval of the bond issue by the applicable elected representative of the issuer of the bond issue, and, if the bond-financed facility is located in a jurisdiction different from the issuer's jurisdiction, approval by that governmental unit (host approval). A bond issue may also be approved by a voter referendum.

Reasonable Public Notice means notice provided at least 14 days before the hearing that is reasonably designed to inform residents of the affected governmental units of the proposed bond issue. The notice must contain:

- The time and place for the public hearing;
- A general, functional description of the type and use of the facility to be financed;
- The maximum aggregate face amount of obligations to be issued with respect to the facility;
- The initial owner, operator, or manager of the facility; and
- The prospective location of the facility, by street address if available. "Facility" includes multiple tracts of land only if the facility is an integrated operation--a test that is difficult to apply.

A notice is presumed reasonably designed to inform residents of the affected governmental units only if it meets certain requirements, including a requirement that it be published in one or more newspapers of general circulation available to residents of that locality, or is announced by radio or television in the broadcast area.

A Public Hearing must provide a reasonable opportunity for individuals to express their views orally or in writing.

Public Approval for a Plan of Financing may be given once for a three-year plan when the first bond issued pursuant to the plan is issued within one year of the governmental approval.

A Deviation from information in the public approval documents will not invalidate the public approval if such deviation is "insubstantial." The definition of "insubstantial deviation" is unclear.

2008 Proposed Regulations and 2017 Proposed Regulations

The 2008 Proposed Regulations did not revoke the Existing Regulations; instead they proposed new rules and modifications to certain rules in the Existing Regulations. The 2017 Proposed Regulations would (i) consolidate the Existing Regulations and the 2008 Proposed Regulations, with the rules in the 2008 Proposed Regulations controlling, (ii) make certain important and helpful modifications to those consolidated regulations, and (iii) provide new rules, as summarized below.

Modifications proposed by the 2017 Proposed Regulations

Reasonable Public Notice

- *No Host Approval for Certain Bonds.* Host approval would not be required for qualified mortgage revenue bonds (including qualified mortgage bonds under Section 143(a) of the 1986 Code, qualified veterans' bonds under Section 143(b) of the 1986 Code, or refundings of bonds issued to finance mortgages of owner-occupied residents under the law in effect before Section 143(a) and (b)), qualified student loan bonds, and 501(c)(3) bond financings of working capital expenditures.
- *General, Functional Description Requirement.* The functional description requirements would change as follows: (i) the term "facility" would be replaced with "project," which would be defined as one or more capital projects or facilities, including land, buildings, equipment, and other property, to be financed with the issue, that are located on the same site, or adjacent or proximate sites used for similar purposes, and would also include mortgage loans as defined therein, student loans financed by qualified student loan bonds, and 501(c)(3) bonds for working capital expenditures, and (ii) to provide that the requirement for a general, functional description of the project to be financed would be met if the notice identifies the project by the category of exempt facility bond being issued or, for other types of private activity bonds, a reference to the type of qualified bond, and type and use of the project to be financed.
- *Maximum Stated Amount of Bonds for Multiple Projects.* The maximum stated amount in the public approval documents for an issue that finances multiple projects would have to specify separately the maximum stated amount for each project.
- *Owner, Operator, or Manager Identified.* The initial owner, operator, or manager could be identified as the true beneficial owner or user in lieu of the legal owner or user.
- *Project Location Identified.* The requirement to state the location of the project would be simplified to allow a description of boundary streets or other geographic boundaries. In addition, a project that includes one or more capital projects or facilities located on the same site or adjacent or reasonably proximate sites would be allowed to provide a consolidated description of the location of the project.
- *Methods for Providing Reasonable Notice.* The methods under which public notice is presumed reasonable would be expanded to include: (i) electronic posting on the government's website, if the government regularly uses the website to inform its residents about events affecting the residents, and the government provides a reasonable alternative for residents without access to computers, and (ii) other methods permitted under general state law for public notices and hearings. The 2017 Proposed Regulations solicit comments respecting other appropriate methods.

Public Hearings. The form in which public comments may be provided would be expanded to allow electronic submissions.

Public Approval. Public approval would be timely only if the issuer obtains the public approval within one year before the issue date of the bonds.

Deviations from Information in the Public Approval Documents.

- *Determining Whether a Deviation is Substantial.* For deviations from the information provided in the public approval documents, safe harbors are proposed under which a deviation would be treated as insubstantial when: (i) the stated principal amount of proceeds used for a project is no more than 10 percent greater than the maximum stated principal amount approved for the project, or is any amount

less than the maximum stated principal amount; (ii) the actual initial owner or principal user of the project is related to the entity stated in the public approval documents; or (iii) proceeds are used to pay working capital expenses directly associated with any project set forth in the public approval documents. Otherwise, whether a deviation is substantial depends on all the facts and circumstances, except that a change in the fundamental nature or type of project would be a substantial deviation.

- *Curing a Substantial Deviation.* Relief would be provided for substantial deviations. A substantial deviation would be curable with a subsequent public approval when: (i) the public approval requirements were met at issuance, (ii) the substantial deviation was not reasonably expected on the issue date of the bonds, and (iii) the deviation was due to unforeseen events or unforeseen changes in circumstances arising after issuance that results in the proceeds being used in a manner or amount different from that provided in the public approval documents.

New Rules

Mortgage Revenue Bonds. For mortgage revenue bonds, the public approval documents would need to state that the bonds are to be issued to finance residential mortgages, the maximum stated principal amount of the bonds that will be issued for that purpose, and a general description of the geographic jurisdiction in which the financed residences will be located. No information on specific borrowers would be required.

Student Loan Bonds. For qualified student loan bonds, the public approval documents would need to state that the bonds are to be issued to finance student loans, the maximum stated principal amount of the bonds to be issued to finance such loans. No information on specific borrowers or locations would be required.

Pooled 501(c)(3) Loan Financings. For qualified 501(c)(3) bonds financing loans under the special provision for pooled loan financings under section 147(b)(4) of the 1986 Code, public approval could be accomplished through a two-step approval process: (i) the first occurring before the bonds are issued and generally including information known at that time (*i.e.*, the bonds will be qualified 501(c)(3) bonds used to finance loans under Section 147(b)(4)(B) of the 1986 Code, the maximum stated principal amount of the bonds, and a general description of the project to be financed, such as loans for hospital facilities) and a statement that additional public approval will be obtained before such loans are originated, and (ii) the second occurring before a loan is originated, as if the bonds financing the loan were reissued at that time (which public approval documents would include information about the borrower and the facility to be financed). The 2017 Proposed Regulations would provide that no post-issuance, supplemental approval is required for loans for which the information was provided as required under the general public approval rules.

Guidance for Statutory Changes for Certain Bonds. Guidance would be added to address statutory changes for certain types of private activity bonds, such as certain financings involving airports, high-speed rail facilities, qualified scholarship funding corporations, and volunteer fire departments.

Proposed Effective Date for the 2017 Proposed Regulations: The proposed regulations are proposed to apply to public approval occurring on or after a date that is 90 days after the final regulations are published in the Federal Register. An issuer may apply the 2017 Proposed Regulations pursuant to a public approval that occurs after Sept. 27, 2017.

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