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Revenue Procedure 2018-26: New Remedial Actions

Revenue Procedure 2018-26, issued April 11, 2018, provides new or additional remedial actions to issuers of tax-advantaged bonds (tax-exempt bonds, tax-credit bonds, and direct-pay bonds): 1) to remediate certain long-term leases of property financed with tax-advantaged bonds, and 2) to permit remedial actions for certain types of true tax-credit bonds (*i.e.,* bonds using actual credits rather than direct-pay subsidies) and direct-pay bonds (*i.e.,* those tax credit bonds where the issuer receives subsidies in lieu of credits (which includes most outstanding build America bonds)). Tax-credit and direct-pay bonds previously had very limited potential for remediation, and, among other remedial actions, Revenue Procedure 2018-26 allows issuers of direct-pay bonds to adjust the tax credit subsidy claimed with respect to those bonds to account for nonqualified use. These new remedies are presented as an overlay on the existing remedial action regulations. In applying these new rules, one should consider the specific definitions and rules set forth in Revenue Procedure 2018-26 because, although the procedure incorporates several existing rules, it modifies others, adds new ones, and, in certain cases, provides different rules depending on the type of bond and type of noncompliance. The chart at the bottom of this Alert identifies permitted remedial actions for different types of bonds and some key requirements for those actions.

Additional Remedial Action for Long-Term Lease: Applicable to all Tax-Advantaged Bonds

In the new remedial action for long-term leases, when property financed with tax-advantaged bonds subject to restrictions under Section 141 or 145 of the Internal Revenue Code of 1986, as amended (the "Code") is leased to a nongovernmental person under an eligible lease (as defined in Revenue Procedure 2018-26), the bond issuer may cure nonqualified use by applying the existing "alternative use of disposition proceeds" remedial action under Treasury Regulations Section 1.141-12(e), with certain modifications. These modifications include treating an amount equal to the present value of the lease as disposition proceeds. To apply this remedial action, the relevant bonds, including tax-credit and direct pay bonds, must meet the existing prerequisites for remedial action and generally apply the rules under Treasury Regulations Section 1.141-12.

Remedial Action by Reducing Credit Claimed: Applicable to Direct-Pay Bonds

Direct-pay bonds are tax-credit bonds for which the issuer elects at issuance to receive the tax subsidy through refundable tax credits from the federal government. It has generally been thought that an issuer should be able to cure noncompliance by agreeing not to file a claim for these credits for any nonqualified bonds, thereby eliminating the subsidy on those bonds. Revenue Procedure 2018-26 adopts this approach, but with a twist: the issuer must also use the disposition proceeds it receives in the manner discussed below under *Remedial Actions for Tax-Advantaged Bonds: Redemption/Defeasance*. This requirement means that the issuer must not only fund the entire interest payable to the bondholders until the bonds are fully paid, but must also use *all* of the disposition proceeds (not merely the amount of the disposition proceeds that exceeds the amount of the lost subsidy) for a qualifying use. This is one of three remedial actions that an issuer may choose for direct-pay bonds.

Remedial Actions by Redemption or Defeasance or Alternative Use of Disposition Proceeds: Applicable Principally to Tax-Credit and Direct-Pay Bonds

To cure nonqualified use of tax-credit or direct-pay bonds, Revenue Procedure 2018-26 generally allows an issuer to (i) redeem or defease nonqualified bonds, or (ii) use disposition proceeds for an alternative qualifying use (thus providing two more remedial actions for direct-pay bonds). To apply the new remedial actions to direct-pay and tax-credit bonds, an issuer applies the special rules in Revenue Procedure 2018-26. These special rules seem to be drawn, at least in part, from the remedial action rules for QZAB's in Treasury Regulation section 1.1397E-1(h)(8). For tax-advantaged bonds subject to Code section 141, however, the remedial action provisions in Treasury Regulations section 1.141-12 generally apply for curing private business use and private loan restrictions in lieu of the rules in the Revenue Procedure. Thus, depending on the type of noncompliance, an issuer of direct-pay bonds or tax-credit bonds would need to apply different rules even when the type of remediation (*e.g.*, redemption and defeasance) is the same. QZAB's issued under Code section 1397 must generally use the remedial action rules in Treasury Regulations section 1.1397-1(h)(8) instead of the rules presented below.

Redemption and Defeasance

As with Treasury Regulations section 1.141-12, to use this remediation method, an issuer must redeem and/or defease the nonqualified bonds within 90 days of when the nonqualified use (as defined in Revenue Procedure 2018-26) occurs, and the disposition proceeds received constitute gross proceeds and are subject to yield restriction and rebate rules. Some key differences between Treasury Regulations Section 1.141-12 and Revenue Procedure 2018-26 are as follows:

1. For all tax-advantaged bonds, Revenue Procedure 2018-26 specifically allows escrows to be yield restricted, or invested in higher-yielding investments (within the meaning of Code section 148(b)) if the issuer makes arbitrage rebate payments to effectively yield-restrict the escrow;

2. For tax-credit and direct-pay bonds, Revenue Procedure 2018-26 provides that disposition proceeds include investment earnings on amounts received in the disposition;

3. For tax-credit and direct-pay bonds, Revenue Procedure 2018-26 provides that all disposition proceeds must be treated as proceeds for the applicable Code section (which is not uniformly the case under the 1.141-12 regulations). Treating disposition proceeds as "proceeds" for purposes of use of these rules may give rise to some interpretative questions, as well as some practical questions concerning pros and cons of each choice of remedial action;

4. For tax-credit and direct-pay bonds, Revenue Procedure 2018-26 appears to provide that even if the disposition proceeds consist only of cash in an amount that is less than the amount of nonqualified bonds, the issuer must still redeem or defease the full amount of nonqualified bonds (this result may be inconsistent with the remedial action provisions for QZAB's issued under Section 1397, which provide that in certain cases dispositions for cash require an issuer to use all disposition proceeds received to redeem/defease nonqualified bonds);

5. For tax-credit and direct-pay bonds, Revenue Procedure 2018-26 has no stated rule that permits anticipatory remedial action; however, an issuer is permitted to take remedial action when it fails to expect that it will spend the proceeds for a qualified use in the requisite spending period, if applicable; and

6. For tax-credit and direct-pay bonds, Revenue Procedure 2018-16 has no requirement that bonds be subject to call within 10-1/2 years after issuance, or to provide a notice of defeasance, if applicable, to the IRS.

Alternative Use of Disposition Proceeds

Revenue Procedure 2018-26 also provides "alternative use of disposition proceeds" as a separate remedial action choice for tax-credit and direct-pay bonds when a disposition is purely for cash. These remedial action rules closely parallel the alternative use of disposition proceeds under Treasury Regulations section 1.141-12. One notable difference is that an issuer does not have to reasonably expect to spend all of the disposition proceeds within two years. As with the remedial action for QZAB's, the issuer may choose to "add on" the redemption/defeasance option to the alternative use of proceeds option (*e.g.*, when the issuer has reasonable expectations to spend only a portion of the disposition proceeds within two years). As described above, even where the issuer elects a different remedial action, the issuer must treat the disposition proceeds as proceeds and spend them on an appropriate use within the required spending time, if applicable, or use them to pay debt-service, if permitted. However, if another remedial action is being applied as the primary remedy (*e.g.*, redemption and/or defeasance), the issuer is subject only to any expenditure requirement that applies to that type of bond generally and not to the two-year requirement in this provision. Given this outcome, one might question the use of "Alternative Use of Disposition Proceeds" as the primary remedy in situations in which the issuer does not have an alternative project ready to fund. In addition, it appears that an issuer cannot change from one qualifying use to another, as may be done under Treasury Regulations section 1.141-12--the alternative use must be a qualifying use under the "applicable" Code section.

Effective Date

Revenue Procedure 2018-26 applies to nonqualified use, as defined therein, occurring on or after April 11, 2018, but may also be applied for nonqualified use occurring before that date.

Overall a Helpful Revenue Procedure

Although it may raise some difficult questions of application, Revenue Procedure 2018-26 answers many questions and provides practical solutions to common noncompliance problems as well as highly practical remedies for noncompliance relating to direct-pay bonds.

Presented below is chart outlining the existing and new remedial actions.

Type of Bond	Redemption and/or Defeasance	Alternative Use of Proceeds	Alternative Use of Facility	Give up Subsidy
Tax-exempt Governmental Bonds	• 1.141-12 • May apply rule in RP 2018-26 (7.02(2)) to allow investment and rebate on escrow • May redeem pro-rata portion of nonqualified bonds in disposition for cash • Anticipatory remedial action permitted	• 1.141-12 requiring expectation that all disposition proceeds be spent in two years • For curing eligible long-term leases, RP 2018-26 (5.01)	1.141-12	N/A
Tax-exempt Exempt Facility Bonds and Qualified Small Issue Bonds under Section 144(a) and Qualified Redevelopment Bonds under section 144(c) and for specified purposes for section 147 (see 1.147-2)	1.142-2	N/A	N/A	N/A
Tax-exempt 501(c)(3) Bonds	• 1.141-12 • May apply rule in RP 2018-26 (7.02(2)) to allow investment and rebate on escrow • May redeem pro-rata portion of nonqualified bonds in disposition for cash • Anticipatory remedial action permitted	• 1.141-12 requiring expectation that all disposition proceeds be spent in two years • For curing eligible long-term leases, RP 2018-26 (5.01)	1.141-12	N/A
Direct-pay Bonds, except QZABS under 1397	• RP 2018-26 (7.02) which also requires disposition proceeds (including earnings thereon) be used for same qualifying purpose • 1.141-12 (with no deemed reissuance and 7.02(2) modification) for curing private use or private loan • If RP 2018-26 (7.02) applies, no special rule for disposition for cash; amounts in excess of nonqualified bonds must be used for qualifying costs • If RP 2018-26 (7.02) may use rebate to restrict yield	• RP 2018-26 (7.05) and may use RP 7.02 for amounts not expected to be spent in two years • 1.141-12 for curing private use or private loan • RP 2018-26 (5.01) for curing eligible long-term leases	N/A	RP 2018-26 (6) which also requires using disposition proceeds for qualifying use
Tax-credit Bonds, except QZABS under Section 1397	• RP 2018-26 (7.02) which also requires disposition proceeds (including earnings thereon) be used for same qualifying purpose • 1.141-12 (with no deemed reissuance and 7.02(2) modification) for curing private use or private loan • If RP 2018-26 (7.02) applies, no special rule for disposition for cash; amounts in excess of nonqualified bonds must be used for qualifying costs • If RP 2018-26 (7.02) may use rebate to restrict yield	• RP 2018-26 (7.05) and may use RP 7.02 for amounts not expected to be spent in two years • 1.141-12 for curing private use or private loan • RP 2018-26 (5.01) for curing eligible long-term leases	N/A	N/A
QZABS under Section 1397	• 1.1397-1(h)(8) • May redeem pro-rata portion of nonqualified bonds in disposition for cash	• 1.1397-1(h)(8) • RP 2018-26 (5.01) for curing eligible long-term leases	N/A	N/A

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