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January 5, 2011

Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments on Bond-Financed Grants

Dear Commissioner Shulman:

Enclosed are comments on bond-financed grants. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Charles H. Egerton
Chair, Section of Taxation

Enclosure

cc: Michael F. Mundaca, Assistant Secretary (Tax Policy), Department of the Treasury
William J. Wilkins, Chief Counsel, Internal Revenue Service
Jeffrey Van Hove, Acting Tax Legislative Counsel, Department of the Treasury
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John J. Cross III, Associate Tax Legislative Counsel, Department of the Treasury
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ABA SECTION OF TAXATION
COMMENTS ON BOND-FINANCED GRANTS

These comments ("Comments") are being submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Maxwell D. Solet of the Tax Exempt Financing Committee of the Section of Taxation. Substantive contributions were made by Kimberly C. Betterton, Jeannette M. Bond, Charles C. Cardall, Linda L. D'Onofrio, Marc A. Feller, Perry E. Israel, William H. McBride, Robert S. Price, Lisa P. Soeder, Gary E. Walsh, and David A. Walton. The Comments were reviewed by Jeremy A. Spector, Committee Chair. The Comments were further reviewed by Carol L. Lew of the Section's Committee on Government Submissions and by Andrew J. Dubroff, Council Director for the Tax Exempt Financing Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: January 5, 2011

EXECUTIVE SUMMARY

Tax-exempt bonds frequently are issued to fund grants. For purposes of the arbitrage limitations imposed by the Internal Revenue Code of 1986, as amended,[1] bond proceeds are treated as expended upon disbursement to the grantee. Notwithstanding such treatment, we recommend that the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "Service) publish guidance confirming that a governmental issuer may "look through" to the use of bond proceeds by the grantee in determining the appropriate term of a bond issue and the use of bond proceeds when specific use requirements are imposed. In the case of a grant for working capital purposes of the grantee, we recommend that an issuer be permitted to blend the shorter life applicable to such use with the longer lives of capital projects financed by the same issue. We believe bonds that fund grants ordinarily should not be treated as private activity bonds. In addition, we believe similar rules should apply to tax-exempt bonds and to taxable tax credit bonds, a growing sector of the State and local debt market.

[1] References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

INTRODUCTION

Although most State and local bonds are issued to finance direct expenditures by the governmental issuers, bonds also commonly are issued to finance loans and grants to unrelated persons, including other governmental entities, exempt charitable organizations, private for-profit entities, and individuals. The Code and Regulations include numerous provisions that address use of bond proceeds to make loans, but there is little authority addressing the use of bond proceeds for grants.[2]

The questions discussed in these Comments initially arose in the context of bonds bearing interest that is excluded from gross income pursuant to sections 103 and 141 through 150, but recent amendments to the Code have created new categories of taxable debt instruments to be issued by State or local governments. The Code imposes specific requirements as to use of proceeds for each of these new categories of bonds, which therefore raises the question whether grants for such purposes are allowed. These Comments address treatment of grants funded by taxable debt obligations as well as by traditional tax-exempt debt.[3]

Bond financing of grant programs has occurred for many years and in numerous states. The aggregate amount of outstanding bonds issued for such purposes measures many billions of dollars. These Comments address particular issues that commonly arise in bond-financed grant programs, including the appropriate term of the bond issue, private activity, and arbitrage.

TYPES OF GRANT PROGRAMS

Although the uses of bond-financed grants are too numerous to allow a complete description or a rigorous typology, the following examples provide a useful overview.

- An issuer uses bond proceeds to make a grant to a local government entity to pay a portion of the costs of a specific type of facility (*e.g.*, public schools, sewage treatment facilities). The grant is awarded based upon an application process and a grant agreement that specifically describes the project.

- An issuer uses bond proceeds to make a grant to a local government entity to pay a portion of the costs of capital projects for specified purposes, without specifying the nature of the assets to be acquired (*e.g.*, buildings or computers).

- An issuer uses bond proceeds to make a grant to a local government entity for a capital project. The grantee may have initially paid all or a portion of the costs of such project with proceeds of its own bonds and pays such bonds with the grant proceeds.

- An issuer uses bond proceeds to make a grant for capital projects to a section 501(c)(3) organization, such as a health care or educational institution.

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[2] Whether a transaction is a loan or a grant is determined based upon factors such as whether there is an expectation of repayment, without regard to the formal label borne by the transaction.

[3] The Section of Taxation previously submitted comments on Build America Bonds, dated November 20, 2009, available at: http://www.abanet.org/tax/pubpolicy/2009/091120commentsconcerningbuildamericabonds.pdf.

The grant may or may not specifically describe the assets to be acquired with the grant proceeds.

- An issuer uses bond proceeds to make a grant for capital projects to a for-profit company under an economic development program. The grant may or may not specifically describe the assets to be acquired with the grant proceeds.

- An issuer uses bond proceeds to make a grant to a governmental entity, which may use some or all of the proceeds for operating expenses or programs or, in the case of a distressed governmental entity, to cover an operating deficit.

- An issuer uses bond proceeds to make a grant for a particular non-capital purpose (*e.g.*, to a start-up company before it generates a self-sustaining revenue stream).

Grants may be financed on an individual basis but frequently are part of governmental programs to finance grants to multiple grantees.

EXISTING AUTHORITY

There is very little authority addressing bond-financed grants.

The Regulations on arbitrage state that bond proceeds are treated as spent at the time a grant is made.

> **Expenditures for grants —**
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> (i) **In general**. Gross proceeds of an issue that are used to make a grant are allocated to an expenditure on the date on which the grant is made.
>
> (ii) **Characterization of repayments of grants**. If any amount of a grant financed by gross proceeds of an issue is repaid to the grantor, the repaid amount is treated as unspent proceeds of the issue as of the repayment date unless expended within 60 days of repayment.
>
> (iii) **Definition of grant**. Grant means a transfer for a governmental purpose of money or property to a transferee that is not a related party to or an agent of the transferor. The transfer must not impose any obligation or condition to directly or indirectly repay any amount to the transferor. Obligations or conditions intended solely to assure expenditure of the transferred moneys in accordance with the governmental purpose of the transfer do not prevent a transfer from being a grant.[4]

We understand that Treasury and the Service promulgated this Regulation in recognition of the needs of state issuers financing large grant programs. This Regulation relieves grantors of the burden of tracking grants for purposes of arbitrage yield restriction and rebate, but this

[4] Reg. § 1.148-6(d)(4).

Regulation does not deal explicitly with determining the use of proceeds for purposes of section 141, section 145, or other purposes.[5]

TERM OF THE ISSUE

There is no authority establishing generally applicable limitations on the term of a bond issue, although specific limitations are imposed or provided in particular contexts. For example, the Code provides that an issue of private activity bonds may not have an average maturity that exceeds 120% of the average reasonably expected economic life of the financed facilities.[6] For purposes of the arbitrage rules, Regulations apply the same limitation as a safe harbor against creation of "other replacement proceeds" in the case of bonds issued to finance or refinance capital projects.[7] A two-year safe harbor is provided for the same purpose in the case of working capital financings.[8] Notwithstanding these two safe harbors, the general rule provided in the arbitrage Regulations provides only that the term of a bond issue should not be "longer than is reasonably necessary for the governmental purposes of the issue."[9] This standard also is applied, under the arbitrage Regulations, in determining whether an issue has the effect of "overburdening the tax-exempt bond market."[10] It is in this context that the question arises as to how long bonds issued to finance grants may be outstanding.

Most bond-funded grants are used to finance capital expenditures by the grant recipient. A "capital expenditure" is "any cost of a type that is properly chargeable to capital account" (or that would be so chargeable under certain circumstances) "under general Federal income tax principles."[11] The question is whether the life of a grant-funded capital project is the appropriate measure for determining the life of bonds used to finance the grant when such project costs are chargeable to the capital account of the grant recipient, not the issuer-grantor.

Most bond counsel "look through" to the grantee's use of bond proceeds in determining the appropriate term of the bond issue. This practice probably results from a sense of the intent of the Code and Regulations rather than because that approach is specifically authorized. Some counsel have supported this practice by noting that a governmental issuer could make direct expenditures for a capital project and then transfer ownership of the financed facility to a separate governmental entity or private party and thereby produce the same result as a grant of bond proceeds. Others have analogized this practice to the "ultimate use of proceeds" rule applicable to exempt facility bonds.[12] A more technical justification might be that a "capital expenditure" for purposes of the bond provisions of the Code is defined as "any cost of a *type*

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5 Some counsel have inferred from this arbitrage expenditure rule that, for private activity purposes as well, proceeds may be treated as spent at the time of the grant with respect to the governmental program that provides for the grant, similar to the treatment of expenditures to third-party construction contractors, whose private use of such amounts is not taken into account.

6 I.R.C. § 147(b).

7 Reg. § 1.148-1(c)(4)(i)(B)(2).

8 Reg. § 1.148-1(c)(4)(i)(B)(1).

9 Reg. § 1.148-1(c)(4)(i)(A)(1).

10 Reg. § 1.148-10(a)(4).

11 Reg. § 1.150-1(b).

12 Reg. § 1.103-8(a)(4).

that is properly chargeable to capital account,"[13] without reference to whether such charge would be made by the issuer or another person.

Finally, in the case of intergovernmental grants (*e.g.*, grants by a state-level issuer to local governments), issuers frequently have more efficient access to credit markets because of credit-worthiness, economies of scale, and access to state-level revenues not directly available to local borrowers. We do not believe the Code should be interpreted to discourage use of such efficiencies absent clear evidence of legislative intent or strong policy reasons. We also believe that imposing a significantly shorter permissible life on a grant financing than would be available for a comparable financing by the grantee would cause just such a disincentive.

Although most bond-funded grants are used by the grantee for capital projects, some may be used, in whole or in part, for working capital purposes. The "look through" procedure described above then imposes on the issuer/grantor, and its bond counsel, the same responsibility as exists in the case of direct working capital borrowings (*i.e.*, determination of what is the appropriate term "reasonably necessary for the governmental purposes of the issue"). As noted, current arbitrage Regulations provide a two-year safe harbor[14] that may be blended with longer periods applicable to other projects financed by the same issue. In other instances, such as long-term deficit financings, issuers have sought to document the factors justifying a longer period. A similar exercise is undertaken in connection with bond-funded grants that are to be used for non-capital projects.

We request that Treasury and the Service issue guidance confirming this analysis.

PRIVATE ACTIVITY

The use of bond proceeds to fund grants generally does not create problems under the Code's private activity provisions. The Code requires an analysis of the private business use of bond proceeds, and the Regulations provide that "[i]n determining whether an issue meets the private business use test, it is necessary to look to both the indirect and direct uses of proceeds."[15] For grant programs, it is not clear when the analysis stops. We believe an even-handed application of the "look-through" analysis suggests that, when that analysis is relied upon for purposes of determining the term of the issue, it also should be applied for private use purposes, looking through to use of grant funds by the grantee. However, grants ordinarily fail the private security or payment test under section 141(b)(2), so, absent evidence of a private loan under section 141(c), bonds to finance grants, even to private persons, will not constitute private activity bonds under section 141(a). Thus, ordinarily the character of bonds under the private activity rules will not turn on whether or not a "look-through" analysis is applied.

The private activity analysis remains subject to general anti-abuse restrictions that authorize the Commissioner, upon identification of transactions undertaken "with a principal purpose of transferring to nongovernmental persons . . . significant benefits of tax-exempt financing," to "take any action to reflect the substance of the transaction."[16] In particular, such

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13 Reg. § 1.150-1(b) (emphasis added)

14 Reg. § 1.148-1(c)(4)(i)(B)(1).

15 I.R.C. § 141(b)(1); Reg. § 1.141-3(a)(2).

16 Reg. § 1.141-14(a).

action may involve "[r]eallocating payments to use or proceeds."[17] In the case of grant programs that involve private use of bond proceeds, issuers must confirm that private users do not make payments that would be treated as allocable to such private use if made directly to the issuer (*e.g.*, payments to a separate local government entity).

We request that Treasury and the Service issue guidance confirming this analysis and, if Treasury and the Service have identified particular abusive arrangements, describing those arrangements.

ARBITRAGE

As noted above, Regulations provide that the "[g]ross proceeds of an issue that are used to make a grant are allocated to an expenditure on the date on which the grant is made."[18] This longstanding rule enables issuers to avoid the administrative burden of tracking the investment of bond proceeds by grantees. A "grant" for this purpose is "a transfer for a governmental purpose of money or property to a transferee that is not a related party to or an agent of the transferor."[19] Thus, an issuer may only benefit from this rule if the grantee is neither a related party nor its agent. In the case of grants to other governmental entities, status as a "related party" usually turns on the existence of discretionary approval and removal rights as to the governing body of a controlled entity or discretionary rights to use funds or assets of the controlled entity.[20] However, a governmental entity with substantial taxing, eminent domain, and police powers, such as a city, is specifically excluded from being a controlled entity[21] and therefore is not a related party for this purpose.

This analysis also remains subject to general anti-abuse restrictions that authorize the Commissioner, upon identification of transactions undertaken "for a principal purpose of obtaining a material financial advantage based on the difference between tax-exempt and taxable interest rates" to take discretionary action beyond the ordinary arbitrage Regulations "to clearly reflect the economic substance of the transaction."[22] This discretionary action includes the power to "reallocate payments and receipts on investments" and to "otherwise adjust any item whatsoever bearing upon the investments and expenditures of gross proceeds of an issue."[23]

To ensure that its bonds are not vulnerable to challenge, an issuer must determine that grantees reasonably expect to expend grant proceeds in a timely and orderly manner in accordance with the purpose of the grant even though the grant proceeds are no longer bond proceeds otherwise subject to arbitrage limitations.

We request that Treasury and the Service issue guidance confirming this analysis and, if Treasury and the Service have identified particular abusive arrangements, describing those arrangements.

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17 Reg. § 1.141-14(a)(3).
18 Reg. § 1.148-6(d)(4)(i).
19 Reg. § 1.148-6(d)(4)(iii).
20 Reg. § 1.150-1(b), (e)(1), (e)(2).
21 Reg. § 1.150-1(e)(3).
22 Reg. § 1.148-10(e).
23 *Id.*

USE OF PROCEEDS

Although federal tax law imposes numerous requirements as to the use of proceeds of private activity bonds,[24] tax-exempt bonds issued to fund grants ordinarily are not private activity bonds for the reasons stated above. Therefore, such "governmental bonds" ordinarily remain subject only to State and local law limitations on allowable use of bond proceeds.

In the case of newly created categories of taxable debt instruments, however, the allowable uses for bond proceeds are mandated under the Code. Build America Bonds ("BABs"), including Recovery Zone Economic Development Bonds ("RZEDBs"),[25] which are issued as "direct payment" bonds eligible for a refundable credit, are required to be used only for capital expenditures and limited other purposes.[26] Proceeds of Qualified School Construction Bonds must be "used for the construction, rehabilitation, or repair of a public school facility or for the acquisition of land."[27] Other taxable bonds that provide a tax credit to the holder or the issuer impose similar specific requirements as to use of proceeds.[28] Each raises the question whether grants for such purposes are allowed.

We believe an issuer should be permitted to "look through" to the grantee's use of bond proceeds to satisfy these statutory requirements for the same reasons that justify looking through in determining the appropriate term of the bond issue, as discussed above. The enhanced efficiency and access to credit markets of State-level issuers may be particularly significant in the case of these new categories of debt. Local issuers may be disadvantaged because of their own lack of experience with these new types of bonds. In addition, the small size of their separate borrowings may limit investor interest.

We request that Treasury and the Service issue guidance confirming that issuers may look through to the grantee's use in determining the use of bond proceeds.

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[24] *See* I.R.C. §§ 142-145.

[25/] BABs and RZEDBs must be bonds as to which the interest payments would be excludable from gross income under section 103 but for an election to be treated as BABs (or RZEDBs). *See* I.R.C. §§ 54AA(d)(1)(A), 1400U-2. Therefore they are subject initially to the same analysis as tax-exempt bonds.

[26/] I.R.C. § 54AA(g)(2)(A).

[27] I.R.C. § 54F(a)(1).

[28] These other taxable bonds include: Qualified Forestry Conservation Bonds, issued under section 54B; New Clean Renewable Energy Bonds, issued under section 54C; Qualified Energy Conservation Bonds, issued under section 54D; and Qualified Zone Academy Bonds, issued under section 54E.