RECOMMENDATION TO MODIFY
SECTIONS 1.141-12 AND 1.142-2 OF THE INCOME TAX REGULATIONS

The accompanying report recommending modification of Sections 1.141-12 and 1.142-2 of the Income Tax Regulations, containing certain “remedial action” rules, was prepared by members of the Subcommittee on Enforcement of the Tax-Exempt Financing Committee of the Section of Taxation. Primary responsibility for the report was taken by Clifford M. Gerber, Chair of the Subcommittee on Enforcement. Coordinating responsibility was taken by Carol L. Lew, Chair of the Tax-Exempt Financing Committee. Members of the Subcommittee on Enforcement who participated in the development and drafting of the report were Henry S. Klaiman and Laurence J. Salva. The report reflects the individual views of the Section members who prepared it and has not been approved by either the Section of Taxation or the American Bar Association.

The report was reviewed by Milton S. Wakschlag, of the Section’s Committee on Governmental Submissions and by Stevie D. Conlon, the Council Director for the Committee on Tax-Exempt Financing.

Although members of the Section of Taxation who participated in preparing the report have clients that would be affected by the federal tax principles addressed, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a governmental submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of the report.

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RECOMMENDATION TO MODIFY

REMEDIAL ACTION REGULATIONS

This report recommends amending sections 1.141-12 and 1.142-2 of the Income Tax Regulations, which contain rules under which an issuer may preserve the exclusion of interest on its bonds from gross income under section 103 of the Internal Revenue Code of 1986, as amended (the “Code”), upon the occurrence of certain violations of the so-called private activity bond rules (a “change in use”) by taking certain “remedial action” with respect to such bonds on a timely basis. The amendments to the Income Tax Regulations recommended by this report would attempt to establish a uniform method of determining the amount of “nonqualified bonds” under sections 141, 142, 144, 145 and 147 of the Code, Revenue Procedure 97-15, 1997-1 C.B. 635, and Notice 2001-60, 2001-40 I.R.B. 304. The amendments to the Income Tax Regulations recommended by this report would also simplify an issuer’s ability to select bonds to allocate to the nonqualified bonds.

This report and the recommended amendments to sections 1.141-12 and 1.142-2 of the Income Tax Regulations were prepared by individual members of the Committee on Tax-Exempt Financing of the Section of Taxation. This report and the recommended amendments to sections 1.141-12 and 1.142-2 of the Income Tax Regulations have not been approved by the Section of Taxation, the Delegates or the Board of Governors of the American Bar Association and, accordingly, cannot be construed as representing the position of the Section or the Association.

Executive Summary

The recommended amendments to section 1.141-12 and 1.142-2 of the Income Tax Regulations attempt to establish a uniform method of determining the amount of nonqualified
bonds under sections 141, 142, 144, 145 and 147 of the Code,\(^1\) Revenue Procedure 97-15,\(^2\) and Notice 2001-60.\(^3\) The recommended amendments provide generally for the amount of nonqualified bonds to be determined not based on the highest percentage of “private business use” in any one-year period commencing on the date of the change in use, but on the excess of the amount of private business use resulting from the change in use over the permitted limit for private business use. The recommended amendments also simplify an issuer’s selection of bonds to be allocated to the nonqualified bonds by giving the issuer greater discretion in its selection of bonds, but at the same time ensuring that the issuer, through such selection, does not effectively extend the remaining average maturity of the bond issue with respect to which the change in use has occurred and remedial action has been taken. The recommended amendments include an Explanation of Proposed Amendment, which precedes the actual regulatory language and is intended to assist the Internal Revenue Service in drafting a preamble to any proposed regulatory amendment adopting the recommendations in this report.

**Background**

Section 1.141-12 of the Income Tax Regulations provides that an action that would otherwise be treated as a “deliberate action” under section 1.141-2 of the Income Tax Regulations and that causes a bond issue to meet the private business tests or the private loan


\(^2\)1997-1 C.B. 635.

\(^3\)2001-40 I.R.B. 304.
The financing test is not treated as a deliberate action if certain requirements are satisfied and the issuer takes a “remedial action” described in section 1.141-12 of the Income Tax Regulations. The alternative remedial actions consist of (1) the redemption or defeasance of the nonqualified bonds of the issue, (2) the use of the “disposition proceeds” derived from the deliberate action for a qualifying purpose and the use of property financed with the proceeds of the issue in an alternative qualifying manner.

Under the redemption/defeasance remedial action, set forth in paragraph (d) of section 1.141-12 of the Income Tax Regulations, an issuer is required to redeem a percentage of the outstanding bonds of the issue representing the nonqualified bonds. The term “nonqualified bonds” is defined in paragraph (j) of section 1.141-12 of the Income Tax Regulations to mean the highest percentage of private business use in any one-year period commencing with the date of the deliberate action. If an issuer is unable to redeem the nonqualified bonds within 90 days of the date of the deliberate action, the issuer is required to establish a defeasance escrow with respect to the nonqualified bonds within 90 days of the date of the deliberate action. If the issuer is unable to redeem the nonqualified bonds and instead establishes a defeasance escrow with respect to the nonqualified bonds, the issuer must notify the Internal Revenue Service of the establishment of the defeasance escrow within 90 days of the date on which the defeasance escrow is established.

In selecting bonds of the issue to represent the nonqualified bonds, an issuer may select such bonds on a pro rata basis. Alternatively, the issuer may treat bonds with longer maturities (on a bond-by-bond basis) as the nonqualified bonds.
The nonqualified bonds concept is also used in the context of the alternative use of disposition proceeds remedial action as applied to 501(c)(3) organizations and in the context of the alternative use of facility remedial action. In the first, among other things, the nonqualified bonds are treated as “reissued” for purposes of sections 141, 145, 147, 149 and 150 of the Code, and such bonds must satisfy all requirements applicable to qualified 501(c)(3) bonds. In the second, among other things, the nonqualified bonds are treated as “reissued” for purposes of sections 55 through 59 and 141, 142, 144, 145, 147, 149 and 150 of the Code, and such bonds must satisfy all requirements applicable to qualified bonds as defined in section 141(e) throughout the remaining term of the nonqualified bonds.

Section 1.142-2 of the Income Tax Regulations does not incorporate either the alternative use of disposition proceeds or alternative use of facility approach. It does provide that if less than 95 percent of the net proceeds of an exempt facility bond issue are actually used to provide an exempt facility and for no other purpose, the issue will nonetheless be treated as meeting the requirements of section 142 of the Code if the issue meets certain conditions and the issuer takes a remedial action in accordance with section 1.142-2 of the Income Tax Regulations. Such remedial action must consist of the redemption or defeasance of the nonqualified bonds under rules similar to those under section 1.141-12 of the Income Tax Regulations. For purposes of section 1.142-2 of the Income Tax Regulations, the nonqualified bonds represent the portion of the outstanding bonds in an amount that, if the remaining bonds were issued on the date on which the failure to properly use the proceeds of the bonds occurs, at least 95 percent of the net proceeds of the remaining bonds would be used to provide an exempt facility. This is a different approach from that currently employed with respect to governmental bonds and qualified
Revenue Procedure 97-15 provides a closing agreement program under which an issuer may preserve the tax-exempt status of a bond issue with respect to which a deliberate action causes the bond issue to fail to meet certain requirements of sections 141 through 150 of the Code by entering into a closing agreement with the Internal Revenue Service. Among other things, entering into such a closing agreement pursuant to Revenue Procedure 97-15 requires the issuer to redeem the nonqualified bonds, as determined under section 1.141-12(j) or 1.142-2(e) of the Income Tax Regulations, as applicable, on their next redemption date and to pay a “closing agreement amount” representing a measure of the tax exposure on the interest accrued on the nonqualified bonds between the date of the post-issuance action and the next redemption date for the bonds.

Closing Agreement Program Proposal

On May 7, 2001, members of the Committee on Tax-Exempt Financing of the Section of Taxation submitted to the Internal Revenue Service a proposed closing agreement program with respect to certain “foot-fault” violations (the “Closing Agreement Proposal”) that would permit an issuer to enter into a closing agreement to preserve the tax-exempt status of its bonds. The Closing Agreement Proposal determines the closing agreement amount an issuer would be required to pay to the Internal Revenue Service based on the amount by which the amount of private business use, or the amount of nonqualified costs in the case of exempt facility bonds, exceeds the applicable limitation on such private business use or nonqualified costs. Though the stated scope of the Closing Agreement Proposal was limited to minor violations, there has been a
perceived inconsistency between application of the definition of nonqualified bonds put forth by the Closing Agreement Proposal and the definition of nonqualified bonds contained in section 1.141-12 of the Income Tax Regulations and as employed by Revenue Procedure 97-15. Because the Code specifically permits a certain amount of private business use, members of this Committee believe that only the excess of the amount of private business use over the amount of private business use permitted by the Internal Revenue Code should be subject to any remedial action rules and form the basis for the closing agreement amount pursuant to any closing agreement guidelines.

On September 25, 2001, the Internal Revenue Service issued Notice 2001-60, which provides information about a voluntary closing agreement program for tax-exempt bonds (“TEB VCAP”). Notice 2001-60 sets forth procedures whereby issuers of tax-exempt bonds can resolve violations of the Code through closing agreements with the Internal Revenue Service. Notice 2001-60 expressly requests comments regarding a number of areas to be addressed in the TEB VCAP, including determination of the amounts that should be specified for particular tax law violations. It is the purpose of this recommendation to respond to that section of Notice 2001-60 and, specifically, to reconcile the above-described inconsistency between section 1.141-12 of the Income Tax Regulations and the Closing Agreement Proposal.

**Explanation of Provisions**

The recommended amendments would modify the definition of nonqualified bonds under section 1.141-12 of the Income Tax Regulations to reflect only the amount by which the amount of private business use or the amount of proceeds loaned to an entity other than a state or local governmental unit exceeds the permitted limit for private business use or private loans. Because
the definition of nonqualified bonds for purposes of section 1.142-2 of the Income Tax Regulations already recognizes the preservation of some measure of permitted use of proceeds toward nonqualified uses, no change to such definition is recommended.

In the case of both sections 1.141-12 and 1.142-2 of the Income Tax Regulations, an additional change is recommended that would allow an issuer to designate any bonds as the nonqualified bonds by providing a rule that the redemption or defeasance of the nonqualified bonds would not have the effect of extending the remaining average maturity of the bond issue of which the nonqualified bonds are a part.

Because Revenue Procedure 97-15 incorporates the definition of nonqualified bonds as used in sections 1.141-12 and 1.142-2 of the Income Tax Regulations, no change is recommended for Revenue Procedure 97-15 at the present time.

The text of the recommended amendments to the Income Tax Regulations, including an explanation for use in drafting the preamble to any proposed regulatory amendment adopting the recommendations in this report, begins on the next page.
Amendments to
Sections 1.141-12 and 142-2 of the Income Tax Regulations

Par. __. In section 1.141-12, paragraph (j) is revised to read as follows:

(j) Nonqualified bonds --

(1) Amount of nonqualified bonds.

The percentage of the outstanding bonds of an issue that represents the nonqualified bonds equals the excess of the highest percentage of private business use in any one-year period commencing with the deliberate action over the percentage of private business use permitted under section 141(b) (in the case of the private business tests) or section 141(c) (in the case of the private loan financing test) with respect to such issue.

(2) Allocation of nonqualified bonds.

Allocations of bonds of the issue to the nonqualified bonds must be made by ratably allocating each bond of the issue or a ratable number of substantially identical whole bonds of the issue on a pro rata basis or, for purposes of paragraph (d) of this section (relating to redemption or defeasance), by allocating any bonds of the issue to the nonqualified bonds so long as the remaining average maturity of such issue, determined as of the date on which the nonqualified bonds are redeemed or defeased in accordance with this section and excluding the nonqualified bonds redeemed or defeased by the issuer on such date in accordance with this section from such determination, is not greater than the remaining average maturity of such issue, determined as of that date but without regard to the redemption or defeasance of any bonds, including the nonqualified bonds, occurring on that date.

Par __. In paragraph (e) of section 1.142-2, the last sentence is stricken, and the following sentence is added in its place:

(e) ** Allocations of bonds of the issue to the nonqualified bonds must be made by ratably allocating each bond of the issue or a ratable number of substantially identical whole bonds of the issue on a pro rata basis or by allocating any bonds of the issue to the nonqualified bonds so long as the remaining average maturity of such issue, determined as of the date on which the nonqualified bonds are redeemed or defeased in accordance with this section and excluding the nonqualified bonds redeemed or defeased by the issuer on such date in accordance with this section from such determination, is not greater than the remaining average maturity of such issue, determined as of that date but without regard to the redemption or defeasance of any bonds, including the nonqualified bonds, occurring on that date.
Explanation of Amendments to
Sections 1.141-12 and 1.142-2 of the Income Tax Regulations

Purpose


Background

Sections 1.141-12 and 1.142-2 establish rules under which an issuer may preserve the exclusion of the interest from gross income for federal income tax purposes on an issue of tax-exempt bonds upon the occurrence of certain violations of the private activity bond rules, provided that certain remedial actions are timely taken. In this regard, (A) section 1.141-12 applies to “governmental bonds” and, by incorporation by reference with certain modifications, to “qualified 501(c)(3) bonds,” and (B) section 1.142-2 applies to “qualified exempt facility bonds” and, by incorporation by reference with certain modifications, to “qualified small issue bonds,” “qualified student loan bonds” and “qualified redevelopment bonds,” and to certain provisions of section 147.

Section 1.141-12 provides that an action that would otherwise be treated as a “deliberate action” under section 1.141-2 and that causes a bond issue to meet the private business tests or the private loan financing test is not treated as a deliberate action if certain requirements are satisfied and the issuer takes a “remedial action” described in section 1.141-12. The alternative remedial actions are set forth in paragraphs (d), (e) and (f) and consist of, respectively, (I) the redemption or defeasance of the nonqualified bonds of the issue (the “Redemption or Defeasance Option”), (II) the use of the “disposition proceeds” derived from the deliberate action for a qualifying purpose (the “Disposition Proceeds Option”), and (III) the use of the property financed or refinanced with the proceeds of the issue in an otherwise qualifying manner (the “Alternative Use of Facility Option”).

With regard to the Redemption or Defeasance Option, an issuer is required to redeem a percentage of the outstanding bonds of the issue representing the nonqualified bonds. The term “nonqualified bonds” is defined in paragraph (j) of section 1.141-12 to mean the highest percentage of private business use in any one-year period commencing with the date of the deliberate action. In selecting bonds of the issue to represent the nonqualified bonds, an issuer may select such bonds on a pro rata basis. Alternatively, the issuer may treat bonds with longer maturities (on a bond-by-bond basis) as the nonqualified bonds.

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Under the Redemption or Defeasance Option, if an issuer is unable to redeem the nonqualified bonds within 90 days of the date of the deliberate action, the issuer is required to establish a defeasance escrow with respect to the nonqualified bonds within such 90-day period. An issuer may not use proceeds of tax-exempt bonds to redeem or defease the nonqualified bonds under the Redemption or Defeasance Option. If the issuer establishes a defeasance escrow with respect to the nonqualified bonds, the issuer must notify the Internal Revenue Service of the establishment of the defeasance escrow within 90 days of the date on which the defeasance escrow is established.

The establishment of a defeasance escrow does not satisfy the requirements of the Redemption or Defeasance Option if the period between the issue date of the bonds and first optional call date of the bonds exceeds 10-1/2 years.

Under the Disposition Proceeds Option as applied to 501(c)(3) organizations, the nonqualified bonds are treated as “reissued” for purposes of sections 141, 145, 147, 149 and 150, and such bonds must satisfy all requirements applicable to qualified 501(c)(3) bonds.

Under the Alternative Use of Facility Option, the nonqualified bonds are treated as “reissued” for purposes of sections 55 through 59 and 141, 142, 144, 145, 147, 149 and 150, and such bonds must satisfy all requirements applicable to qualified bonds as defined in section 141(e) throughout the remaining term of the nonqualified bonds.

Section 1.142-2 does not incorporate the Disposition Proceeds Option or the Alternative Use of Facility Option. Instead, section 1.142-2 incorporates rules similar to the Redemption or Defeasance Option and provides that if less than 95 percent of the net proceeds of an exempt facility bond issue are actually used to provide an exempt facility and for no other purpose, the issue will nonetheless be treated as meeting the requirements of section 142 if the issue meets certain conditions and the issuer takes a remedial action in accordance with section 1.142-2. Such remedial action must consist of the redemption or defeasance of the nonqualified bonds under rules similar to the rules under the Redemption or Defeasance Option. Paragraph (e) of section 1.142-2 provides that nonqualified bonds are the portion of the outstanding bonds in an amount that, if the remaining bonds were issued on the date on which the failure to properly use the proceeds of the bonds occurs, at least 95 percent of the net proceeds of the remaining bonds would be used to provide an exempt facility.

Revenue Procedure 97-15 provides a closing agreement program under which an issuer may preserve the tax-exempt status of a bond issue with respect to which a deliberate action causes the bond issue to fail to meet certain requirements of sections 141 through 150 by entering into a closing agreement with the Internal Revenue Service. Among other things, entering into such a closing agreement pursuant to Revenue Procedure 97-15 requires the issuer to redeem the nonqualified bonds, as determined under section 1.141-12(j) or 1.142-2(e), as applicable, on their next redemption date and to pay a “closing agreement amount” representing a measure of the tax exposure on the interest accrued on the nonqualified bonds between the date of the post-issuance action and the next redemption date for the bonds.
Reasons for Change

On May 7, 2001, individual members of the Committee on Tax-Exempt Financing of the American Bar Association Section of Taxation submitted to the Internal Revenue Service a proposed closing agreement program (the “Proposal”) with respect to certain “foot-fault” violations of certain rules contained within sections 103 and 141 through 150 that would permit an issuer to enter into a closing agreement under section 7121 with the Internal Revenue Service to preserve the tax-exempt status of its bonds for federal income tax purposes. With regard to violations of the private activity bond rules, the Proposal determines the closing agreement amount that an issuer would be required to pay to the Internal Revenue Service based on the amount by which the amount of private business use, or the amount of nonqualified costs in the case of exempt facility bonds, exceeds the applicable limit established by the Internal Revenue Code and applicable regulations. Though the stated scope of the Proposal is limited to minor violations, there is nonetheless a perceived inconsistency between application of the definition of nonqualified bonds put forth by the Proposal and the definition of nonqualified bonds contained in paragraph (j) of section 1.141-12 and as employed by Revenue Procedure 97-15. The proposed provision reconciles such inconsistency by establishing a fair and uniform method for determining the amount of nonqualified bonds with respect to all types of tax-exempt bonds.

On September 25, 2001, the Internal Revenue Service issued Notice 2001-60, which provides information about and establishes basic procedures regarding a voluntary closing agreement program for tax-exempt bonds (the “TEB VCAP”). Notice 2001-60 expressly requests comments regarding a number of areas to be addressed in the TEB VCAP, including determination of the amounts that should be specified for particular tax law violations. In addition to the proposed modification of the Income Tax Regulations, the principles of this proposal should be incorporated into the closing agreement procedures of the TEB VCAP, consistent with the Proposal.

Explanation of Provisions

This proposal modifies the definition of nonqualified bonds under paragraph (j) of section 1.141-12 to reflect only the amount by which the amount of private business use or the amount of proceeds loaned to a nongovernmental entity exceeds the permitted limit for such private business use or private loans. Because the definition of nonqualified bonds for purposes of section 1.142-2 already recognizes the preservation of some measure of permitted use of proceeds toward nonqualified uses, no change is proposed to such definition.

In the case of both sections 1.141-12 and 1.142-2, an additional change is proposed that would allow an issuer to designate any bonds as the nonqualified bonds by establishing the redemption or defeasance of the nonqualified bonds does not have the effect of extending the remaining average maturity of the issue of which the nonqualified bonds are a part.
Because Revenue Procedure 97-15 incorporates the definition of nonqualified bonds as used in sections 1.141-12 and 1.142-2, no change is proposed with respect to Revenue Procedure 97-15.