# IRS PRIVATE ACTIVITY BOND ISSUES FOR MUNICIPAL PROJECTS

## ENVIRONMENTAL IMPROVEMENT FUND

### Municipal Advisory

**Subject:** Avoiding Private Activity Bond Problems with a municipality's loan from the Environmental Improvement Fund

**Issue:** A Private Activity Bond problem can arise if a municipality negotiates special agreements with a private company such as payment agreements, user charges, installment payments, management contracts, or leases. In order to avoid a Private Activity Bond problem, a municipality should consult a qualified bond attorney prior to negotiating any special arrangements.

**Overview:** The Environmental Improvement Fund (EIF) requires that each municipality that borrows money under the Clean Water Fund Program or the Safe Drinking Water Loan Program make a covenant that interest on the EIF loan will be excludable from gross income for federal income tax purposes. This advisory addresses certain situations that can cause obligations issued for a municipal wastewater treatment system to become taxable Private Activity Bonds. This same situation can cause a problem for other obligations that were issued on a tax-exempt basis to finance the municipal wastewater treatment or drinking water system.

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**Why does the IRS have Private Activity Bond Regulations?** In general terms, the Private Activity Bond Regulations are intended to prevent tax-exempt bonds from being used to provide a benefit to a nongovernmental entity for a business purpose.

**What types of relationships with private companies are subject to the IRS Private Activity Bond Regulations?** Following this Municipal Advisory is a Guidance section which includes descriptions of situations that could create a Private Activity Bond problem for a wastewater treatment or drinking water system. The Guidance is not definitive but instead is intended to alert you to situations that can create problems, including Payments from a Private Company, Special User Rates, and Management Contracts.

**Do the Private Activity Bond Regulations only apply to bonds being purchased by the State's Clean Water Fund Program, Safe Drinking Water Loan Program or the Land Recycling Loan Program?** No. The Private Activity Bond Regulations apply to municipal tax-exempt bonds regardless of who purchases the bonds.

**Why does the EIF loan program care if bonds are tax-exempt?** The State issues tax-exempt bonds to provide the most favorable borrowing terms to municipalities. To do so, the State needs each municipality to covenant that it will not take any action that will cause the municipality's loan to become taxable. The standard Financial Assistance Agreement between a municipality and the State includes such a covenant.

**Can bonds originally issued as tax-exempt later become taxable bonds?** Yes. For example, entering into a special payment arrangement with a private business for use of a treatment facility may cause bonds previously issued as tax-exempt for that facility to become taxable. In this situation, purchasers of the prior bonds may have recourse against the municipality for failing to maintain the tax-exempt status of those bonds.

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## Guidance

The Private Activity Bond Regulations address various types of relationships that a municipality may have with a private company. Certain types of relationships may preclude a municipality from using tax-exempt municipal bonds to pay for a municipal project. This document is intended to help you identify those situations before your municipality commits to a project financing plan that includes tax-exempt debt issuance. While our interest is primarily in avoiding financing problems for projects funded by the Clean Water Fund Program or the Safe Drinking Water Loan Program, the Private Activity Bond Regulations **also** apply to other sources of tax-exempt financing and other municipal projects.

Following are examples of some types of relationships with a private company that may adversely affect the ability of the municipality to issue tax-exempt bonds to finance a municipal wastewater project. In addition, these types of relationships could cause a municipality's outstanding tax-exempt sewerage bonds to become taxable bonds. If your municipality is considering contracting with a private company to manage and/or operate your municipal wastewater or drinking water system, you should pay particular attention to the discussion below about management contracts.

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**Payments from a Private Company:** If a municipality has a contract with a private company that requires the private company to make a special payment such as the following, the contract may create a Private Activity Bond problem:

1. A contractual payment, or series of payments, due from the private company to the municipality if the company ceases or reduces its use of the municipal sewer system, ceases operations in the municipality, or moves to another municipality.

2. A guaranteed **fixed** payment from the private company to the municipality for municipal debt payments or capital costs associated with the system.

3. A guaranteed payment from the private company to the municipality for a **percentage** of scheduled municipal debt payments or capital costs associated with the system.

**Special User Rates:** If a municipality offers sewer use rates or other special provisions to a private company that are not available to other sewer system users in the same service class, this may create a Private Activity Bond problem. Private Activity Bond problems may also arise if the municipality constructs a pre-treatment facility for a private company or includes equipment and facilities in a wastewater treatment plant more sophisticated than necessary to process ordinary sewage.

**Management Contracts:** If a private company manages or operates the municipality's wastewater system, the structure of the contract with the company will determine whether it creates a Private Activity Bond problem.

A. Types of contracts that generally do not create Private Activity problems:

- Periodic Fixed Fee Arrangements

| % of Compensation Derived from Fixed Fee | Maximum Term of Contract |
| --- | --- |
| 95% | lesser of 15 years or 80% useful life ** |
| 80% | lesser of 10 years or 80% useful life ** |
| | **20 years for public utility property under certain conditions |
| 50% | 5 years [terminable after third year without cause or penalty] |

- A percentage of gross revenues or expenses of the facility (but not both) that does not exceed 2 years and includes a termination provision at the end of the first year without penalty. [This only applies to the startup phase of a municipal facility.]

  *A contract that does not fall within the above limits may create a Private Activity Bond problem.*

B. Provisions that may create IRS Private Activity Bond issues:

- The private company receives a productivity reward based on all or part of the net profits generated by the facility. In general, a productivity reward based on increases in gross revenues or reductions in total expenses (but not both) will not result in a compensation arrangement based on a share of net profits so long as the fixed fee portion of the contract falls within the limits described in the chart above.

- The private company is a "related party" to the local governmental unit. Private Activity issues can also arise if any directors, officers, shareholders or employees of a private company serve on the governing body of the governmental unit.

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DISCLAIMER: This information is intended to alert municipalities and engineering firms to potential tax-exempt bond problems that may arise from relationships with private companies. These relationships may impact the municipality's ability to issue tax-exempt debt for a municipal project. This document is not intended to provide legal advice or tax advice. Other situations, such as leasing a municipal facility to a private company, allowing part ownership of the facility by a private company, and on-site research or testing by a private company, can also lead to IRS Private Activity problems. The municipality's bond counsel should be consulted on the application of IRS regulations if the municipality has relationships with private companies that could affect the ability of the municipality to issue tax-exempt debt to finance a municipal project. The IRS Private Activity Bond Regulations are subject to change or further interpretation by the IRS.

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