

PRIVATE BUSINESS USE RESTRICTIONS FOR SCHOOL DISTRICT BONDS

Federal tax exemption of interest on tax-exempt bonds is conditioned on meeting the various tax requirements throughout the term of the bond. At issuance, the issuer certifies as to its reasonable expectation that the various requirements will not be violated. The general sanction for violation is that the interest on the bonds becomes taxable retroactive to the date of issuance. The goal of any school district that benefits from tax-exempt financing, however, is to meet the requirements throughout the term.

What is the limitation on private business use?

No more than 10% of the proceeds on any bond issue may be used for “private business use.” Private business use arises from use of property financed by tax-exempt bonds by persons in their trade or businesses. For this purpose, private business users include the federal government and nonprofit organizations. State and local governments were not treated as private business users. Use by a person as a member of the general public also is not treated as private business use. For federal tax purposes, general public use means that use on the same basis by persons who are not using the facility in a trade or business in addition to persons who are using it in a trade or business.

What are the types of private business use?

The broad categories of arrangements that typically result in private business use include through ownership, a lease, license or facility use contract, or a management or services contract. If a School District sold surplus school property to a for-profit entity, the change in ownership would be private business use.

Leases. The document does not have to be labeled as a lease to be treated as private business use. It may be called a license or “facilities use” agreement. The basic concept is that the entity has exclusive, priority use of a bond-financed facility. Most likely it is a written agreement, but oral agreements may result in private business use. Leases with other state and local governmental units are not treated as private business use. Leases with nonprofit and for-profit groups or with the federal government are treated as private business use.

Examples of Potential Private Business Use Leases:

Girl Scout/Boy Scout Meetings in a Classroom or Gymnasium. Either of these entities is a nonprofit group, so the use of a classroom or the gymnasium would be treated as private business use if the group met on a regular basis.

Community Theatre Group. Most community theatre groups would be organized as a nonprofit organization and would be treated as private business use. If a drama class from another public school wanted to use the auditorium for a theatre production, this would not be treated as private business use.

Sports League Use of Playing Fields. If the local soccer league or Little League baseball program uses sports fields financed with bond proceeds, the organization is likely to be a nonprofit organization. Use of the fields by a city parks and recreation department would not be private business use.

Summer Camps. Summer camps run by nonprofit or for-profit groups or by a coach outside of his or her employment contract with the School District will be treated as private business use. Summer programs sponsored by the city parks and recreation department would not be private business sue.

Booster Club Concessions at Football Stadium. Concession stands financed with bond proceeds that are operated by the school booster club are treated as private business use if the booster club is a nonprofit organization legally separate from the School District. A concession stand run by the school glee club or band would not be private business use because it would be part of the School District.

Church Services. Rental of an auditorium or gymnasium by a church for worship services or Sunday School classes would be treated as private business use because the church is a nonprofit group.

Lease Arrangements that are Exceptions. Even if the school district has entered into a lease, the use will not be counted toward the private business use limitation if it falls within one of the exceptions relating to short-term use or incidental uses. Most of the examples of leases discussed above are likely to fit within one of these exceptions.

100-day Use Contracts. Private business use does not arise if the term of the use under the arrangement, including all renewal options, is not longer than 100 days and the arrangement would be treated as general public use, except that it is unlikely that an individual or family would rent the facility (*i.e.*, contracts for annual use of an auditorium or gymnasium sports fields, where it is unlikely that individuals or families would be renting auditorium space). This exception would require that the School District have a standard rate schedule. For example, a contract which charged standard rates for use one night a week plus one week in the summer for a year with the Boy Scouts or for use three weekends (Friday through Sunday) for each of three plays put on by the Community Theatre group would fall within the exception.

50-day Use Contracts. Private business use does not include a negotiated arm's-length arrangement with compensation under the arrangement at fair market value if the term of the use under the arrangement, including all renewal options, is not longer than 50 days. This exception would not require that the school district have a standard rate schedule. A summer camp with a for-profit entity to use the fields and gymnasium for 3 weeks, 5 days each week would fit within this exception. An agreement with a church to use the auditorium every Sunday plus Christmas Eve and Christmas Day would exceed the 50-day use limit.

200-Day Contract. If the School District has a facility that is available to individuals and to entities using it in their trade or business, the tax regulations allow a contract of up to 200 days. If the entity has an option to renew, the option must be at fair market value. This exception would most likely be relevant to a parking lot made available to students and faculty of the School District and to companies near the school facility. If both individuals and the

companies were able to purchase 6-month parking passes, the 200-day contract exception would be available.

No Fee/At Cost Use of Facilities. If the School District makes its facilities available at no cost or for a fee that is equal to the School District's allocable operating costs, there is no private business use problem.

How are contracts with outside managers or service providers treated?

A management or service contract may result in private business use of bond-financed property. As a general rule, a management contract that provides for compensation for services rendered based, in whole or in part, on a share of net profits from the operation of the facility will result in private business use. Certain service contracts are incidental and not treated as private business use, such as a service contract for copying machines, an outside janitorial or security contract, or a bus maintenance contract.

Examples of potential private use service contracts include food service where meals are prepared in bond-financed facilities or a contract with a transportation company which provides drivers for buses financed with bond proceeds.

Safe Harbor Exceptions for Service Contracts. Contracts that have a fixed fee or short term often fall within safe harbors published by the Internal Revenue Service. For example, a contract for a private company to use the school kitchen/cafeteria that provides for a fixed fee per meal served could have up to a 3-year term so long as the school district could cancel without penalty at the end of 2 years. A contract for bus drivers using bond-financed buses that provides for an hourly fixed fee could have a term of up to 10 years.

How are research contracts treated?

The School District would only need to be concerned about research sponsored by the federal government or a private company that used bond-financed space. The tax regulations treat contracts that give the sponsor a right to license or patent a product developed in the research at other than fair market value or which involve product testing of the sponsor's product. Most research contracts sponsored by the federal government are within safe harbors published by the Internal Revenue Service because the federal contracts typically require dissemination of the results and nonexclusive rights.

What rules apply for advertising?

Certain "incidental uses" of a financed facility that do not exceed 2.5% of the proceeds of the bonds are disregarded for purposes of measuring private business use. Incidental uses generally involve use of open space, such as pay telephones, vending machines, advertising displays, and use for television cameras.

Examples of Incidental Uses:

Sports Stadium Advertising. Dasher boards or advertising displays from for-profit companies around the football field or basketball arena are likely to fall within this incidental uses exception.

Vending Machines. Vending machines in a bond-financed facility serviced by Coca-Cola or a local company where the machines are owned by the company and the gross revenues are split between the School District and the vendor are also within this exception.

Scoreboard Advertising. A scoreboard purchased with bond proceeds often presents an advertising opportunity. If the for-profit advertiser pays for the entire cost of the scoreboard, no tax problem exists because bond proceeds were not used. If bond proceeds were used to purchase the scoreboard, the amount spent should be examined to see if the advertising fits within the 2.5% incidental uses exception to private business use.

Advertising on buses. Advertising displays on school buses are likely to occupy a small space that is within the 2.5% incidental uses limit.

Naming Rights: If the School District enters into a commercial naming rights contract with a for-profit company for a bond-financed facility, such as for the football stadium, the IRS may treat this as private business use. This is a different contract from traditional advertising on boards in the football stadium and should be discussed with bond counsel.

How is private business use measured?

The 10% private business use limitation applies to 10% of the proceeds of the bond issue. If a School District rented more than 10% of the square footage of a building, that is not the end of the analysis unless the entire building was financed with the proceeds of a single bond issue. The square footage of space used by a private business user may be useful in calculating the amount of bond proceeds spent on the space, but the 10% limit will be analyzed in terms of what percentage that amount is of the proceeds of a bond issue. If the space used by a private business user has been financed by more than one bond issue, the School District would need to determine the dollar amount spent from each bond issue to determine if the 10% limitation had been exceeded in either issue. If a single bond issue was used to finance space used by two different private business users, the proceeds used for each user would be aggregated to determine if the 10% limit was exceeded.

Private business use is measured over the term of the bond issue (including refundings). Thus, private business use that occurs for a year or two with respect to a bond issue with a term of 20 to 30 years may not exceed the 10% limit over the term.

What if the School District determines there is private business use above the 10% limit?

The tax concern would arise if the School District had both private business use and payments from the private business user that exceeded 10 % of the debt service on the bonds. Generally applicable taxes, even though paid by private businesses in addition to individuals and families, are not treated as private business payments. However, both direct and indirect payments are considered for purposes of measuring the 10% private payment test. For example, if the bonds are secured by the general obligation of the School District but the School District receives rental payments from use of the bond-financed gymnasium by a church that is not within one of the private business use exceptions, the rental payments are treated as indirectly being used to pay debt service.

How are private payments measured?

The rules apply to amounts that might be indirectly available to pay debt service. The tax regulations permit the School District to subtract from the private payments its operating expenses directly allocable to the rental activity. For example, a School District might subtract the cost of janitorial services, electric and heating/cooling expenditures allocable to the time the gymnasium was rented out to a church for Sunday activities.

The 10% test is measured by taking into account the private payments as a percentage of debt service over the entire term of the bonds. Thus, private payments from a private business use that occurs for a year or two with respect to a bond issue with a term of 20 to 30 years is not likely to exceed the 10% payment limit. The tax regulations provide specific rules for calculating the 10% private payment test and a School District should consult its bond counsel in doing the calculation.

What happens if a School District finds it has violated the private business use and private payment tests?

The tax regulations provide certain remedial actions for curing private business use. The School District will only have to remediate the portion of outstanding bonds allocable to the bad use (the “nonqualified bonds”). In general, the School District would have three choices:

1. Redeem nonqualified bonds within 90 days of taking the action that has caused the violation (or defease the bonds if they cannot be redeemed within 90 days). If the bonds are defeased, the school district must notify the IRS.
2. If the School District receives cash upfront from the private business user (a sale of property, for example), the School District can use the cash proceeds to pay for new costs that qualify for governmental financing. The School District has up to two years to spend the money. Once the cash from the disposition is spent, the bond proceeds are treated as financing the new property for the rest of the term of the bonds.
3. If the private business use otherwise qualifies for tax-exempt financing (for example, if the property is leased to a 501(c)(3) organization), and steps are taken to qualify the financing for tax-exempt bonds, the 501(c)(3) organization can assume the repayment obligation on the bonds.

If none of the remedial actions are appropriate for the particular violation, the School District can work with the Internal Revenue Service to negotiate a settlement under the Voluntary Closing Agreement Program. The settlement will likely involve redeeming nonqualified bonds and paying penalties. The Internal Revenue Service has announced that it will provide more favorable terms for issuers that have adopted and implemented post-issuance compliance procedures.