26 CFR 601.601 Rules and regulations.
(Also, §§54, 54A, 54AA, 141, 142, 1397E, 1400N, 1400U-2, 6431; 1.141-12, & 1.142-2)

Rev. Proc. 2018-26

SECTION 1. PURPOSE

This revenue procedure provides certain remedial actions that issuers of State and local tax-exempt bonds and other tax-advantaged bonds (as defined in § 1.150-1(b) of the Income Tax Regulations) may take to preserve the tax-advantaged status of the bonds when nonqualified uses (as defined in section 4.04 of this revenue procedure) of the bond proceeds occur.

SECTION 2. BACKGROUND

.01 Various provisions of the Internal Revenue Code (the "Code") provide tax benefits to facilitate lower borrowing costs for State and local governments and other qualified issuers if certain requirements are met. These benefits are in the form of a tax exemption under § 103 on the interest paid to holders of eligible State and local bonds ("tax-exempt bonds"), refundable tax credits under § 6431 payable to issuers of certain qualified bonds ("direct pay bonds"), or tax credits under § 54A and similar provisions to holders of qualified tax credit bonds ("tax credit bonds").[1] Eligibility requirements for these tax benefits include prescribed uses of the proceeds of the bonds.

[1] Public Law No. 115-97, § 13404, 131 Stat. 2138 (2017), repealed the Code provisions related to tax credit bonds and direct pay bonds effective for bonds issued after December 31, 2017. References in this revenue procedure to these Code sections refer to those sections as in effect prior to repeal.

.02 For some types of tax-advantaged bonds, existing regulations provide remedial actions to cure certain nonqualified uses. For example, for tax-exempt governmental bonds (as defined in § 1.150-1(b)), § 1.141-12 provides remedial actions (including bond redemption or defeasance, alternative qualified use of disposition proceeds, and alternative qualified use of facilities) to cure violations of the private business use and private loan restrictions under § 141. Similarly, for certain types of tax-exempt private activity bonds (as defined in § 141), § 1.142-2 provides remedial actions (including bond redemption or defeasance) to cure violations of particular requirements for qualified private activity bonds under §§ 142, 144, and 147. In addition, for qualified zone academy bonds ("QZABs") as defined in § 1397E, § 1.1397E-1(h)(8) provides remedial actions (including bond redemption or defeasance and alternative qualified use of disposition proceeds) to cure violations of requirements for QZABs under § 1397E.

.03 The existing remedial actions for tax-exempt governmental bonds do not include a remedial action to cure the nonqualified uses that generally result from longer-term leases of financed property to private businesses, other than the remedial action of bond redemption or defeasance. Taxpayers have recommended adding a remedial action for this purpose similar to the existing remedial action that allows curing nonqualified uses that result from sales of financed property to private businesses through alternative qualified uses of the disposition proceeds of those sales. Section 1.141-12(h) permits the Commissioner, by publication in the Internal Revenue Bulletin, to provide additional remedial actions for purposes of the private business use and private loan restrictions. Section 5 of this revenue procedure provides such a remedial action.

.04 For direct pay bonds, no existing remedial action allows adjustment of the refundable Federal tax credit for nonqualified uses. Such a remedial action would provide a simple and administrable method of preserving the tax-advantaged status of direct pay bonds. Section 6 of this revenue procedure provides this remedial action.

.05 Finally, for certain types of tax credit bonds and for direct pay bonds, none of the existing remedial actions described in section 2.02 of this revenue procedure are available. Extending the availability of existing remedial actions to these types of bonds would allow issuers similarly to cure nonqualified uses of these bonds. Section 7 of this revenue procedure provides remedial actions for these bonds.

SECTION 3. SCOPE

This revenue procedure applies to tax-advantaged bonds to allow issuers to take certain remedial actions to protect the tax-advantaged status of the bonds when nonqualified uses of bond proceeds occur if the requirements of particular remedial actions under this revenue procedure are met.

SECTION 4. DEFINITIONS

The definitions in this section 4 apply for purposes of this revenue procedure.

.01 <u>Applicable Code section</u> means the Code section that sets forth the qualification requirements for a particular type of bond.

.02 <u>Defeasance escrow</u> means an irrevocable escrow established to redeem nonqualified bonds on the earliest call date after the date on which a nonqualified use occurs in an amount that, together with investment earnings, is sufficient to pay all the principal of, interest on, and call premium, if any, on the nonqualified bonds from the date the escrow is established to that call date. No amount in a defeasance escrow may be invested in an investment the obligor of which is a user (or a related party (as defined in § 1.150-1(b)) to a user) of proceeds of the bonds. All purchases or sales of investments in a defeasance escrow must be made at the fair market value of the investment within the meaning of § 1.148-5(d)(6).

.03 Disposition proceeds means, except as otherwise provided in this section 4.03, disposition proceeds (as defined in § 1.141-12(c)(1)), plus investment earnings on those amounts. For property financed with different sources of funding, disposition proceeds are allocated among the sources under § 1.141-12(c)(3). For purposes of section 5 of this revenue procedure, the definition of disposition proceeds in § 1.141-12(c)(1) applies.

.04 Nonqualified use means a failure to spend proceeds of tax-advantaged bonds within any required expenditure period specified in the applicable Code section and any use of expended proceeds of tax-advantaged bonds for a purpose other than a qualified use (as defined in section 4.06 of this revenue procedure). A nonqualified use under § 141 occurs on the date of the deliberate action (as defined in § 1.141-2(d)(3)). For dates on which other nonqualified uses occur, see section 7.03 of this revenue procedure.

.05 Nonqualified bonds means the portion of the outstanding bonds in an amount that, if the remaining bonds were issued on the date on which nonqualified use of proceeds occurs, the proceeds of the remaining bonds would be used in a timely manner for a qualified use. Allocations of nonqualified bonds are made in accordance with § 1.142-2(e).

.06 Qualified use means a use required or permitted by the applicable Code section. For example, qualified uses include a qualified purpose under § 54A(d)(2)(C) for tax credit bonds under § 54A, capital expenditures for direct pay build America bonds under § 54AA(g), and a prescribed amount of governmental use for tax-exempt governmental bonds under § 141 and build America bonds under § 54AA.

SECTION 5. REMEDIAL ACTION FOR ELIGIBLE LEASES OF PROPERTY FINANCED WITH TAX-ADVANTAGED BONDS SUBJECT TO § 141 OR § 145(a)

.01 Modified alternative use of disposition proceeds remedy for eligible leases. In the case of a deliberate action (as defined in § 1.141-2(d)(3)) that consists of an eligible lease (as defined in section 5.02 of this revenue procedure) to a nongovernmental person (as defined in § 1.141-1(b)) of property financed with tax-advantaged bonds subject to the private activity bond restrictions under § 141 or § 145(a), provided the requirements of § 1.141-12(a) are met, the issuer may cure the nonqualified use resulting from the lease by applying the alternative use of disposition proceeds remedial action under § 1.141-12(e) in the same manner as to a disposition with the following modifications--

(1) Treating the eligible lease as a disposition for which the consideration is exclusively cash;

(2) Treating funds (excluding proceeds of tax-advantaged bonds) in an amount equal to the lease amount (as defined in section 5.03 of this revenue procedure) as disposition proceeds;

(3) Treating the leased property as transferred property; and

(4) Allocating proceeds of the issue that, under § 1.141-12(c)(2), are allocable to the funds treated as disposition proceeds, to those funds during the term of the lease only (and to the leased property thereafter).

.02 Eligible lease. A lease is an eligible lease if--

(1) The consideration for the lease consists exclusively of cash lease payments (regardless of when paid) that are not financed with proceeds of another issue of tax-advantaged bonds; and

(2) The term of the lease--

(a) Is at least equal to the lesser of 20 years or 75 percent of the weighted average reasonably expected economic life of the leased property (determined in the same manner as under section 147(b)) as of the start of the term of the lease; or

(b) Runs through the end of the measurement period (as defined in § 1.141-3(g)(2)) during which the private business use restrictions are measured for compliance under section 141.

.03 Lease amount. The lease amount is an amount equal to the present value of all of the lease payments required to be made under the lease. For this purpose, present value is determined as of the start of the term of the lease by using the yield on the issue as of the start of the term of the lease as the discount rate.

SECTION 6. REMEDIAL ACTION FOR DIRECT PAY BONDS TO REDUCE THE REFUNDABLE FEDERAL TAX CREDIT

In the case of direct pay bonds, an issuer may cure a nonqualified use by reducing the amount of the refundable Federal tax credit to eliminate the amount allocable to the nonqualified bonds. Further, the issuer must treat any disposition proceeds as described in section 7.02(3) of this revenue procedure. To effect this remedial action, beginning with the first Form 8038-CP (Return for Credit Payment to Issuers of Qualified Bonds) or successor form filed for any interest payment date for the bonds after the nonqualified use occurs, the issuer, in reporting the amount of the interest payable, must exclude the portion of that interest allocable to the nonqualified bonds that accrues on or after the date of the nonqualified use. For the first such Form 8038-CP (or successor form), the issuer must print or type across the top of the form “Remedial Action under Section 6 of Rev. Proc. 2018-26” and attach the required explanation for the difference in scheduled credit payment. The explanation must state that a nonqualified use occurred and the date of the nonqualified use and include a revised debt service schedule reflecting the exclusion of amounts allocable to the nonqualified bonds beginning with the date of the nonqualified use.

SECTION 7. CERTAIN GENERAL REMEDIAL ACTIONS FOR TAX-ADVANTAGED BONDS

.01 In general. In the case of tax-credit bonds or direct pay bonds, except as otherwise provided in section 7.06 of this revenue procedure, an issuer may cure a nonqualified use by taking a remedial action of redemption or defeasance of nonqualified bonds under section 7.02 of this revenue procedure or alternative use of disposition proceeds under section 7.05 of this revenue procedure. In the case of tax-exempt bonds, issuers may apply section 7.02(2) of this revenue procedure to defeasance escrows established under § 1.141-12(d) or § 1.142-2(c).

.02 Redemption or defeasance of nonqualified bonds. The requirements for redemption or defeasance of nonqualified bonds under this section 7.02 are met if--

(1) Amount and timing of redemption or defeasance. Within 90 days after the date on which the nonqualified use occurs, the issuer redeems the nonqualified bonds of the issue or establishes a defeasance escrow for any nonqualified bonds that are not so redeemed; and

(2) Yield restriction or rebate requirement. The issuer either restricts the investments in the defeasance escrow to investments that are not higher yielding investments (as defined in § 148(b)) or the issuer makes rebate payments to the United States, at the same time and in the same manner as arbitrage rebate amounts are required to be paid, in amounts equal to any earnings on investments in the defeasance escrow that are higher than the yield on the issue with respect to which the defeasance escrow was established. For this purpose, the first computation period begins on the date on which the defeasance escrow is established. Further, for purposes of this section 7.02(2), § 148 and the regulations thereunder (as modified by the applicable Code section and this section 7.02(2)) apply, and compliance with the rebate requirement in this section 7.02(2) is treated as satisfying applicable arbitrage investment restrictions under § 148 for the defeasance escrow.

(3) Treatment of disposition proceeds. The issuer treats the disposition proceeds as gross proceeds for purposes of § 148 as modified by the applicable Code section (the arbitrage requirements) and as proceeds for purposes of the applicable Code section. For purposes of applying the temporary period and spending exceptions to the arbitrage requirements, the issuer may treat the date of the receipt of the disposition proceeds as if it were the issue date of the nonqualified bonds and disregard the receipt

of disposition proceeds for the spending exceptions under § 1.148-7 for which the requirements were met before the receipt of the disposition proceeds.

.03 When a nonqualified use occurs. For unspent proceeds of bonds, a nonqualified use occurs on the earlier of the first date on which the issuer fails to have a reasonable expectation to spend the proceeds for a qualified use (within the required expenditure period, if any) or the last day of the required expenditure period, if any. For proceeds of bonds that have been spent, a nonqualified use occurs on the first date on which an action causes proceeds to be used for other than a qualified use.

.04 Reissuance. For purposes of determining whether the establishment of a defeasance escrow under section 7.02 of this revenue procedure results in an exchange under § 1.1001-1(a), the defeased bonds are treated as tax-exempt bonds for purposes of § 1.1001-3(e)(5)(ii)(B)(1).

.05 Alternative use of disposition proceeds. The requirements for alternative use of disposition proceeds under this section 7.05 are met if--

(1) Disposition for cash. The nonqualified use consists of a disposition for which the consideration is exclusively cash;

(2) Reasonably expected use of disposition proceeds. The issuer reasonably expects to spend the disposition proceeds within two years after the date of the disposition on alternative qualified uses or, to the extent the issuer does not expect to so spend the disposition proceeds, the issuer takes a remedial action under section 7.02 of this revenue procedure for such disposition proceeds within 90 days after the date of disposition;

(3) Unspent disposition proceeds. If the issuer fails to spend all of the disposition proceeds that it reasonably expected to spend within the prescribed two-year period in the manner described in section 7.05(2) of this revenue procedure, the issuer takes a remedial action under section 7.02 of this revenue procedure for the remaining disposition proceeds within 90 days after the end of that two-year period; and

(4) Treatment of disposition proceeds. The issuer treats the disposition proceeds as described in section 7.02(3) of this revenue procedure.

.06 Certain special rules on applicability. For QZABs under § 1397E, the remedial actions under § 1.1397E-1(h)(8) apply in lieu of this section 7. For tax-advantaged bonds subject to § 141, the remedial action provisions under § 1.141-12 apply in lieu of this section 7 for purposes of curing violations of the private business use and private loan restrictions; however, for defeasance escrows established under § 1.141-12(d), section 7.04 of this revenue procedure applies and issuers may apply section 7.02(2) of this revenue procedure.

SECTION 8. EFFECTIVE DATE

This revenue procedure applies to a nonqualified use that occurs on or after April 11, 2018, and may be applied to a nonqualified use that occurs before April 11, 2018.

SECTION 9. DRAFTING INFORMATION

The principal authors of this revenue procedure are Timothy L. Jones, Johanna Som de Cerff, and Zoran Stojanovic of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue procedure, contact Zoran Stojanovic at 202-317-6980 (not a toll-free call).