Measure For Measure: A Problem Play In Applying The Private Business Use Measurement Period

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While sitting through several sessions at the Bond Attorneys Workshop last week, I heard references to “measurement period” in different contexts. Although trying to stay focused on the always scintillating discussion, my mind wandered to the good and the bad of that concept. This post explores certain consequences of measurement period, including some surprising results.

Let’s start with the definition, which sounds simple and predictable:

**General rule.** Except as provided in this paragraph (g)(2), the measurement period of property financed by an issue begins on the later of the issue date of that issue or the date the property is placed in service and ends on the earlier of the last date of the reasonably expected economic life of the property or the latest maturity date of any bond of the issue financing the property (determined without regard to any optional redemption dates). In general, the period of reasonably expected economic life of the property for this purpose is based on reasonable expectations as of the issue date. Treas. Reg. 1.141-3(g)(2)(i).

For purposes of this post, we’ll stay with the general rule. The special rules for measurement period, including for refunding issues, are beyond the scope of this post. See, e.g., Treas. Reg. 1.141-13.

Wanting to save the good news for last, let me start with the negatives of this definition, some of which will undoubtedly surprise many of our clients. Private business use and private payments/security are measured over the measurement period. Thus, assume tax-advantaged governmental bonds were redeemed on February 1, 2015. The bonds were scheduled to fully mature on June 1, 2025, but the issuer had accumulated substantial revenues that it could either invest at less than 1 percent or use to redeem these 5 percent bonds, so it did the latter. Now in late 2015, the treasurer of the issuer excitedly tells you, his trusted bond counsel, that he just got the opportunity to lease for 10 years the currently unused 50 percent of the building financed by those bonds to a business that is moving into town. The treasurer exclaims, “What a lucky coincidence that we redeemed the bonds that financed that building!” Not surprisingly, the treasurer believes he has no private activity bond concerns because the bonds have been redeemed. But the definition of measurement period states that it runs through the maturity date (or end of useful life, if shorter). You do some quick calculating and conclude that, taking into account the period through the maturity date, the lease will cause the private business use limit to be exceeded. You also believe, based on the rent to be received, that the private payment limit will be exceeded. You consider the statute of limitations but immediately recognize that the limitations period will not fully expire until April 15, 2019 (three years after the due date of the tax return on which the final bond interest payment would appear for a calendar year individual taxpayer). Of course, the treasurer is flabbergasted by this news and says in a tone bordering on accusatory, “You’re not going to kill this lease, are you!”

Fortunately you are too smart to suggest that he postpone entering into the lease until the limitations period runs in 2019. Instead, you begin thinking about remedial actions. But what remedial action is available? The issuer can’t redeem nonqualified bonds because all of the bonds have already been redeemed. Does this mean the issuer need not do anything? Maybe, but then why does the definition of measurement run to the maturity date? Does the prior redemption qualify as the remedial action (assuming all of the additional requirements for remedial
action are satisfied)? Unfortunately the IRS doesn't seem to permit “anticipatory remedial action.” Is the rule different if the redemption wasn’t “anticipatory” because no violation was then expected? Maybe it should but what’s the authority for that position? Maybe VCAP is required. Presumably if VCAP is required, the payment would be minimal. But the issuer still faces the legal fees and the diversion of its scarce time to pursuing the closing agreement. This is a silly and unfortunate consequence of allowing the measurement period to run to the maturity date in all cases (assuming the useful life of the bond-financed asset is longer). Some form of relief is sorely needed for situations like this.

Shifting to some good news from the definition of measurement period, let’s focus on the alternative trigger for the end of that period — useful life of the financed property. Assume a city (“City”) issues 20-year bonds for police cars and a new municipal office building. The cars cost $200,000 in total and have an expected useful life of 10 years. The building costs $600,000 and has a useful life of 40 years. Ten percent of the building will be leased to private persons indefinitely. As expected, after 10 years, the City concludes that it can no longer use the cars because of their age and condition, and it asks bond counsel whether there are any restrictions on the sale of the cars. If the future use of the cars had to be taken into account, and if they were sold for business use, the private business use limit might be exceeded. Fortunately, measurement period is determined on an asset-by-asset basis. Thus, because the cars are beyond their useful life to the City, their future use need not be taken into account in the PBU calculation.

A further question warranting some (but not too much) consideration arises because PBU is measured on an annual basis and then averaged over the measurement period. The question is whether different “weighting” of the years included in the measurement period is required as assets drop out of the PBU calculation because their useful life has expired. Continuing the above example, is an early year in which all $800,000 of financed assets are in service weighted more heavily in the PBU measurement than a later year after the cars are disposed of and, thus, only the building, with a cost of $600,000, remains in service? Fortunately for the sake of simplicity (or more accurately, less complexity), the regulations do not require (or permit) such a weighting of annual PBU percentages. This result is embedded within the very mechanical PBU measurement rules, and is analogous to the absence of a “time value of money/use” concept. Contrast the relative simplicity in measuring private business use with the measurement of private payments, which are measured on a present value basis.

Applying the above conclusions to the City’s facts, the PBU percentage is 8.75 percent, calculated as follows. During the first 10 years, the PBU percentage is 7.5 percent each year, assuming for simplicity that all financed assets are placed in service on the issue date (((200,000 x 0% PBU) + (600,000 x 10% PBU))/800,000). During the second 10 years the PBU percentage is 10 percent each year ((600,000 x 10% PBU)/600,000). The average of the 20 annual PBU percentages is 8.75 percent.

Moving from governmental bonds to qualified 501(c)(3) bonds illustrates a further important consequence of the definition of measurement period. All assets financed with 501(c)(3) bonds must be owned by a governmental person or 501(c)(3) organization. Because the private business use regulations, and thus the measurement period rules, are incorporated into the qualified 501(c)(3) bond regulations for purposes of the ownership requirement, the ownership requirement ceases to apply to a financed asset as of the end of its useful life. In addition to this conclusion being the result of highly technical rules, it is also the only sensible consequence — otherwise 501(c)(3) hospitals and other 501(c)(3) organizations would be prohibited from deriving any value from financed assets no longer usable by it but possibly useful to others.

I will close with a caveat. It is easy to talk about useful lives and assume their length. However, the determination of the useful life of an asset is based on reasonable expectations as of the issue date of the bonds, and this determination isn’t so easy, especially with the prospect of an audit — with the benefit of hindsight — hanging over our heads. For example, if a hospital sells for a material portion of its original cost bond-financed equipment it determines it can no longer use, will the IRS argue that the borrower’s expectation of useful life was understated? Hospital protocols requiring the disposition of various assets after specified periods of use should counter such an IRS argument. But what about those entities — especially non-hospital entities, such as higher ed institutions — that don’t have these protocols? Some have suggested that safe harbor lives permitted for useful life limitation purposes can be relied upon for this purpose. However, the very nature of those lives as a safe harbor makes that suggestion questionable. For useful life purposes, an issuer may rely on the safe harbor life but is also permitted to use a longer life if supportable. This suggests that the safe harbor lives do not represent an upper limit on life, but only a lower limit. Thus, while a safe harbor life may provide some indication of a reasonable useful life, it must be supportable as an actual (or not-to-exceed) useful life.

In conclusion, the measurement period can be applied for the benefits described above, but only after paying careful attention to the lives assigned to the financed assets.

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