The Great Lakes Environmental Law Center

Protecting the world's greatest freshwater resource and the communities that depend upon it

440 Burroughs Street, Suite 111, Box 70
Detroit, Michigan 48202
www.glelc.org

April 14, 2010

Mayor John Hieftje and City Council Members
City of Ann Arbor
Guy C. Larcom, Jr. Municipal Building
100 N. Fifth Avenue
Ann Arbor, MI 48104

CC: Susan Pollay, Ann Arbor Downtown Development Authority

Re: Restrictions on Use of Build America Bonds Relating to S. Fifth Avenue Parking Structure Project

Dear Mayor and City Council:

The Great Lakes Environmental Law Center offers the following information regarding restrictions on use of Build America Bonds relating to the S. Fifth Avenue parking structure project. Given our prior litigation and settlement with the city, we wish to make explicitly clear that we do not intend to pursue any further legal action on this matter, either as a party or as attorneys for another party. We are simply providing this information to assist the city in avoiding any potential liabilities resulting from violations of the terms and restrictions of Build America Bonds. As stated in the bond offering, failure to comply with the Build America Bond requirements "may cause loss of the Refundable Credit to be retroactive to the date of issuance of the Bonds."

In February and July of 2009, the city of Ann Arbor approved a total of $49,420,000 worth of Capital Improvement Bonds to construct a 677 space, 4 story, underground parking structure in the city. The bonds are general obligation bonds and were designated as "Build America Bonds" under section 54AA of the Internal Revenue Code. More specifically, the bonds are classified as *Direct Payment* Build America Bonds. There are three types of Build America Bonds and the particular type issued for the parking structure provides the issuer, in this case the city, with a Federal subsidy through a tax credit paid by the Treasury Department and the Internal Revenue Service ("IRS") in an amount equal to 35 percent of the total coupon interest payable to investors in these taxable bonds.[1] Direct Payment Build America Bonds "may be issued to finance

[1] IRS Notice 2009-26, at 1-2.

governmental purposes for which tax-exempt governmental bonds (excluding private activity bonds under §141) could be issued under §103" of the Internal Revenue Code.[2] Therefore, sections 103 and 141 of the Internal Revenue Code govern the use of proceeds from Build America Bonds. If the bonds issued for the parking structure would be considered "private activity bonds" under §141, then that particular use for the bonds is impermissible. Just like tax-exempt bonds, proceeds from Build America Bonds *must* be used for *public* and not private use.

A bond is a private activity bond if it meets the (A) private business use test and (B) private security or payment test. These are known as the private business tests. If the Build America Bonds are used to finance parking for a private facility such as a hotel, as the city may be considering, there is a risk that the terms of the Build America Bonds will be violated and the City will lose millions of dollars in federal subsidy.

The purpose of the private activity bond tests of section 141 is to "limit the volume of tax-exempt bonds that finance the activities of nongovernmental persons, without regard to whether a financing actually transfers benefits of tax-exempt financing to a nongovernmental person."[3] According to the IRS regulations regarding section 141, that section "may not be applied in a manner that is inconsistent with these purposes."[4] Additionally, these tests may be met even if at the exact time of issuance of the bonds the proceeds were planned to be used for not more than 10% private use. If the issuer of the bonds "reasonably expects," as of the issue date, that the issue will meet either of the private activity bonds tests of section 141, then those bonds are private activity bonds.[5] Further, if the issuer takes any "deliberate action, subsequent to the issue date, that causes the conditions of either" of the tests to be met, those bonds are also classified as private activity bonds.[6] A deliberate action is any action that is within the issuer's control.[7] Intent to violate section 141 is not necessary for an action to be considered deliberate.[8] The only reason an action would not be considered deliberate is if it is an involuntary or compulsory conversion or it is taken in response to a directive action made by the federal government.[9]

An issue meets the private business use test if more than 10% of the proceeds are to be used for any private business use.[10] Presumably, the parking structure does not itself cause this test to be met, although there is still some uncertainty regarding the amount of bond proceeds being used to support future private development at the site rather than construction of public parking spaces. However, if the parking spaces are used for private facility parking in the future, that could cause the bonds to be classified as private activity bonds. If more than 10% of the proceeds of an issue are used in a business of a

[2] *Id*. at 4.
[3] 26 CFR 1.141-2(a).
[4] *Id*.
[5] 26 CFR 1.141-2(d)(1).
[6] *Id*.
[7] 26 CFR 1.14102(d)(3).
[8] *Id*.
[9] 26 CFR 1.141-2(d)(3)(i).
[10] *Id*.

nongovernmental person or a combination of nongovernmental persons then the private business use test is met.[11] Generally, the private use test is met if a nongovernmental person has special legal entitlements to use the financed property under an arrangement with the issuer.[12] However, a special economic benefit to a private party may also be sufficient.[13] There are many arrangements that would cause the private use test to be met. For example, if the infrastructure built with the proceeds of the Build America Bonds (such as the parking spaces) are contracted to a private person or entity or if that private person or entity has a special entitlement or priority to use the spaces, rather than being solely available for use by the public, the private use test will be met. It does not matter if this arrangement is fashioned *after* the issuance of the bonds, or even after construction of the structure. Entering into an arrangement that would provide a special entitlement to a person in a private business, or more simply, to a nongovernmental person, would no doubt be a deliberate action within the control of the city and therefore the bonds would become classified as private activity bonds.

The second private use test is met if the payment of the principal (or the interest on the principal) of more than 10 percent of the proceeds of the issue is either:

(A) secured by any interest in

(i) property used or to be used for a private business use, or

(ii) payments in respect of such property, or

(B) to be derived from payments (whether or not to the issuer) in respect of property, or borrowed money, used or to be used for a private business use.[14]

The payment of, or security for, debt service is determined from both the terms of the bond documents *and* any underlying arrangements.[15] Underlying arrangements may be the result of separate agreements between parties or may be determined by all the facts and circumstances surrounding the issuance of the bonds.[16]

If a nongovernmental person engaged in a private trade or business makes a payment to the city, directly or indirectly, for use of parking spaces in the new structure, that would be a private payment for use under section 141.[17] Whether a private payment for use of property is made under an arrangement that is entered into in connection with the issuance of an issue is determined on the basis of all of the facts and circumstances, but is treated as such if: (A) the issuer enters into an arrangement during the three year period beginning 18 months before the issue date; and (B) the amount of payments reflects all or a portion of debt service on the issue.[18] If the City enters into an arrangement within 18 months of the issue date whereby the private owners of a future facility will pay the city an amount at least equal to 10 percent of the proceeds from the bonds used to finance the parking structure, the private payment test will be met. If the arrangement is made after

[11] 26 CFR 1.141-3(a)(1).
[12] 26 CFR 1.141-3(b).
[13] 26 CFR 1.141-3(b)(7)(ii).
[14] 26 U.S.C. § 141.
[15] 26 CFR 1.141-4(a)(3).
[16] *Id.*
[17] 26 CFR 1.131-4(c)(2)(i)(A).
[18] 26 CFR 1.141-4(c)(3)(iv).

18 months have passed, all of the facts and circumstances will be considered to determine if the arrangement was entered into in connection with the issuance of the bonds.

As described above, there is a legal risk that the bonds used to construct the parking structure and other infrastructure at the site will violate the private activity test, risking millions of dollars in federal subsidy for the City, if the parking structure spaces are contracted to or if special parking entitlements are provided to a private facility. Further, given statements made by the Downtown Development Authority regarding the significant portion of bond proceeds being used for site infrastructure to benefit a future developer including the private development's share of costs for Library Lane, the service alley, the 12" water main, site work, and building structural support (which appears to solely benefit the private building), even a limited allocation of parking spaces for a private hotel could put the city at risk of losing millions of dollars in federal subsidies. We urge the City to consider these risks in making decisions about future development arrangements at this site.

Respectfully Submitted,

Noah Hall
nhall@wayne.edu
(734) 646-1400