Airports Now Have Greater Flexibility in Tax-Exempt Financing and Leasing Retail Portions of Their Terminals

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Under a new Internal Revenue Service private letter ruling, issuers of tax-exempt bonds and conduit borrowers now have a greater degree of flexibility to use “qualified equity” for “prohibited uses” without endangering the tax-exempt status of the bonds. In general, a “prohibited use” for a tax-exempt bond-financed airport terminal would include retail facilities that sell alcohol for off-site consumption (like a duty-free shop), health clubs and gambling facilities such those featuring slot machines; “qualified equity” is money from any source other than proceeds of a tax-exempt bond (e.g., proceeds of taxable bonds and equity contributed by the issuer or conduit borrower).

The new ruling extends a 2015 regulation applicable to governmental purpose bonds to “exempt facilities”, such as airports, docks, mass commuting facilities, utility facilities, and low-income housing facilities. Before the 2015 regulation, non-bond proceeds (i.e. qualified equity) had to be allocated to the physical location of the prohibited use within a mixed-use facility. Furthermore, once this allocation was made, which is generally not later than when the facility is placed in service, it was fixed for the term of the bond (often 30 years). Once the allocation was made to a specific location, the prohibited use portion could not be moved to another area within the facility. As a result, the qualified equity would be lost and the amount of the facility which could have been used for a prohibited use would be reduced.

Under the 2015 regulation, projects are divided into permitted use and prohibited use portions on a notional, rather than physical, basis with tax-exempt proceeds first allocated to the qualified use portion and any other funds first allocated to the private business use portion. In other words, qualified equity will be allocated first (i.e., it will “float”) to any private business use irrespective of whether the issuer/borrower identified the private business use on the issue date, or whether the private business use ‘moved’ (or arose) subsequent to the issuance of the bonds. Under the new rule, floating qualified equity can be moved around as needed, rather than dedicated to a specific location.

The new ruling allows exempt facilities, like airports, to allocate qualified equity to those prohibited uses wherever they are located, providing the airport with greater flexibility in leasing portions of terminals to a wider variety of tenants. As the degree and variety of the types of retail in airports continues to increase, the flexibility of this new rule will provide airports with greater options in terms of financing new and renovated facilities and leasing to tenants while at the same time greatly reducing tax-exempt bond compliance risk.

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