Don’t mess with the IRS

Will You Be Ready When the IRS Comes Calling?

Tax-Exempt Bond Rules and Post-issuance Compliance

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- Investment of Bond Proceeds -- Arbitrage Rebate
- Use of Bond Proceeds -- Private Use
- Working Capital Financings

Consequences of Non-compliance

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- Interest treated as taxable
- Loss of BAB/RZEDB subsidy, if applicable
- Additional arbitrage rebate may be owed (non-paid or underpaid rebate amounts, plus interest)
- Penalties

- <u>Arbitrage</u>: Spread between (i) the interest due on tax-exempt bonds and (ii) the earnings on the investment of such tax-exempt bond proceeds in higher yielding securities.
- <u>Rebate</u>: Issuer must pay (or rebate) arbitrage profits to federal government.
  - Why?
    - Federal government sees tax exemption as a subsidy
    - Federal government does not want to give a double benefit by allowing issuers to arbitrage
- <u>Arbitrage Rebate</u>: earnings on bond proceeds invested above bond yield must be paid to the US Treasury, unless the Issuer meets one or more exceptions:
  - Small issuer exception
  - Spend-down exceptions
  - Advance refundings (escrow securities yield restricted)

Arbitrage Rebate Rules – Exceptions

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- Small Issuer Exception – Issuers of less than $5,000,000 of bonds (or $15,000,000 of bonds for public school facility construction) – no rebate payment required
  - After 3 years, unspent proceeds subject to yield and investment restriction

- 6-Month Exception - no rebate payment required if all proceeds of the issue are spent within 6 months of the issue date.
- 18-Month Spend-down Exception

Period	Spend-down Requirement
6 months	15%
12 months	60%
18 months	100%

Arbitrage Rebate Rules – Exceptions (continued)

- Two-Year Construction Spend-down Exception
  - At least 75% of the proceeds must be spent on construction expenditures

Period	Spend-down Requirement
6 months	10%
12 months	45%
18 months	75%
24 months	100%

Arbitrage Rebate Post-issuance Compliance Tips

- Obtain computation of bond yield and establish procedure to track investment returns
- Monitor compliance with temporary period expectations for expenditure of bond proceeds
- Monitor compliance with 6-month, 18-month or 2-year spending exceptions to rebate, if relevant
- Arrange for timely computation of rebate liability and, if rebate is payable, for timely filing of Form 8038-T and rebate payment

Use of Bond Proceeds –
Private Activity Bonds

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- "Private business use" occurs when more than 5% of bond proceeds finance a public facility that is used by nongovernmental trade or business
  - for these purposes, federal government is a nongovernmental person
  - Use as a member of the general public is not private business use
  - Examples of private use:
    - Sale, transfer or lease of bond-financed property to private user
    - Granting special legal entitlements of use of bond-financed property to private user
    - Management of bond-financed property by private user under a management contract
- "Private payment or security" occurs when more than 5% of bond proceeds are secured by an interest or derived from payments related to a "private business use" in bond-financed property
  - Example of private payment:
    - Payments of lease rentals to the issuer by a private operator

Private Business Use Exceptions

- Certain exceptions to private business use
  - Short-term arrangements
    - 50 days/100 days/200 days, depending on how rates are charged, who is renting (individual or business)
  - Incidental uses
    - De minimis uses such as vending machines & kiosks
  - Management contracts that meet certain safe harbors
  - Research agreements that meet certain safe harbors

Private Activity Post-issuance Compliance Tips

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- Allocate bond proceeds and funds from other sources to ensure that bond proceeds are used for qualifying costs
- Map out what outstanding bond issue financed which facilities and in what amounts; Monitor private use of bond-financed facilities to ensure compliance with applicable percentage limitations
- Identify in advance any new sale, lease or license, management contract, or other arrangement involving private use
- Promptly consult with bond counsel as to any possible private use — remedial actions may need to be taken

Working Capital Borrowings

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- In addition to financing capital expenditures, tax-exempt bonds can be used to finance operating expenses, but ONLY if there are no other available amounts to finance these expenditures
- Tax law does not allow for the tax-exempt borrowing to increase a reasonable working capital reserve
- Requires detailed analysis of cash flows, deficit projections, historical reserve calculation
  - Calculations can be complicated
  - Many times, working capital borrowing are done on a taxable basis to avoid the calculations and monitoring required to issue working capital bonds on a tax-exempt basis
- Maturity Limitations
  - Maturity within 13 months from the issue date = safe harbor
  - Maturity between 13 months and 5 years of the issue date = must project the deficit the entire time bonds are outstanding (at least once every 13 months)

Record Retention

- In order to demonstrate tax compliance, Issuers must retain records related to:
  - investment of bond proceeds
    - purchase and sale of securities, SLGS subscriptions, yield calculations for each class of investments, rebate calculations
    - Account statements from bank, escrow agent or trustee
  - expenditure of proceeds
    - Description of expenditure (capital, operating expense)
    - Amount
    - Identity of payee
    - Invoice or billing statement
    - Payment date
  - use of bond-financed property by public and private sources
    - Leases and management contracts
  - sources of payment or security for the bonds

Record Retention (continued)

Generally, bond counsel recommends that material records should be kept as long as the bonds remain outstanding, plus 3 years after the final redemption date

- For a refunding issue, material records relating to the original new money bonds and material records related to the refunding issue should be maintained until 3 years after the final redemption of both bond issues
- General record keeping policy may need to be revised to reflect the bond record retention policy

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