Don’t mess with the IRS

Will You Be Ready When the IRS Comes Calling?

Tax-Exempt Bond Rules and Post-issuance Compliance
Presentation Outline

• Investment of Bond Proceeds -- Arbitrage Rebate
• Use of Bond Proceeds -- Private Use
• Working Capital Financings
Consequences of Non-compliance

• 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
Investment of Bond Proceeds – Arbitrage Rebate Rules

• **Arbitrage**: 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.

• **Rebate**: 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

• **Arbitrage Rebate**: 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

- 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

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<th>Period</th>
<th>Spend-down Requirement</th>
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<tbody>
<tr>
<td>6 months</td>
<td>15%</td>
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<tr>
<td>12 months</td>
<td>60%</td>
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<td>18 months</td>
<td>100%</td>
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Two-Year Construction Spend-down Exception

- At least 75% of the proceeds must be spent on construction expenditures

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<thead>
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<th>Period</th>
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<td>6 months</td>
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<tr>
<td>12 months</td>
<td>45%</td>
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<td>18 months</td>
<td>75%</td>
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<tr>
<td>24 months</td>
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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

• “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
• 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

• 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).
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**
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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