POST-ISSUANCE COMPLIANCE: HOW TO AVOID SEC AND IRS PROBLEMS

Illinois Community College Chief Financial Officers

October 17, 2013

Presented by:
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General Counsel
Learning Objectives

• Understand the current regulatory and enforcement climate encouraging the adoption of policies and procedures

• Learn the fundamentals of drafting and implementing effective policies

• Understand the benefit of adhering to adopted policies (and the dangers of ignoring them)

• Understand what questions you need to ask *before* closing.
POST-ISSUANCE SECURITIES LAW COMPLIANCE
Four Basic Tools:

1. SEC Rule 15c2-12 (the “Rule”)
2. The Official Statement
3. “CAFR”
4. The Continuing Disclosure Undertaking
SEC Rule 15c2-12 (the “Rule”)

Codified at 17 CFR Section 240.15c2-12

• Promulgated in 1989 and amended in 1995 to include continuing disclosure requirements

• Applies directly to “brokers, dealers, or municipal securities dealers”

• Indirectly affects issuers/borrowers by denying them access to the market unless the Rule’s requirements are satisfied
Applicability. Brokers, dealers and municipal securities dealers ("Participating Underwriters") involved in a primary offering of municipal securities in a principal amount greater than $1 million ("Offering") must comply with the requirements of Rule 15c2-12 or must be exempt from the requirements of Rule 15c2-12 before acting as an underwriter in such an Offering.
Obtain and review “deemed final” official statement (“DFOS”). The Participating Underwriter must obtain and review an official statement “deemed final” by an issuer of municipal securities (with certain permitted omissions) prior to bidding for, purchasing, offering or selling such municipal securities.
Determine that satisfactory continuing disclosure commitment has been made. Participating Underwriters must have reasonably determined that an issuer of municipal securities and/or an Obligated Person for whom financial or operating data is presented in the final official statement has undertaken in writing for the benefit of the bondholders to provide certain required information. Undertaking is often in the form of a Continuing Disclosure Agreement from all Obligated Persons and may be an agreement with a disseminating agent.

Obligated Person is defined by the Rule to be any person, including an issuer of municipal securities, who is either generally or through an enterprise fund or account of such person committed by contract or other arrangement to support payment of all or part of the obligations on the municipal securities in the Offering (other than bond insurers, letters of credit or liquidity providers).
SEC Rule 15c2-12 (cont’ d)

- **Scope of Required Information.** The information required to be disclosed to the market through the undertaking includes:
  1. certain annual financial information
  2. audited financial statements
  3. event notices
SEC Rule 15c2-12 (cont’d)

Annual financial information.

Annual financial information must be provided (X) for each Obligated Person for whom financial information is presented in the final official statement or (Y) for each Obligated Person meeting the objective criteria specified in the undertaking. Undertaking must identify these people.

*Annual financial information* is defined by the Rule to mean financial information or operating data, provided annually, of the type included in the final official statement with respect to the affected Obligated Person. Undertaking must specify in reasonable detail the type of financial information and operating data to be provided and specify the date on which the annual financial information for the preceding fiscal year will be delivered.

The Rule does not specify the reporting format or content of such annual report. Content is determined at time of preparing the final official statement and annual information must be of the same type. The final official statement serves as a baseline for continuing information.
SEC Rule 15c2-12 (cont’ d)

Audited financial statements.

If not otherwise submitted as part of the annual financial information, audited financial statements for each Obligated Person are required to be disseminated only when and if otherwise available.

The Release states that “it is anticipated that full financial statements will be provided for entities with ongoing revenues and operating expenses.”

The Rule does not mandate any specific use or either GAAP or GAAS. Undertaking must specify in reasonable detail the accounting principles to be used, and whether the financial statements will be audited.
Event notices

Effective December 1, 2010, the undertaking must require disclosure of the following fourteen events within 10 business days of the occurrence of the event:

1. Principal and interest payment delinquencies;
2. Non-payment related defaults, if material;
3. Unscheduled draws on debt service reserves reflecting financial difficulties;
4. Unscheduled draws on credit enhancements reflecting financial difficulties;
5. Substitution of credit or liquidity providers, or their failure to perform;
6. Adverse tax opinions, the issuance by the Internal Revenue Service of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701-TEB) or other material notices or determinations with respect to the tax status of the security, or other material events affecting the tax status of the security;
SEC Rule 15c2-12 (cont’d)

Events notices (cont’d).

7. Modifications to rights of security holders, if material;

8. Bond calls, if material, and tender offers;

9. Defeasances;

10. Release, substitution, or sale of property securing repayment of the securities, if material;

11. Rating changes;

12. Bankruptcy, insolvency, receivership or similar event of the obligated person;
Events notices (cont’d).

13. The consummation of a merger, consolidation, or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business, the entry into a definitive agreement to undertake such an action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms, if material; and

14. Appointment of a successor or additional trustee or the change of name of a trustee, if material.

The Rule also requires notice of a failure of any person to provide annual financial information as required by the undertaking.
“The term final official statement means a document or set of documents prepared by an issuer of municipal securities or its representatives that is complete as of the date delivered to the Participating Underwriter(s) and that sets forth information concerning the terms of the proposed issue of securities; information, including financial information or operating data, concerning such issuers of municipal securities and those other entities, enterprises, funds, accounts, and other persons material to an evaluation of the Offering; and a description of the undertakings to be provided…and of any instances in the previous five years in which each person specified…failed to comply, in all material respects, with any previous undertakings in a written contract or agreement…”

*Annual financial information* is defined by the Rule to mean financial information or operating data, provided annually, of the type included in the final official statement with respect to the affected Obligated Person.
The Official Statement will need to describe (a) the undertakings to be provided and (b) any instances in the previous five years in which there was a failure to comply, in all material respects, with any previous undertakings in a written contract or agreement.

If the CDU is a separate document, it will sometimes be included as an appendix.
Comprehensive Annual Financial Report

CAFRs generally contain the historic financial information and operating data included in an official statement.
Continuing Disclosure Undertaking

1. In writing, but does not need to be a separate document.

2. Rule Requirements: Undertaking must specify (a) in reasonable detail, the type of financial information and operating data to be provided, (b) in reasonable detail, the accounting principles to be used, and whether the financial statements will be audited, and (c) the date on which the annual financial information for the preceding fiscal year will be delivered.
Best Practices

1. Check the Annual Report due date.

2. Check the financial information and operating data requirements in the CDU against what is being provided in the CAFR and the OS.

3. Adopt and Implement Policies and Procedures
Written Policies and Procedures

1. Identify the individual(s) who will be responsible for speaking on behalf of the issuer and establish a protocol for such person(s) to approve all external communications.

2. Depending on the issuer’s size, consider creating a “Disclosure Working Group” or team (the “DG Team”).
Written Policies and Procedures (cont’d)

3.  Develop written policies and procedures addressing:

   a.  Annual Reports (identification of information required to be submitted per the CDU, the date(s) of submission of such information, etc.).

   b.  Event Notices (identification of person(s) responsible for monitoring events and, if there is a materiality requirement, the process for determining materiality).
Written Policies and Procedures (cont’d)

c. Voluntary Event Disclosure (identification of potential areas of investor interest and the person(s) responsible for monitoring such information.

d. Providing information required to be filed with other entities (e.g., rating agencies, etc.) or more frequently than annually

e. Monitoring issuer/obligated person “website” information.

f. Coordinating continuing disclosure with primary disclosure.

g. Identification of person(s) responsible for drafting/reviewing annual reports and/or notices.

h. Identification of person(s) responsible for making filings (with DAC, EMMA).
1. Create a template for each bond issue. This list should include bonds which are exempt from the Rule:

<table>
<thead>
<tr>
<th>Name of Issue/Principal Amount</th>
<th>Date of Issue</th>
<th>Final Maturity Date</th>
<th>CUSIP for Final Maturity</th>
<th>Trustee or Paying Agent</th>
<th>Date by which Annual Report Must Be Filed (or “exemption” under the Rule)</th>
</tr>
</thead>
<tbody>
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</tbody>
</table>
2. Maintain a template for “Annual Financial Information” for each bond issue subject to the Rule.

<table>
<thead>
<tr>
<th>Financial Information and Operating Data</th>
<th>Bonds for Which Information is Required</th>
<th>Source of Information</th>
<th>DG Team Member(s) Responsible for Drafting and/or Compiling</th>
<th>DG Team Member(s) Responsible for Reviewing</th>
<th>Date by which Information Must Be Filed</th>
<th>Date Information Was Filed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit/CAFR</td>
<td>All</td>
<td>Auditors</td>
<td></td>
<td></td>
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<tr>
<td>Budget for Current FY</td>
<td>All</td>
<td>Budget Office</td>
<td></td>
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</tr>
<tr>
<td>Five-Year Summary Update</td>
<td>All</td>
<td>Finance Director</td>
<td></td>
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</tr>
<tr>
<td>Rate Covenant Compliance</td>
<td>2008 Bonds</td>
<td>Utilities General Mgr.</td>
<td></td>
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<tr>
<td>Debt Information</td>
<td>All</td>
<td>Debt Office</td>
<td></td>
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</tbody>
</table>
3. **Event Notices:** For bonds (subject to the Rule) issued on or after December 1, 2010, the following events would need to be filed within ten (10) business days of their occurrence:

<table>
<thead>
<tr>
<th>Event</th>
<th>DG Team Member(s) Responsible for Monitoring</th>
<th>Date of Occurrence of Event</th>
<th>DG Team Member(s) Responsible for Determining Materiality (if required)</th>
<th>DG Team Member(s) Responsible for Drafting Notice</th>
<th>Date Event Notice Was Filed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal and interest payment delinquencies</td>
<td></td>
<td></td>
<td>n/a</td>
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<td></td>
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<tr>
<td>Non-payment related defaults, if material</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Unscheduled draws on debt service reserves reflecting financial difficulty</td>
<td></td>
<td></td>
<td>n/a</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unscheduled draws on credit enhancements reflecting financial difficulty</td>
<td></td>
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<td></td>
<td></td>
<td>n/a</td>
</tr>
</tbody>
</table>
### Written Policies and Procedures (cont’d)

<table>
<thead>
<tr>
<th>Event Description</th>
<th>n/a</th>
</tr>
</thead>
<tbody>
<tr>
<td>Substitution of credit or liquidity providers, or their failure to perform</td>
<td>n/a</td>
</tr>
<tr>
<td>Adverse tax opinions, the issuance by the IRS of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701 TEB) or other material notices of determination with respect to the tax status of the security or other material events affecting the tax status of the security</td>
<td>n/a (for adverse tax opinions and the issuance by the IRS of proposed or final determinations of taxability)</td>
</tr>
<tr>
<td>Modifications to rights of security holders, if material</td>
<td></td>
</tr>
<tr>
<td>Bond calls, if material, and tender offers</td>
<td>n/a (for tender offers)</td>
</tr>
<tr>
<td>Defeasances</td>
<td>n/a</td>
</tr>
</tbody>
</table>
Written Policies and Procedures (cont’d)

<table>
<thead>
<tr>
<th>Release, substitution, or sale of property securing repayment of the securities, if material</th>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Rating changes</td>
<td></td>
<td></td>
<td></td>
<td>n/a</td>
</tr>
</tbody>
</table>

24
<table>
<thead>
<tr>
<th>Bankruptcy, insolvency, receivership or similar event of the obligated person</th>
<th></th>
<th>n/a</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>The consummation of a merger, consolidation, or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business, the entry into a definitive agreement to undertake such an action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms, if material</td>
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<tr>
<td>Appointment of a successor or additional trustee or the change of name of a trustee, if material</td>
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<tr>
<td>Failure to provide in a timely manner notice to provide required annual financial information by the date specified in the DDAA/CDA</td>
<td></td>
<td>n/a</td>
<td></td>
</tr>
</tbody>
</table>
For bonds (subject to the Rule) issued prior to December 1, 2010 (and the issuer/obligated person is not also subject to a CDU for post November 30, 2010 bonds), the following events, if determined to be material would need to be filed “in a timely manner”:

<table>
<thead>
<tr>
<th>Event</th>
<th>DG Team Member(s) Responsible for Monitoring</th>
<th>Date of Occurrence of Event</th>
<th>DG Team Member(s) Responsible for Determining Materiality</th>
<th>DG Team Member(s) Responsible for Drafting Notice</th>
<th>Date Event Notice Was Filed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal and interest payment delinquencies</td>
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<tr>
<td>Non-payment related defaults</td>
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<tr>
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<tr>
<td>Unscheduled draws on credit enhancements reflecting financial difficulty</td>
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<tr>
<td>Written Policies and Procedures (cont’d)</td>
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<td>----------------------------------------</td>
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<tr>
<td>Substitution of credit or liquidity providers, or their failure to perform</td>
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<tr>
<td>Adverse tax opinions, or events affecting the tax-exempt status of the security</td>
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<tr>
<td>Modifications to rights of security holders</td>
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<tr>
<td>Bond calls</td>
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<tr>
<td>Defeasances</td>
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<tr>
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<tr>
<td>Rating changes</td>
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<tr>
<td>Failure to provide in a timely manner notice to provide required annual financial information by the date specified in the DDAA</td>
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</tbody>
</table>
Written Policies and Procedures (cont’d)

4. Voluntary Disclosure

   a. In addition to preparing Annual Reports and Event Notice, the DG Team may wish to keep investors informed by providing information that is not required to be provided under the DDAA. Examples of such types of information are investments, interim financial information, capital improvement plans, fund balance policies, etc.

   b. Because providing this information is voluntary, the DG Team must constantly monitor and seek out events which may impact the issuer or obligated person, and then bring these events to the DG Team’s collective attention so that a determination can be made if the event should be disclosed.

   c. For example, if there is a news report that the community’s largest employer (and/or taxpayer, utility system rate payer, etc.) is reducing employment, the DG Team may want to assess the impact on enrollment, etc.
Written Policies and Procedures (cont’d)

d. Also, if the issuer/obligated person maintains an ”Investor Relations” website, or routinely posts Board agenda packages, including interim financial information, capital improvement plans, etc. on its website, the DG Team must check and, in some cases, “reissue” the posted material with an explanatory note (e.g., the interim financial information is presented on a cash, as opposed to accrual basis).

The following template could be used as a starting point:

<table>
<thead>
<tr>
<th>Information</th>
<th>Source</th>
<th>DG Team Responsible for Monitoring</th>
<th>Date Information was Identified</th>
<th>Date Information was Reviewed by DG Team</th>
<th>Date Information was Disclosed or Determined not to be Disclosed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interim Financials</td>
<td>Board package</td>
<td>Finance Director</td>
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<tr>
<td>Pension Report</td>
<td>Consultant</td>
<td>Finance Director</td>
<td></td>
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</tr>
<tr>
<td>New Industry</td>
<td>Development Council</td>
<td>Economic Development Office</td>
<td></td>
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</tr>
<tr>
<td>Changes in GASB Reporting Requirements</td>
<td>GASB</td>
<td>Finance Director</td>
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</tr>
</tbody>
</table>
Written Policies and Procedures (cont’d)

5. Third Party Information/Quarterly Disclosure Requirements
   a. Often, an issuer or borrower is required to file interim financial information or “no-default” certificates with third parties (e.g., bond insurers, credit enhancers, trustees). These filing requirements are generally not addressed by the CDU.
   b. Consider creating the following template:

<table>
<thead>
<tr>
<th>Financial Information and Operating Data</th>
<th>Bonds for Which Information is Required</th>
<th>Source of Information</th>
<th>DG Team Member(s) Responsible for Drafting and/or Compiling</th>
<th>DG Team Member(s) Responsible for Reviewing</th>
<th>Date by which Information Must Be Filed</th>
<th>Date Information Was Filed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quarterly Financial Statements</td>
<td>2008 Bonds</td>
<td>Budget Office</td>
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<tr>
<td>Budget Amendments</td>
<td>All</td>
<td>Budget Office</td>
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</tr>
<tr>
<td>Issuance of Additional Bonds</td>
<td>All</td>
<td>Finance Director</td>
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</tbody>
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Post-Issuance Tax Compliance
Post-issuance tax compliance means adherence with the numerous federal tax rules imposed on tax-exempt/advantaged bonds, including:

- Limitations on the use of bond proceeds and bond-financed property
- Reporting requirements
- Arbitrage rebate monitoring and payment requirements
- Bond proceeds investment restrictions
- Record retention requirements

Increasingly, the IRS is asking borrowers whether they have written policies and procedures designed to ensure compliance with federal tax law.
Why the Federal Government Cares

- Tax-exempt bonds are a drain on the U.S. Treasury. The Government Accounting Office estimates the Treasury loses approximately $37,000,000,000/year in federal tax revenue as a result of tax-exempt bonds.

- Perception is that compliance in certain sectors of the market is low, resulting in improper loss of federal revenues.

- We are learning that borrowers are not adhering to the level of monitoring expected by the IRS.
IRSI Enforcement

Audits, correspondence exams and compliance initiatives are on the rise.

- By the numbers:
  - 200 compliance questionnaires to 501(c)(3) organizations in 2007
  - 200 compliance questionnaires to “governmentals” in 2008
  - In FY 2009, the IRS closed 581 audits of tax-exempt bonds
  - In FY 2010, the IRS closed 1560 audits of tax-exempt bonds
  - In FY 2011, the IRS closed 1481 audits of tax-exempt bonds
  - In FY 2011, the IRS initiated 453 compliance checks
  - In FY 2011, the IRS entered into 46 closing agreements with borrowers

- Governmental bonds are generally considered “low” risk for noncompliance with federal tax law, although governmental hospital financings are treated as “medium” risk and governmental advance refundings are viewed as “high” risk.
IRS Enforcement (cont’d)

- All 501(c)(3) bonds are considered “high” risk for noncompliance.

- Form 8038-G and 8038, filed in connection with the issuance of governmental and 501(c)(3) bonds now require the issuer to check a box indicating whether the issuer has written post-issuance policies in place to ensure compliance with certain federal tax law requirements.

- Schedule K to IRS Form 990 now requires 501(c)(3) borrowers to provide information related to their outstanding tax-exempt bonds, including, in some circumstances, the amount of private use to the tenth of a percent (0.1%).
The Road to Taxable Bonds
Taxable Bonds – An Example

Bonds issued in the amount of $30 million in 2004 to finance an office building. In 2010, the IRS audits the deal and concludes that one of the borrower’s arrangements is not compliant with the federal tax rules. This arrangement results in private business use in excess of permitted limits.

Step 1: IRS attempts to negotiate settlement with borrower, often starting with “taxpayer exposure” on the bonds

Step 2: If parties can’t agree, IRS declares the bonds taxable

Step 3: IRS begins taxing bondholders (defaults, lawsuits, etc.)
No Borrower Wants to Get to Step 2

Having bonds declared taxable is very rare, as most borrowers will do whatever they practically can to avoid getting to that point.

- Lawsuits between borrower and bondholders, underwriter and bondholders, etc.
- Other federal investigations (e.g., IRS, SEC)
- Loss of market confidence in borrower
- Potential credit rating issues
IRS calculates “taxpayer exposure” as the amount it estimates holders of the bonds would have paid in federal income tax were interest on the bonds taxable. For these purposes, the IRS assumes a tax rate of 29%, and can generally go back up to 3 years in accordance with the statute of limitations. In addition, the IRS may seek similar payments for the period should the bonds remain outstanding.

$30 million bond issue at 5% interest. In 2010, bonds declared taxable.

- $1,500,000 in interest annually
- $1,500,000 x 29% = $435,000 (2010)
- $1,500,000 x 29% = $435,000 (for each of 2007-2009)

If the bonds can’t be taken off the market, the IRS will want to be made whole for future years, too.
What is the IRS Looking For?

- Historically, the IRS has focused audits and compliance initiatives on arbitrage-related matters (e.g., did the borrower invest the bond proceeds as required by law and did anyone divert arbitrage away from the IRS?) and the initial issuance of the tax-exempt bonds.

- Increasingly, the question is becoming one of whether a borrower is continuing to comply with the representations and covenants it made in connection with the issuance of the bonds, including:
  - Limitations on the use of bond proceeds and bond-financed property
  - Reporting requirements
  - Arbitrage rebate monitoring and payment requirements
  - Bond proceeds investment restrictions
  - Record retention requirements
What Should You Be Doing?
Borrowers should review and understand the documentation they are being asked to sign. Almost universally, the borrower is making covenants that will run for the life of the bonds.
Track Third-Party Use

Governmental bonds are subject to a 10% private use standard. 501(c)(3) bonds are subject to a 5% private use standard, treating costs of issuance as part of the 5% private use. Private use may arise from:

- sale of financed facilities
- leases
- management contracts
- research contracts
- naming rights contracts
- other use arrangements
Retain Records

In general, borrowers are required to keep records related to a tax exempt bond financing until at least 3 years after the date the last bond of the issue is retired.

This includes:

• Financing documents (Resolution, Indenture, Tax Certificate, Loan Agreement, etc.)

• Records related to the expenditure of bond proceeds

• Investment records (e.g., trustee statements)

• Records substantiating that the use of the project is within statutory/regulatory guidelines

In the case of a “refunding,” the record retention requirement applies back to the date of the issuance of the first tax-exempt financing.
Many of the federal tax requirements related to tax-exempt bonds, and those most frequently reviewed on audit by the IRS, involve the expenditure of bond proceeds. Borrowers should be able to track:

- Bond proceeds to funds/accounts established for the financing;
- Bond proceeds to project expenditures;
- Investments acquired with bond proceeds, including the yield on such investments; and
- Any arbitrage rebate liability associated with a bond issue.
Assign Responsibility for Review and Undertake Periodic Reviews

Compliance with the federal tax rules should be assigned to one or more individuals (or departments) and the borrower should routinely review its outstanding financings to ensure compliance.
Adopt Written Policies and Procedures

• The IRS has made clear that it expects borrowers to have written policies and procedures in place that serve as a guide to establish compliance with the federal tax rules applicable to tax-exempt bonds.

• These policies and procedures should outline the federal tax law requirements and provide details as to how such requirements will be satisfied.

• The IRS has expressed concern over how few borrowers reported that they have post-issuance tax compliance policies and procedures in place.

• Policies and procedures means more than the Tax Certificate
Questions From IRS Questionnaires

Do you have written procedures to ensure that your financings remain in compliance with federal tax law requirements related to (and, if so, specify the date of implementation):

- proper use of bond proceeds?
- timely expenditure of bond proceeds?
- documenting compliance with other general requirements?
Questions From the IRS Questionnaires (cont’d)

- Who is primarily responsible for monitoring post-issuance compliance?
- Do you provide training or educational resources to personnel that are responsible for ensuring compliance?
- How long do you maintain your records necessary to support the tax-exempt status of your bonds?
- Do you maintain records of trade or business activities by or with non-governmental entities or persons with respect to your bond-financed facilities?
Where do Borrowers Fall Short?

- Not reviewing their Tax Documents at closing
- Lack of ability to track bond proceeds to projects, including investment earnings
- Record keeping, including relying on third parties (e.g., trustees) for record keeping