Bond Case Briefs

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Developing and Implementing Procedures for Post-Issuance Tax Compliance for Issuers of Governmental Bonds.

Introduction

State and local government issuers of tax-exempt bonds must comply with federal tax rules both at the time the bonds are issued and during the entire period the bonds are outstanding in order for the bonds to maintain tax-exempt status.1 For the last decade, the Internal Revenue Service (IRS) has engaged in extensive enforcement of these rules for tax-exempt bonds through a variety of activities including random audits. If an issuer fails to meet applicable federal tax rules, the IRS can declare the interest on the bonds to be taxable, although the IRS has not frequently done so.2 In connection with these enforcement efforts, the IRS has encouraged issuers to develop post-issuance compliance policies and procedures to help detect and correct potential violations of federal tax law on a timely basis.

The National Association of Bond Lawyers (NABL) released together with this GFOA Alert a white paper entitled "Considerations For Developing Post-Issuance Tax Compliance Procedures" (the "NABL Considerations"), which presents an in-depth discussion of post-issuance tax compliance and the applicable tax requirements that must be satisfied. This Alert provides a general overview of post-issuance tax compliance and highlights points that may be discussed in greater detail in the NABL Considerations or other publications.3 The Alert focuses on compliance for "governmental bonds," (i.e., bonds issued for governmental use and purposes) but can be helpful for complying with qualified 501(c)(3) or other types of private activity bonds.

What is Post-Issuance Compliance?

Post-issuance compliance consists of practices and procedures designed to assist an issuer of governmental bonds in complying with the federal tax requirements that apply from the date the bonds are issued until the date the bonds, or any refunding bonds, are no longer outstanding. The substantive rules can be categorized as: (a) arbitrage and rebate; and (b) use of bond proceeds and of bond financed facilities. Compliance with these rules must be documented by records that meet IRS requirements.

Why Implement Post-Issuance Compliance?

The IRS has encouraged issuers to adopt post-issuance compliance procedures in order to assist in preventing, identifying and correcting possible tax violations that may occur during the term that tax-exempt bonds are outstanding. These procedures help an issuer prevent or correct violations so the IRS does not have a reason to either declare the bonds taxable or negotiate a settlement. The IRS Forms 8038 that must be filed when bonds are issued ask whether the issuer had written procedures and the IRS previously offered issuers with written procedures the possibility of a lower settlement amount in connection tax violations discovered by the issuer for which the issuer sought a closing agreement pursuant to the IRS's Voluntary Closing Agreement Program (VCAP). More recently, the IRS is offering a lower settlement amount if the issuer has "effective" procedures (whether or not written).4 Procedures may also prove helpful in providing information and documentation in the event that the IRS audits an issue. See "Why are Post-Issuance Tax Compliance Procedures Important" in the NABL Considerations.

What Rules Need To Be Monitored?

For governmental bonds, i.e., bonds issued by state and local governments to finance public purpose projects, in the broadest terms, the tax requirements can be grouped into two categories: (a) arbitrage and rebate; and (b) use of bond proceeds and of bond-financed facilities. Each of these categories involve many rules that make it advisable for an issuer to adopt practices that track how bond proceeds are invested and how and when bond proceeds are spent.

Arbitrage and Rebate

Federal tax law and regulations restrict the amount of "arbitrage" an issuer can earn and retain from investing proceeds of a tax-exempt bond.5 As applied to tax-exempt bonds, "arbitrage" generally refers to the profit earned from taxable investments purchased with proceeds of bonds bearing interest at tax-exempt rates. There are two main categories of requirements – yield restriction and rebate. If ***either*** the yield restriction requirements ***or*** the rebate requirements are not satisfied, tax-exempt bonds become "arbitrage bonds" and lose their tax-exempt status.*6*

Yield Restriction

The general rule of "yield restriction" is that bond proceeds may not be invested at a "materially higher" yield than the yield on the bonds.7 Exceptions to this rule apply during "temporary periods" such as the 3-year temporary period that is available for proceeds that an issuer expects to spend on construction or acquisition of capital projects under certain circumstances.8 Additional exceptions including other temporary periods of varying length may apply.9 If there is no exception or a temporary period ends and proceeds remain unspent, either the investments must be yield restricted or a "yield reduction payment" must be made to the federal government.

Rebate

The general rule is that any actual earnings in excess of the yield on the bonds must be paid as "rebate" to the federal government. There are a number of possible exceptions including the $5,000,000 "small issuer" exception for issuers with general taxing powers who do not issue more than $5,000,000 in bonds during a calendar year, and limited exceptions for earnings on a reasonably required debt service reserve fund and on a bona fide debt service fund. There is also an exception for tax and revenue anticipation notes, for proceeds invested in other tax-exempt obligations and exceptions that apply if proceeds are spent within 6-months, 18-months or 2 years for construction.10 Rebate, if any, is due every 5 years or when bonds are paid off, either at maturity or redemption. If there is no rebate exception, it is necessary to determine whether any rebate is due. The calculation depends on a number of factors including whether the bonds are fixed or variable rate and whether there are any hedges (e.g., interest rate swaps) that must be taken into account.

To comply with both the yield restriction and rebate rules an issuer needs to have procedures that identify the type of, and return on, investments made with bond proceeds and when proceeds are spent.

Use of Proceeds and of Bond-Financed Facilities

The general rule for governmental bonds is that no more than 10% of bond proceeds may be used in a private business use and no more than 10% of debt service on the bonds may be paid or secured by payments arising from or related to private business use. The 10% limit is reduced to 5% in the case of unrelated private business use or related business use which is disproportionate. No more than 5% of bond proceeds may be used for and no more than 5% of debt service on the bonds may be paid or secured by payments in respect of, unrelated private business use or disproportionate related business use. In addition, with certain exceptions, no more than the lesser of 5% of bond proceeds or $5,000,000 may be used to finance direct or indirect loans to non-governmental persons.11

To monitor compliance with this requirement, an issuer needs to have procedures to identify who is a private "nonqualified user" and what constitutes private business use. For governmental bonds, any user other than a state or local government is a "nonqualified user". This means that individuals, for-profit entities, non-profits including section 501(c)(3) organizations and the federal government are "nonqualified users," and use by users in any of these categories must be analyzed to determine whether it is "private business use". Use in the trade or business of any non-qualified user is "private business use". Use by the general public is not typically business use. "Private business use" can be created by a lease or license of a bond financed facility. It can also be created through a management or service contract between the issuer (or other qualified user) and a non-qualified user on terms that do not meet a safe-harbor recognized by the IRS12 that gives the non-qualified user a share in the net profits from the use of the facility. Research agreements or special arrangements that give a non-qualified user priority or a benefit not available to the general public may also create private business use.

When are Procedures Effective?

To be effective, procedures should address the substantive issues necessary to assure tax and other legal and contractual compliance. Procedures should also be implementable, manageable, and diligently followed by the issuer. The design and implementation should take into account the issuer's size, organizational structure, frequency of bond issuance and budget/staffing resources.

If implemented properly, the following elements should assist an issuer with effective oversight of tax rules relating to tax-exempt bonds: (1) identify the individual or individuals responsible for coordinating activities; (2) provide for due diligence review at regular intervals; (3) facilitate training for responsible individuals; (4) describe retention of adequate records to substantiate compliance; (5) accommodate review that identifies areas that are most susceptible to noncompliance; and (6) include procedures to correct identified noncompliance in a timely manner.

Designing a Post-Issuance Compliance Program

General Considerations

A post-issuance compliance program should reflect an issuer's size, resources and borrowing pattern. An issuer may decide to handle compliance in-house or to engage bond counsel or other third-party provider for some or all compliance activities including arbitrage, rebate and monitoring of private business use and payments. In either case, the post-issuance compliance program should have the following elements. The following is a summary of the considerations for designing a post-issuance compliance program. More detail is provided under the heading "Characteristics of Effective Procedures" in the NABL Considerations.

Responsible Staff Should Be Assigned

Whether an issuer will conduct compliance in-house or will engage providers, a "chief compliance officer" with overall responsibility for implementation of the program should be assigned. In a large organization, there may be staff in addition to the chief compliance officer that can be assigned specific responsibilities or the chief compliance officer can have authority to delegate where appropriate. If third-party providers will be engaged to perform some or all of the activities, the program should specify how the providers will be engaged and monitored. The chief compliance officer or officers should be designated by job title rather than name to assure continuity.

Identify the Source of the Tax Requirements Being Monitored

It will be helpful to identify the documents that set forth the tax requirements being monitored so that the compliance officer(s) can find details if necessary.

Identify the Frequency of the Actions to Be Undertaken

The IRS has recommended at least an annual review as a general matter. However, it may be advisable to provide for a review when specific events occur, such as renewal of management contracts, or other events that may result in private business use. A program should also provide for a final allocation of bond proceeds as required by tax regulations.13

Establish a Deadline Reminder System

Where deadlines exist, a reminder system should be established and a back-up reminder is helpful in avoiding an oversight. Examples of deadlines include ending of temporary periods for yield restriction and deadlines for meeting spend down exceptions for rebate compliance, paying rebate if applicable, and making final allocations.

Identify Records to be Maintained and the Record Retention Period

Records necessary to assure and document compliance should be maintained for the required time periods. The issuer should list the records being maintained and where or by whom. Tax records must be maintained until full payment of the bonds and any refunding bonds plus three years. In addition, state or local record retention requirements need to be considered. In some cases, an issuer may need to seek approval for changes in its record retention policy in order to keep tax or other records for periods longer than otherwise permitted under state law.

Specific to tax-exemption compliance, the following records should be maintained.

1. The bond transcript for each bond issue (which includes among other documents, the trust indenture, loan, lease, or other financing agreement, the relevant IRS Form 8038 (including Forms 8038-G or 8038, as applicable) with proof of filing, the bond counsel opinion and the tax agreement including all attachments, exhibits and any verification report).
2. Records of debt service payments for each issue of bonds.
3. Documentation evidencing the expenditure of bond proceeds, such as construction or contractor invoices and receipts for equipment and furnishings, bond trustee requisitions and project completion certificates, as well as records of any special allocations made for tax purposes including post-issuance changes in allocations.
4. Documentation evidencing the lease or use of bond-financed property by public and private sources, including, but not limited to, service, vendor, and management contracts, research agreements, licenses to use bond-financed property, or naming rights agreements.
5. Documentation pertaining to investment of bond proceeds, including the yield calculations for each class of investments, actual investment income received from the investment of proceeds, investment agreements, payments made pursuant to investment agreements and rebate calculations and copies of any 8038-T or 8038-R filed with respect to the bonds.

6. Documentation pertaining to remedial action and other change-of-use records.
7. Amendments and other changes to the bond Documents (including interest rate conversions and defeasances).
8. Letters of credit and other guarantees for bond issues.
9. Interest rate swaps and other derivatives that are related to bond issues.

Require Training for Responsible Officers

Periodic training for compliance officers should be identified and documented. The issuer should also determine whether the training can be done in-house or whether third-party conferences, courses or providers are appropriate.

Describe Procedures to Identify and Correct Violations

The policy should describe the review process to assure compliance and describe what actions will be taken to correct any non-compliance. Corrective strategies may require engaging counsel or third-party advisors to assist in the remedial action.

Address Other Substantive Issues for Tax-Advantaged Bond Compliance

The policy should also consider other substantive matters that should be included in a post-issuance compliance program for tax-advantaged bonds such as yield restriction, rebate and tracking possible private business use.

How Should A Post-Issuance Program Be Adopted and Reflected?

An issuer's post-issuance compliance procedures can be included in its general debt management policies or be stated separately. Procedures may be adopted by formal action of the issuer's governing board or be developed independently by management.

Conclusion

GFOA recommends that state and local governments adopt comprehensive written debt management policies, in so doing, the GFOA and NABL work together to provide tools for the state and local government to use in managing these policies, such as the Post Issuance Compliance Checklist. This Alert provides a general overview of the NABL white paper "*Considerations for Developing Post-Issuance Tax Compliance Procedures*" and in so doing, this Alert brings additional awareness to post-issuance tax compliance for issuers within the parameters of federal tax rules. Compliance with federal tax rules both at the time a state or local government issues bonds and during the entire period the bonds are outstanding is necessary in order for the bonds to maintain their tax-exempt status is enforced through current federal tax rules.

Footnotes

1. State and local governments may also issue tax-credit and taxable direct-pay bonds that must satisfy federal tax rules on a continuing basis to retain tax-advantaged status. References herein to tax-exempt bonds also refer to tax-advantaged bonds.
2. If bonds are declared taxable, the tax must be collected from bondholders. The IRS has chosen in most instances to negotiate settlements with the issuers.
3. This Alert together with the NABL Considerations updates information about this topic previously provided through the joint publication with the National Association of Bond Lawyers (NABL) in 2007 of the NABL/GFOA Post-Issuance Compliance Checklist (the "Checklist") and in GFOA's best practices for debt management policies released in 2012. The debt management

policies best practices publication is [available online](#).

4. See Internal Revenue Manual ("IRM") 7.2.3.4.4 relating to the IRS's Voluntary Closing Agreement Program (VCAP), which was released in September 2015. This IRM states: "Under this revision of the IRM, post issuance compliance procedures are not required to be in any other pre-specified format. To obtain a TEB VCAP, however, an issuer is required to provide evidence that it has implemented a change to its procedures that is reasonably expected to prevent the same type of violation from happening in any of its bond issues. This change to the procedures is being made to allow issuers to develop their own best practices for post-issuance compliance procedures and to measure the benefit of those procedures by their effectiveness, that is, whether they enable the issuer to capture a violation quickly. TEB continues to strongly encourage issuers to have post-issuance compliance procedures that effectively monitor compliance with all of the IRC and Regulations requirements applicable to the bonds." (Emphasis added).
5. Internal Revenue Code §148 and regulations thereunder.
6. See "Tax Exempt Bonds: A Roadmap to Arbitrage Requirements for Tax-Exempt Governmental Bonds and Qualified Section 501(c)(3) Bonds of Smaller Issuers and Conduit Borrowers", 2013 Report of the Advisory Committee to Tax-Exempt and Governmental Entities (referred to herein as "Twelfth ACT Report").
7. For "new money" bonds, as a general rule, "materially higher" means 1/8 of 1% and for advance refunding bonds, "materially higher" is 1/1000 of 1%. Treas. Reg. §§1.148-2(d)(2)(i) and (ii).
8. This exception applies if, at the time of bond issuance, the issuer reasonably expects to become obligated to spend at least 5% of bond proceeds within 6 months, to allocate at least 85% of proceeds on the financed project within 3 years and to complete the project with due diligence. Treas. Reg. §1.148-2(e)(2)(i)(A)(B) and (C).
9. Temporary period exceptions of varying lengths are also available for bona fide debt service funds, investment proceeds, working capital and refundings. See Treas. Reg. §1.148 -2 (2 and 1.148-9 (d). In addition, there are exceptions for a reasonably required debt service reserve fund and a "minor portion" of the lesser of $100,000 or 5% and for investments in other tax-exempt obligations. Treas. Reg. §1.148-2(d)(2)(v), (f) and (g).
10. See "Exceptions to Rebate", Section VC of the Twelfth ACT Report, supra for a discussion of the exceptions to rebate.
11. Issuers should consult bond counsel for detailed information about the rules that apply to private business use and payments in respect of private business use.
12. Rev. Proc. 97-13 as modified by Rev. Proc. 2001-39 and as amplified by Notice 2014-67, and Rev. Proc. 97-14 as modified by 2007-47 provide safe harbors against "private business use" for management contracts and research agreements
13. Treas. Reg. §1.148-6(d) requires that expenditures be allocated to bond proceeds no later than 18 months after the later of the date the expenditure is made or the project is placed in service and in no event later than 60 days after the 5th anniversary of the date the bonds are issued or retired, if earlier.