Tax Exempt Bonds Questionnaire Project: Final Report on Governmental and Charitable Financings

July 1, 2011

II - Post-Issuance Compliance for Tax-Exempt Bonds

Current Law

Tax-exempt bonds are valid debt obligations of state and local governments, commonly referred to as "issuers." Section 103 of the Code generally excludes the interest paid on these obligations from taxable income. This means that the interest paid to bondholders is not includable in their gross income for federal income tax purposes. This tax-exempt status remains throughout the life of the bonds provided all applicable federal tax laws are satisfied. Various requirements apply under the Code and Income Tax Regulations (the "Treasury Regulations") including, but not limited to, information filing and other requirements related to issuance, the proper and timely use of bond-financed property, and arbitrage yield restriction and rebate requirements. The benefits of tax-exempt financing can apply to the many different types of municipal debt financing arrangements through which government issuers obligate themselves, including bonds, notes, loans, lease purchase contracts, lines of credit, and commercial paper.

Governmental bonds are tax-exempt bonds issued by a State or a political subdivision of a State that are not private activity bonds and meet various requirements applicable to all tax-exempt bonds.[1] The District of Columbia and any possession of the United States qualify as "States" for purposes of § 103. State and local government bonds are private activity bonds if they meet either: (1) *both* the private business use test of § 141(b)(1) and the private security or private payment test of § 141(b)(2), or (2) the private loan financing test of § 141(c). Generally, the private business use test and the private security or payment test are met if more than 10% of the proceeds of the bond issue are used in a private business (including use by the federal government) and more than 10% of the debt service on the bonds is secured by an interest in property "used in a private trade or business" or derived from payments with respect to such property.[2] Bonds meet the private loan financing test if more than the lesser of $5,000,000 or 5% of the proceeds of the bonds are used to make loans to any persons other than state and local government units. Finally, under § 141(d), bonds are treated as private activity bonds if more than the lesser of $5,000,000 or 5% of the proceeds of the bonds are used to

[1] §§ 103 and 141 through 150, and related Treasury Regulations.
[2] In certain situations, more limited use of or security or payment for bonds will cause the bonds to be private activity bonds, such as in the case of disproportionate use of property and in the case of certain output facilities.

acquire output property that prior to the acquisition was used by, or held for use by, nongovernment persons.

Qualified 501(c)(3) bonds are tax-exempt qualified private activity bonds issued by a state or local government, the proceeds of which are used by a § 501(c)(3) organization in furtherance of its exempt purpose.[3] Generally, in order to qualify for recognition of exemption under § 501(a) of the Code as an organization described in § 501(c)(3), an organization must be organized and operated exclusively for educational, religious, or charitable purposes, and no part of the organization's net earnings may inure to or for the benefit of any private shareholders or individuals.[4] Typical § 501(c)(3) organizations that benefit from tax-exempt bond financing include hospitals, universities, and organizations that provide low-income housing or assisted living facilities.

The post-issuance related federal tax rules applicable to qualified 501(c)(3) bonds and governmental bonds generally fall into two basic categories: qualified use of proceeds and financed property requirements,[5] and arbitrage yield restriction and rebate requirements.[6] In order to comply with these and any other applicable requirements, issuers of governmental bonds and qualified 501(c)(3) bonds, as well as the § 501(c)(3) organizations borrowing bond proceeds, must ensure that the rules are met both at the time that the bonds are issued and throughout the term of the bonds ("post-issuance tax law compliance"). The IRS encourages issuers and beneficiaries of tax-exempt bonds to implement procedures that will adequately enable them to safeguard against post-issuance violations that result in loss of the tax-exempt status of their bonds.[7]

Governmental bonds lose their tax-exempt qualified status if at any time *both* the private business use test[8] and the private payment or security tests[9] are satisfied. Certain uses of proceeds of a governmental bond issue can result in private business use, including unrelated or disproportionate use[10] as a result of the private use by parties other than a State or local government.

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[3] § 145(a).
[4] § 501(c)(3).
[5] §§ 103 and 141, and related Treasury Regulations; and § 145(a) through (d) and Treas. Reg. §§ 1.145-1 and 1.145-2.
[6] § 148 and related Treasury Regulations.
[7] IRS Publication 4077, *Tax Exempt Bonds for 501(c)(3) Charitable Organizations Compliance Guide;* IRS Publication 4079, *Tax Exempt Governmental Bonds Compliance Guide*.
[8] **Private Business Use Test —** Section 141(b)(1) of the Code provides that this test is satisfied if more than 10% of the proceeds of the governmental bond issue is used for any private business use.
[9] **Private Payment or Security Test—** Section 141(b)(2) of the Code provides that this test is satisfied if more than 10% of the payment of principal or interest on the bond issue is either made or secured (directly or indirectly) by payments or property used, or to be used, for a private business use.
[10] **Unrelated or Disproportionate Use —**Section 141(b)(3) of the Code provides that a bond issue meets the private business tests if the amount of private business use and private security or payments attributable to unrelated or disproportionate private business use exceeds 5 percent of the proceeds of the issue.

Section 145(a) of the Code requires that proceeds of a qualified 501(c)(3) bond be used to finance property owned by either a § 501(c)(3) organization or a governmental unit. The term "501(c)(3) organization" is defined for this purpose as any organization described in § 501(c)(3) and exempt from tax under § 501(a).[11]

Qualified 501(c)(3) bonds lose their tax-exempt qualified status if at any time either: 1) the ownership test[12] is not satisfied; or 2) *both* the modified private business use test[13] and the modified private payment or security tests[14] are satisfied. If a § 501(c)(3) organization borrows proceeds of a qualified 501(c)(3) bond issue, the borrower must maintain its exempt status throughout the term of the bonds in order for the bonds to continue to remain qualified.[15]

Certain uses of proceeds of a qualified 501(c)(3) bond issue can result in private business use, including unrelated trade or business use[16] by the § 501(c)(3) organization borrowing the proceeds or private use by parties other than the borrower.[17]

Treasury Regulations provide for certain remedial actions to cure uses of proceeds that would otherwise cause qualified governmental bonds or qualified 501(c)(3) bonds to lose their exempt status.[18] Such remedial actions can include redemption or defeasance of nonqualified bonds, alternative qualified use of disposition proceeds, or alternative use of the bond-financed facilities. Issuers of governmental bonds and qualified 501(c)(3) bonds and other private activity bonds may also be eligible to enter into a closing agreement under the Tax Exempt Bonds Voluntary Closing Agreement Program.[19]

The § 501(c)(3) organization borrowing the proceeds of a qualified 501(c)(3) bond issue must allocate those proceeds among the various project expenditures in a

[11] § 150(a)(4).
[12] **Ownership Test —** Section 145(a)(1) of the Code provides that all property financed by the net proceeds of a qualified 501(c)(3) bond issue must be owned by either a § 501(c)(3) organization or a governmental entity.
[13] **Private Business Use Test —** Section 141(b)(1) of the Code, as modified by § 145(a)(2)(B), provides that this test is satisfied if more than 5% of the net proceeds of the qualified 501(c)(3) bond issue is used for any private business use.
[14] **Private Payment or Security Test —** Section 141(b)(2) of the Code, as modified by § 145(a)(2)(B), provides that this test is satisfied if more than 5% of the payment of principal or interest on the bond issue is either made or secured (directly or indirectly) by payments or property used, or to be used, for a private business use.
[15] By inference, § 145(a)(1) of the Code precludes an organization which is neither a State or local governmental unit nor described in § 501(c)(3) from being a borrower of the proceeds of a qualified 501(c)(3) bond issue.
[16] **Unrelated Trade or Business—**Section 513 of the Code, in general, defines unrelated trade or business as any trade or business the conduct of which is not substantially related to the exercise or performance by a § 501(c)(3) organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under § 501.
[17] **Private Use by Parties other than the § 501(c)(3) Borrower—**Except for non-federal governmental persons, this term includes private, for-profit, and other tax-exempt organizations not described in § 501(c)(3) of the Code.
[18] Treas. Regs. §§ 1.145-2(a) and 1.141-12.
[19] See Notice 2008-31, 2008-11 C.B. 592 updating Notice 2001-60, 2001-2 C.B. 304.

manner demonstrating compliance with the qualified use requirements. Project expenditures include not only qualified use expenditures but also nonqualified use expenditures such as issuance costs.

Qualified 501(c)(3) bonds and governmental bonds lose their tax-exempt status if they are arbitrage bonds.[20] In general, arbitrage is realized when the yield on investments acquired with proceeds of a bond issue exceeds the yield on the bond issue. However, the realization of arbitrage itself does not necessarily mean that the bonds are taxable arbitrage bonds. Two general sets of requirements under the Code must be applied in order to determine whether the bonds are arbitrage bonds: (1) the yield restriction requirements;[21] and (2) the arbitrage rebate requirements.[22] Each of these compliance regimes contains distinct requirements and safe harbors.[23]

Qualified 501(c)(3) bonds and governmental bonds are also subject to a variety of federal tax requirements. Section 149 of the Code provides certain general rules applicable to all bonds including the filing of an information return upon issuance,[24] a general prohibition against federal guarantees,[25] and a general prohibition against

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[20] For purposes of § 103 of the Code, the term "arbitrage bond" means any bond issued as part of an issue any portion of the proceeds of which are reasonably expected (at the time of issuance of the bond) to be used directly or indirectly to acquire higher yielding investments, or to replace funds which were used directly or indirectly to acquire higher yielding investments. Section 148(a).

[21] § 148(a).

[22] § 148(f).

[23] The arbitrage yield restriction rules described under Treas. Reg. § 1.148-2(a) generally provide that the direct or indirect investment of the gross proceeds of an issue in higher yielding investments causes the bonds of the issue to be arbitrage bonds. Whether an investment yield is considered materially higher is dependent upon the type of investment acquired with bond proceeds and can be as low as 1/1000th of a percent. Definitions of materially higher yield for purposes of applying the arbitrage yield restriction rules are provided under Treas. Reg. § 1.148-2(d)(2). The term "materially higher yield" is generally defined as a percentage threshold amount that is added to the yield of the bond issue. For example, under the general rule for purpose and nonpurpose investments, the term generally means 1/8th of 1 percentage point. Moreover, several exceptions to this general restriction on permissible yield apply under different fact patterns. Such exceptions include the application of a temporary period (Treas. Reg. § 1.148-2(e)) or investments held in a reasonably required reserve or replacement fund (Treas. Reg. § 1.148-2(f)).

The arbitrage rebate requirements described under Treas. Reg. § 1.148-3 generally provide that the investment yield above the bond yield (positive arbitrage) realized on nonpurpose investments acquired with proceeds of a bond issue must be paid to the U.S. Treasury within certain prescribed timeframes (Treas. Reg. § 1.148-3(a)). Again, similar to the yield restriction rules, several exceptions apply to the rebate requirements including the spending exceptions (Treas. Reg. § 1.148-7) and the small issuer exception (Treas. Reg. § 1.148-8). Payments of arbitrage rebate are due within 60 days of the computation date dependent upon whether the bond issue is a fixed rate issue or a variable rate issue (See guidance on determining the computation date, Treas. Reg. § 1.148-3) and are submitted using IRS Form 8038-T, *Arbitrage Rebate, Yield Reduction and Penalty in Lieu of Arbitrage Rebate.* Failure to timely pay an amount of arbitrage rebate when due may result in either the assessment of interest and a penalty or a determination that the bonds are taxable arbitrage bonds (Treas. Reg. § 1.148-3(h)).

[24] § 149(e).

[25] § 149(b).

hedging regarding interest rate risk through the issuance of tax-exempt bonds significantly prior to the planned expenditure of proceeds.[26] Section 147 of the Code provides certain rules applicable to qualified private activity bonds generally (including qualified 501(c)(3) bonds), including the requirement that a qualified private activity bond receive governmental approval, following reasonable public notice, prior to issuance,[27] and a general limitation on the amount of proceeds related to the costs of issuance expended on a qualified private activity bond issue.[28]

Section 6001 of the Code and § 1.6001-1(a) of the Treasury Regulations generally provide that books and records must be maintained that are sufficient to establish the amounts required to be shown in any return required to be filed. Notice 2006-63 notes that section 6001 imposes record retention requirements on issuers and other parties to tax-exempt bond transactions.

In the case of a tax-exempt bond transaction, the primary taxpayers are the beneficial holders of the bonds. However, in most cases, the beneficial holders of tax-exempt bonds will not have any records to support their exclusion of the interest paid on those bonds. Instead, these records will generally be found in the bond transcript and the books and records of the issuer, the conduit borrower, and other participants to the transaction. Therefore, in order to ensure the continued exclusion of interest by the beneficial holders, it is important that the issuer, the conduit borrower, and other participants retain sufficient records to support the continued exclusion taken by the beneficial holders of the bonds. Pursuant to this statutory regime, IRS agents conducting examinations of tax-exempt bond transactions will look to these parties to provide books, records, and other information documents supporting the bonds continued compliance with federal tax requirements.

Additionally, in the case of many private activity bonds, the conduit borrowers are also primary taxpayers. For instance, the conduit borrower will generally deduct the interest indirectly paid on the bond issue through the loan documents. Conduit borrowers are also often entitled to claim depreciation deductions for bond-financed property. Consequently, conduit borrowers should maintain sufficient records to support their interest deductions, depreciation deductions or other tax deductions, exclusions or credits related to the tax-exempt bond issue.

Moreover, issuers and conduit borrowers should retain sufficient records to show that all tax-exempt bond related returns submitted to the IRS are correct. Such returns include: Form 8038, *Information Return for Tax-Exempt Private Activity Bond Issues*; Form 8038-B, *Information Return for Build America Bonds and Recovery Zone Economic Development Bonds;* Form 8038-G, *Information Return for Tax-Exempt Governmental Obligations;* Form 8038-GC, *Consolidated Information Return*

[26] § 149(g).
[27] § 147(f)
[28] See generally § 147(g). Under Treas. Reg. § 1.150-1(b), the term issuance costs includes the following costs to the extent incurred in connection with the borrowing: underwriters' spread; counsel fees; financial advisory fees; rating agency fees; trustee fees; paying agent fees; bond registrar, certification, and authentication fees; accounting fees; printing costs for bonds and offering documents; public approval process costs; engineering and feasibility study costs; guarantee fees, other than qualified guarantees; and similar costs.

for Small Tax-Exempt Governmental Bond Issues, Leases, and Installment Sales; Form 8038-TC, *Information Return for Tax Credit Bonds and Specified Tax Credit Bonds;* Form 8038-T, *Arbitrage Rebate, Yield Reduction and Penalty in Lieu of Arbitrage Rebate;* Form 8038-R, *Request for Recovery of Overpayment Under Arbitrage Rebate Provisions;* Form 8038-CP, R*eturn for Credit Payments to Issuers of Qualified Bonds;* Form 8328, *Carryforward Election of Unused Private Activity Bond Volume Cap;* and Form 8703*, Annual Certification of a Residential Rental Project*. Exempt organizations who are conduit borrowers generally must provide detailed information as to outstanding bond issues in Schedule K, *Supplemental Information on Tax-Exempt Bonds,* of Form 990, *Return of Organization Exempt from Income Tax.*

In addition to the general rules under § 6001, issuers and conduit borrowers are subject to specific recordkeeping requirements imposed by various other sections of the Code and Treasury Regulations. For example, § 1.148-5(d)(6)(iii)(E) of the Treasury Regulations requires that an issuer retain certain records necessary to qualify for the safe harbor for establishing fair market value for guaranteed investment contracts and investments purchased for a yield restricted defeasance escrow.

Other Available Guidance

In addition to provisions in the Code and Treasury Regulations, general guidance relating to the post-issuance compliance of tax-exempt bonds is found in formal guidance documents,[29] IRS Tax Exempt Bonds Compliance Guides publications,[30] content available on the IRS public website,[31] and reports such as those from the Advisory Committee on Tax Exempt and Government Entities (the "ACT"). The National Association of Bond Lawyers and the Government Finance Officers Association, working jointly, have also developed tools for post-issuance compliance.

IRM Provisions on Voluntary Closing Agreement Program

The Internal Revenue Manual states the intent of TEB's post-issuance corrective program in terms of continuing review by issuers of their post-issuance compliance:

> The primary objective of TEB VCAP is to encourage issuers and other parties to the tax-exempt bond or tax credit bond transaction to exercise due diligence in complying with the Code and applicable Income Tax Regulations

[29] Post-issuance compliance guidance includes, without limitation: Revenue Procedures 97-13, 2005-40, and 2007-47 as well as Notices 88-130, 2006-63, 2008-27, 2008-31, 2008-41, 2008-88, 2009-26 and 2010-35.
[30] See footnote 7.
[31] Content on www.irs.gov/bonds includes answers to frequently asked questions on record retention standards applicable to tax-exempt bonds and tax credit bonds, student-training texts for TEB's Phase I Basic Training and Phase II Advanced Training courses, copies of Advisory Committee on Tax-Exempt and Government Entities reports, compliance guides for qualified 501(c)(3) bonds, private activity bonds and governmental bonds, and IRM provisions relating to TEB operations.

> (the "Regulations") and to provide a vehicle to correct violations of the Code and applicable Regulations as expeditiously as possible.[32]

Information Reporting

The growth in use of direct pay tax credit bonds, such as build America bonds, recovery zone economic developments bonds and specified tax credit bonds, is also expected to assist TEB in promoting post-issuance compliance. Each Form 8038-CP constitutes an issuer certification that as of the date the Form is submitted all applicable requirements have been met for the payment of the refundable tax credit. Form 8038-B and Form 8038-TC *each* require the issuer to indicate whether it has written procedures to monitor compliance relating to arbitrage and other qualifications for tax exemption on bonds. Moreover, exempt organizations who are conduit borrowers of tax-exempt bonds generally must provide detailed information as to continued compliance with the requirements for qualified 501(c)(3) bonds in their annual filings of Form 990, Schedule K.

NABL/GFOA Tax Compliance Checklist – Post Issuance

The National Association of Bond Lawyers and the Government Finance Officers Association have developed a checklist to assist issuers in their post-issuance compliance activities. In the description of the checklist, its developers state:

> The checklist is intended to help issuers and/or borrowers throughout the entire lifetime of the financing to identify matters that need to be analyzed by the issuer and perhaps by counsel. Issuers are encouraged to retain and distribute the checklist to all "responsible" parties and others who may find it useful during the lifetime of a financing. **Keeping the checklist throughout the lifetime of the financing is important. Thus, issuers are encouraged to keep the document with the transcript.[33]** (Emphasis in original.)

ACT Reports

The 2009 Report of the ACT[34] (the "2009 ACT Report") proposed safe harbor record retention time periods. In doing so, the 2009 ACT Report commented: "The thesis of this report is that the best and most practical approach is to establish flexible record retention safe harbors that are conditioned on the adoption and implementation of reasonable bond compliance procedures."[35]

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[32] IRM § 7.2.3.1.1(1).
[33] Explanation of Post Issuance Compliance Checklist, as included in August 16, 2007 letter to Eric Solomon, Assistant Secretary, Office of Tax Policy, U.S. Department of the Treasury, from Carol L. Lew, President, National Association of Bond Lawyers.
[34] IRS Publication 4344 (Rev. 6-2009), *Advisory Committee on Tax Exempt and Government Entities Report of Recommendations*, dated June 10, 2009. See section entitled "Record Retention Requirements for Tax-Exempt Bonds and Tax Credit Bonds: A Specific Proposal for Published Guidance."
[35] *Id*., page 11.

The 2008 Report of the ACT[36] (the "2008 ACT Report") recognized the appropriateness of the monitoring of post-issuance compliance by the issuers of tax-exempt bonds in its proposal for a streamlined closing agreement program for certain violations. In the proposal of the 2008 ACT Report, one element of eligibility would be that the issuer, and when applicable the conduit borrower, provide a compliance certificate in connection with a request for a closing agreement, in which "it should affirm that the parties to the bond issue which resulted in the Covered Violation made a good faith effort to comply with federal tax law."[37]

The 2007 Report of the ACT[38] (the "2007 ACT Report") commented that:

> Because most tax-exempt bonds will remain outstanding for many years, it is important to have procedures, which can be understood and implemented over time even as the responsible officials may change. The particular procedures which are appropriate vary substantially, depending upon the size and complexity of the issuer/borrower, the complexity of the financing, the number of bond issues being monitored, and the type of bond issue involved, e.g., governmental general obligations, qualified 501(c)(3) bonds, multifamily housing bonds. Most important is to assign responsibility for post-issuance tax law compliance and to be sure that sufficient information is routinely identified and maintained to allow those who later inherit that responsibility to successfully continue the job. It is appropriate to ask bond counsel at the time of closing to assist in the development of a procedural framework for post-issuance tax compliance.
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> Whenever possible, monitoring of tax law compliance should be integrated with existing accounting systems so that those who directly manage bond-financed assets will be prompted to identify relevant facts at the time any changes are contemplated and to communicate such plans to the appropriate finance officials. For example, bond-financed property could be specially coded on an existing plant ledger in order to require advance review of contemplated sales, leases, or other contractual arrangements involving bond-financed property.

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[36] IRS Publication 4344 (Rev. 6-2008), *Advisory Committee on Tax Exempt and Government Entities Report of Recommendations*, dated June 11, 2008. See section entitled "The Streamlined Closing Agreement for Tax-Exempt Bonds: A Cure for Common Violations."
[37] *Id*., page 6.
[38] IRS Publication 4344 (Rev. 6-2007), *Advisory Committee on Tax Exempt and Government Entities Report of Recommendations*, dated June 13, 2007. See section entitled "After the Bonds are Issued: Then What?"

> Because of the long term of many tax-exempt bonds, and the need to verify tax-law compliance throughout the term, special care should be given to record retention policies. Record retention requirements may differ from and be more stringent than those required under state law or other governing rules. See Tax Exempt Bond FAQs regarding Record Retention Requirements and the discussion of record retention in the 2005 Report of the Advisory Committee on Tax-Exempt and Government Entities. In Notice 2006-63, the IRS solicited comments as to appropriate record retention standards, including recordkeeping limitation programs and is currently considering industry comments.

The 2007 ACT noted:

> The goal of the types of procedures described here is to identify on a timely basis the facts relevant to the continued tax-exemption of outstanding bonds. The analysis of those facts and the crafting of solutions to potential problems may require on-going consultation with bond counsel. Issuers and borrowers should recognize that such consultation may go beyond the scope of bond counsel's initial engagement.

The 2007 ACT also provided suggested procedures, including setting record retention policies for post-issuance compliance.

In summary, the 2007 ACT stated:

> Post-issuance tax compliance is an integral part of an issuer or borrower's debt management process. In some organizations, compliance may be adequately supported by ad hoc procedures or by the efforts of a single individual. However, consideration should be given to whether ongoing timely, reliable institutional compliance should be supported by practices integrated within the core policies and procedures of the institution. Such practices may assist newly elected or appointed officials in quickly identifying and understanding existing policies and remedies and who is responsible for their implementation in order to avoid a disruption of necessary activities.
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> Post-issuance tax compliance begins with the debt issuance process itself and provides for a continuing focus on investments of bond proceeds and use of bond-financed property. It will require identifying existing policies, the responsible people, the applicable procedures, and the affected population. The facts will differ for every issuer or borrower. The questions may differ as well. The need for effective policies, procedures, and systems to ensure compliance will not.

The 2005 Report of the ACT[39] noted:

> Unlike most taxpayers where the overall examination life cycle is relatively short (e.g., three years after the filing of a Form 1040), the life cycle of a bond issue can be extremely long. A majority of tax-exempt bonds are issued to finance projects with a long useful life such as roads or schools. And it is common for a bond issue to be sold with a final maturity of 30 years. In addition, if a bond issue is refinanced by another bond issue (refunding), the record retention requirements of the original bond would need to continue for the entire life of the refunding bond issue. Therefore, the final maturity of a typical bond issue creates a unique record retention burden since the possible examination period spans several decades.

Issuers of tax-exempt bonds are required to retain all records related to the investment and expenditure of the gross proceeds of the bond issue. Given the fact that many municipalities include multiple projects in a single bond issue, the volume of underlying invoices and investment records can be considerable. Also, issuers of tax-exempt bonds which sell bonds for conduit borrowing issues on a frequent basis may issue twenty or more issues annually with the cumulative retention of all related records becoming staggering.

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[39] IRS Publication 4344 (Rev. 6-2005), *Advisory Committee on Tax Exempt and Government Entities Report of Recommendations*, dated June 8, 2005. See section entitled "Tax-Exempt Bonds: Record Retention Burden."