February 18, 2016

Oregon HFMA Winter Conference

Post-Issuance Bond Compliance

Alan Bond (BLX, New York)

Scott Schickli (Orrick, Portland)

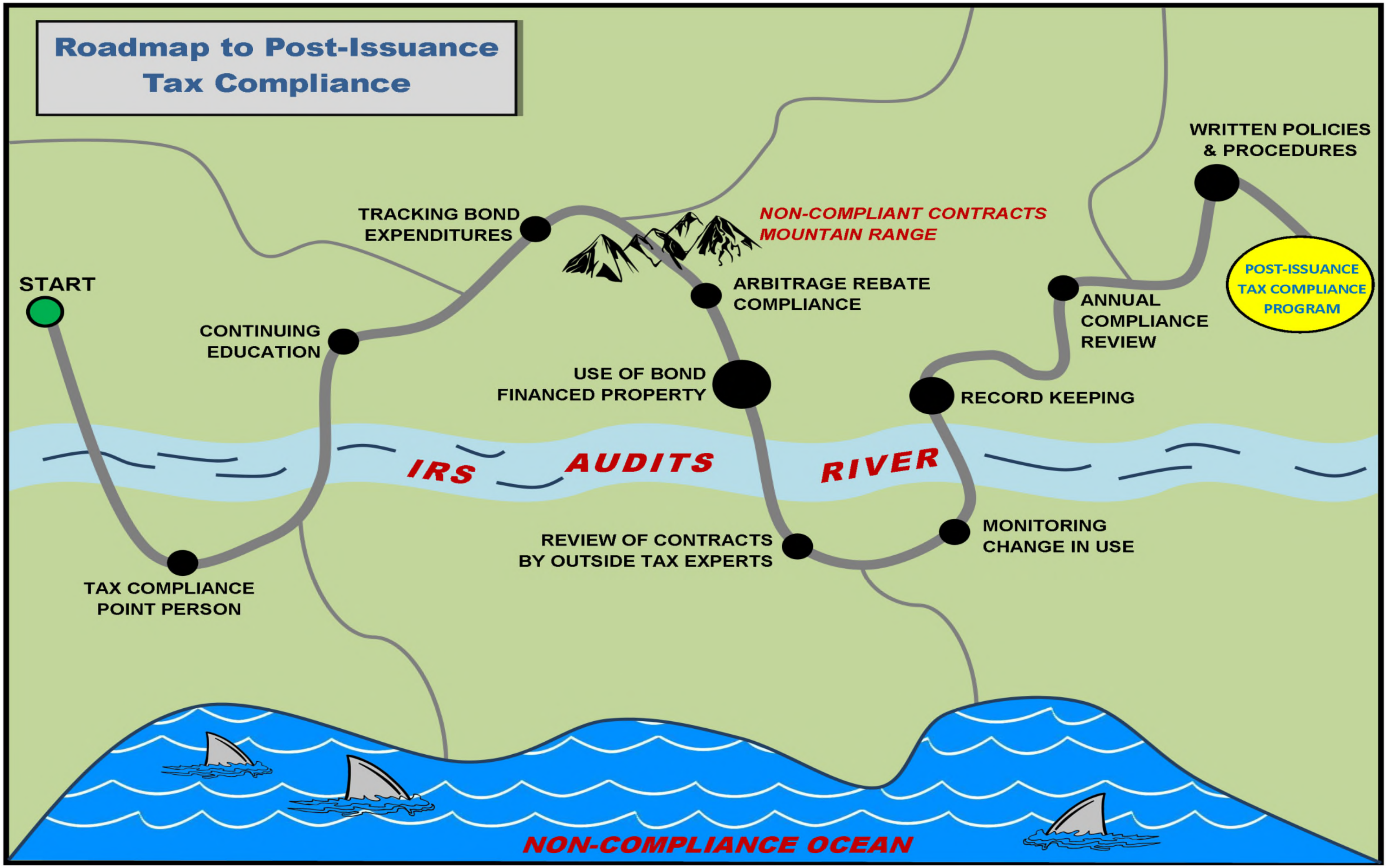
BLX

Discussion Outline

- Post-Issuance Tax Compliance Overview
- Elements of an Effective Post-Issuance Compliance Program
- Private Business Use Overview

Post-Issuance Compliance Overview

Post-Issuance Compliance Overview



Post-Issuance Compliance Overview

"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"

After the Bonds Are Issued Then What?

Advisory Committee on Tax-Exempt and Governmental Entities

Post-Issuance Compliance Overview

IRS Focus on Post-Issuance Tax Compliance Matters

- Questionnaires
- Audits
- Schedule K
- Questions on other IRS Forms (8038, etc.)
- ACT Reports
- Training
- VCAP

Post-Issuance Compliance Overview

IRS Focus on Post-Issuance Tax Compliance Matters

- IRS Examination Program
  - Compliance is being monitored
  - TEB Agents
    - Large growth since inception
    - Now have approximately 80+ agents
    - Recent budget reductions focus attention on efficiency
- Audits
  - 300-400 issues being audited at any time
  - IRS closed over 1,000 audits in 2014
    - Almost 50% had some noncompliance
    - Almost $50 million in settlements
  - IRS has not published 2015 numbers

Post-Issuance Compliance Overview

IRS Focus on Post-Issuance Tax Compliance Matters

- The average tax-exempt bond issue is outstanding for 20-25 years
- Issuers and conduit borrowers must comply with federal tax rules for the life of the original bond and any refunding bonds
- Easy for foot faults and errors to occur or for borrowers to lack requisite records and detailed information to rebuff IRS in an audit challenging the tax-exempt status of bonds
- Majority of "tax problems" discovered at the time of a refunding

Post-Issuance Compliance Overview

Why should you care about the IRS post-issuance compliance initiative?

- Failure to comply with the federal tax requirements will jeopardize the preferential tax status of those bonds
- Defending tax-exempt status of bonds in an IRS audit is <u>expensive</u>, <u>stressful</u>, and <u>time consuming</u>
- Tarnish reputation in credit markets
- Financial settlement to protect bondholders can be costly ($)

Elements of an Effective Post-Issuance Compliance Program

BLX

Elements of an Effective Post-Issuance Compliance Program

Overview

1. Designation of a tax compliance point person(s)
2. Continuing education and training for individuals responsible for post-issuance compliance
3. Tracking and allocating the expenditure of bond proceeds
4. Monitoring the investment income and arbitrage compliance restriction
5. Monitoring the use of bond-financed property

Elements of an Effective Post-Issuance Compliance Program

Overview (cont.)

6. Periodic review of management contracts, other facility use agreements, and research contracts by experts in tax matters
7. Recordkeeping and retention policies and procedures
8. Periodic compliance reviews/ongoing communication with outside tax specialists
9. Written policies and procedures relating post-issuance tax compliance
10. Addressing “change in use” of bond-financed property through self-help remediation and VCAP

Elements of an Effective Post-Issuance Compliance Program

1. Designation of a tax compliance point person(s)
    - Concentrating responsibility in one person who is responsible depending on the organization’s size either for completing all post issuance tax compliance tasks or directing the activities of others engaged in post issuance tax compliance
    - Designating responsibility by job title ensures continuity of function even after current person leaves the organization
    - Designation should be memorialized in written post-issuance tax compliance procedures

Elements of an Effective Post-Issuance Compliance Program

2. Continuing education and training for individuals responsible for post-issuance Compliance
   - Various opportunities available from:
     - Bond Counsel
     - Webinars
     - Programs offered through professional associations
     - Free program offered by the IRS office of Tax Exempt Bonds
   - Whether the Issuer or Borrower has made training and continuing education available to all personnel that are responsible for post-issuance tax compliance has been a question in IRS tax compliance check questionnaires

Elements of an Effective Post-Issuance Compliance Program

3. Tracking and allocating the expenditure of bond proceeds
    - Identify at issuance funds and accounts into which bond proceeds are to be deposited
    - Document the reimbursement of any pre-issuance expenditures
    - Monitor the expenditure of bond proceeds to ensure that bond proceeds are spent within applicable time frames
    - Compile upon project completion, a final allocation of bond proceeds and other funds to bond-financed property

Elements of an Effective Post-Issuance Compliance Program

4. Monitoring investment income and arbitrage compliance
   - Monitor compliance with 3-year “temporary period” expenditure limitations for yield restriction and 24-month, 18-month and 6-month rebate exceptions
   - Establish procedures to ensure investments acquired with bond proceeds are purchased at fair market value
   - Identify situations and establish procedures in which compliance with applicable yield restrictions depends upon later investments (e.g. 0% SLGs), and monitor implementation
   - Arrange for timely computation of rebate liability, filing of Form 8038-T, and payment of rebate and “yield reduction payments,” if applicable

Elements of an Effective Post-Issuance Compliance Program

5. Monitoring the use of bond-financed property
    - Identify and review annually whether bond-financed property is subject to a lease, license, management contract, sponsored research contract or similar use agreement
    - Prepare or have prepared annually single-year or cumulative Private Business Use and unrelated trade or business use calculations
    - Establish protocol for addressing change of use in case of sale of bond financed property

Elements of an Effective Post-Issuance Compliance Program

6. Periodic review of management contracts, other facility use agreements, and research contracts by experts in tax matters
   - Establish protocol for at least annual review by outside tax advisors of management and sponsored research contracts for compliance with IRS Safe Harbor Contract Rules and/or develop uniform management and sponsored research contracts for use in bond-financed property, which satisfy the IRS Safe Harbor Rules

Elements of an Effective Post-Issuance Compliance Program

7. Recordkeeping and retention policies
   - Retain the following documents for the life of the bonds and any refunding bonds plus 3 years
     - Transcript of bond transaction
     - Documentation evidencing all uses of bond-financed property
     - Documentation evidencing all sources of payment or security of bonds
     - Documentation pertaining to any investment of bond proceeds
     - Documentation regarding the allocation of bond proceeds to all expenditures
     - Asset list or schedule of all bond-financed facilities or equipment
     - Records regarding the purchases and sales of bond-financed assets

Elements of an Effective Post-Issuance Compliance Program

8. Periodic compliance reviews/ongoing communication with outside tax specialist
   - Includes bond counsel and other organizations that specialize in post-issuance tax compliance that can provide:
     - Information regarding changes in IRS filing requirements, policies, procedures and enforcement
     - Expertise for infrequent Issuers and Borrowers who lack proficiency in post-issuance tax compliance matters due to limited exposure
     - Tools for frequent Issuers and Borrowers who find that the volume of debt and the associated tracking of expenditures and use of facilities to be unmanageable

Elements of an Effective Post-Issuance Compliance Program

9. Written policies and procedures relating to post-issuance tax compliance
    - Describe all the elements of your post issuance compliance procedures in a written document that is maintained with your other operating procedures
    - Review and update annually

Elements of an Effective Post-Issuance Compliance Program

10. Addressing "change in use" of bond-financed property through self-help remediation and VCAP

- "Deliberate action" may causes bond-financed property to be used in a manner that violates the applicable use limitations
- "Self-help" remedial actions:
  - defeasing the non-qualified portion of the outstanding bonds or
  - using the amounts realized from the sale of the bond-financed property for another qualifying use;
- TEB Voluntary Closing Agreement Program ("VCAP ")
  - IRS Notice 2008-31
  - Internal Revenue Manual Sections 7.2.3

Private Business Use Overview

Private Business Use Overview

501(c)(3) Bond Requirements

- At least 95% of the net proceeds of the bond issue must be used in a manner related to the exempt purposes of the Section 501(c)(3) organization
- No more than 5% of the net proceeds of the bond issue can be used for a "private business use" or an "unrelated trade or business use"
- For this purpose, costs of issuance of the bonds paid with bond proceeds are treated as a private business use
- 2% costs of issuance limit
- All bond-financed property must remain owned by the 501(c)(3) organization.

Private Business Use Overview

Governmental Bond Requirements

- Generally, at least 90% of the proceeds of the bond issue must be used for governmental purposes
- The 90% requirement is increased to 95% in certain circumstances (see Tax Certificate for details)
- Aggregate private use cannot exceed the “lesser of” 90%, 95% or $15 million

Private Business Use Overview

Governmental Bond Requirements

- $800 million governmental bond issue

Par Amount	$800 million	$800 million	$800 million
Tax Code Limit	10%	5%	$15 million
Maximum PBU	$80 million	$40 million	$15 million

- Need to be mindful of “lesser of” concept
- Need to consider all private use within the bond issue

Private Business Use Overview

Basic Tax Analysis in Governmental Bond Financings

- Are the bond financed assets used by members of the general public?
- Does a party other than a State or Local Government agency or department have a "special legal entitlement" to use the bond financed assets?
- Private business use can arise under a management contract even if the assets serve the general public
- Use of bond financed assets by a charitable organization (e.g., a Section 501(c)(3) organization) will generally give rise to private business use
- Contracts with the federal government will generally give rise to private business use

Private Business Use Overview

501(c)(3) Bonds and Private Business Use

- Use of bond financed property by other than a 501(c)(3) organization or a state or local government
- Examples:
  - Leases to for-profit entity
  - Certain management contracts with for-profit entity
  - Certain sponsored research contracts with for-profit entity
- In these examples, the trade or business is provided “rights” to the facility (i.e., a special legal entitlement)

Private Business Use Overview

501(c)(3) Bonds and Unrelated Trade or Business Use

- Use of bond financed property by a 501(c)(3) organization in an "unrelated trade or business activity"
- For tax-exempt bonds – the focus is "activity"
- Unrelated trade or business use involving bond financed property will generally constitute "private business use" <u>even if it does not give rise to a liability for unrelated business use</u>

Private Business Use Overview

Contracts that <u>may</u> give rise to private use include:

- Management Contracts
  - Physician Contracts
  - Cafeteria Contracts
- Research Contracts
  - Federal
  - Business Sponsored

Private Business Use Overview

Contracts that <u>will</u> generally give rise to private use include:

- Leases
  - Cafeteria Contracts
  - Pharmacies
  - Physician Office Space
  - Gift Shops
  - Corporate Events
  - Solar Panels
  - Cell Phone Antennas

Private Business Use Overview

Many so-called "management contracts" are in fact leases (even though it might be called something else)

If someone is paying you rent ($) or splitting profits ($) from an operation in bond financed space they are not generally treated as a manager under the tax rules

Management & Service Contracts

Why can management contracts give rise to private business use?

- May represent a transfer of control or economic benefit from the owner to a private party
- They provide a "special legal entitlement" to use bond financed property

Management & Service Contracts

Management Contract Guidelines – Rev. Proc. 97-13

- Safe harbor contractual requirements that if met, the contract does not cause private business use
- Duration of contract and type of compensation provided are key to determining whether contract falls within safe harbor
  - Long-term agreements are required to have larger portion of fixed compensation
- Sharing or splitting of “net profits” is never permitted under the management contract guidelines

Management & Service Contracts

Variations of agreements addressed in Rev. Proc. 97-13 and IRS Notice 2014-67

- 95% Periodic Fixed Fee Contract
  - Term must not exceed the lesser of 80% of the reasonably expected useful life of the financed property and 15 years
- 80% Periodic Fixed Fee Contract
  - Term must not exceed the lesser of 80% of the reasonably expected useful life of the financed property and 10 years

Management & Service Contracts

Variations of agreements addressed in Rev. Proc. 97-13 and IRS Notice 2014-67 (cont.)

- IRS significantly relaxed rules for management contracts with a term of 5 years or less
- Compensation based on stated amount, periodic fixed fee, capitation fee, per-unit fee, percentage of gross revenues, adjusted gross revenues, or expenses (or any combination of the foregoing) are permitted
- The contract need not be terminable by the governmental unit/501(c)(3) entity prior to the end of the term

Private Business Use Exceptions

Incidental Use

- Small physical use of space
  - ATM, kiosks, vending machines, laundry facilities
  - Cannot exceed 2.5% of proceeds of the issue used to finance the facility
  - Use of the facility is incidental if:
    - the use does not involve the transfer of possession and control of the space
    - the nonpossessory use is not functionally related to any other use of the facility by the same person
    - all nonpossessory uses of the facility do not, in the aggregate, involve the use of more than 2.5% of the facility

Private Business Use Exceptions

Incidental Contracts or Arrangements

- Contracts for services supporting organization activities
  - Janitorial services
  - Equipment Repair
  - Billing activities or similar services

Private Business Use Exceptions

Short-term Use – 50 Day Exception - contracts for use of bond financed property if 50 days or less

- Term of use pursuant to the contract, including renewal options, is not longer than 50 days
- The contract is a negotiated arm's-length arrangement and compensation is at fair market rule
- The property is not financed for a principal purpose of providing that property for use by that party

  * Short term use exceptions do not apply to "unrelated activities" of the 501(c)(3) organization

Sponsored Research Contracts

Why can sponsored research contracts give rise to private business use?

- May be viewed as providing:
  - Special legal entitlement
  - Special economic benefit

Sponsored Research Contracts

Research Contract Guidelines – Rev. Proc. 2007- 47

- Permits certain types of research to be conducted within bond financed space without resulting in research sponsor being treated as private user
- Applies only to “basic research” – any original investigation for the advancement of science not having a commercial objective
- How results of research are licensed is the key to determining whether or not contract falls within the safe harbor

Post-Issuance Compliance Overview

Benefits of an Effective Post-Issuance Compliance Program

- Good Risk Management
- Direction and Guidance relating to ongoing tax compliance
- Generate efficient and prompt response to any IRS inquiry
- Easy and cost-effective review process at time of refunding
- Identify and maximize remaining portion of bond proceeds allowed for private use
- Provide historic analysis of post-issuance compliance for outstanding tax-exempt debt
- Memorialize institutional memory in cases of staff turnover or reduction
- For 501(c)(3) organizations, ease in completion of Schedule K

Contact Information

Alan Bond
BLX Group
abond@blxgroup.com
(212) 506-5275

Scott Schickli
Orrick
sschickli@orrick.com
(503) 943-4830