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POST-ISSUANCE COMPLIANCE FOR TAX-EXEMPT BONDS

Living with a Tax-Exempt Bond Issue

Your bond issue has closed. You can relax—right? Well, not entirely.

The continuing tax-exempt status of your bond issue depends upon actions you take post-closing. The tax status of your bonds is determined at closing based upon your reasonable expectations as to the investment and use of the bond proceeds and the use of the facilities financed with the bonds. However, Treas. Reg. §1.141-2(d) provides that any *deliberate action* taken by an "issuer" (which includes a tax-exempt borrower) after the bonds are issued will result in the bonds losing their tax-exempt status if that action (if expected at the time of the issuance) would have caused the bonds to be private activity bonds on the date of issuance.[1] For this purpose, a deliberate action is any action taken by the borrower that is within its control, even if there is no intent to cause the loss of tax-exempt status. If you take such a deliberate action, the loss of tax-exempt status is retroactive to the date the bonds were issued (although if you have to make changes because of changes in circumstances, you may be able to take some remedial action, discussed below).

Intentional acts by the borrower after the date the bonds are issued can also cause the bonds to be taxable arbitrage bonds. Treas. Reg. §1.148-2(c) says that if an "issuer" (again including conduit borrower) takes any deliberate, intentional action after the date the bonds are issued in order to earn an arbitrage profit, the bonds will be arbitrage bonds if that action (if expected at the time of issuance) would have caused the bonds to be arbitrage bonds. No intent to violate the requirements of Section 148 of the Code (referring to arbitrage bonds) is necessary. This would include situations where a borrower earns arbitrage, is required to rebate it to federal government, and fails to do so. *See* Section 148(f) of the Code.[2]

Typically, the borrower has promised in the loan documents and perhaps in a Tax Certificate that it will not take any actions that would cause the interest on the bonds to be included in federal gross income. In addition, the opinion of bond counsel typically assumes on-going compliance with tax requirements. Accordingly, you have a responsibility to make sure

[1] Some types of tax-exempt bonds, such as qualified 501(c)(3) bonds, are already private activity bonds, but the deliberate action doctrine also applies to the continued tax status of "qualified private activity bonds."
[2] Other actions taken after the date of issuance can also cause the bonds to retroactively lose their tax-exempt status. *See, e.g.,* Section 149(d), which among other things prohibits investment of bond proceeds in federally insured deposits unless an applicable temporary period or similar exception applies.

that your proceeds are invested and used for permitted purposes. Moreover, the IRS is currently pursuing a program of so-called "soft contacts" to determine whether issuers are properly maintaining post-issuance compliance programs, and in any event, if the IRS audits the bond issue, it will ask for all records relating to expenditures of bond proceeds, investments of bond proceeds, and use of bond-financed facilities. Finally, if you ever want to refund your bonds, bond counsel will ask for records relating to use of proceeds and use of the bond-financed facilities. *See* Treas. Reg. §1.141-13(b) (describing how the private activity bond tests apply to refunding bonds are generally requiring that the use of the bond-financed facilities be measured over the combined term of the original bonds and any refunding bonds).

The compliance period lasts as long as the bonds are outstanding. In addition, if the bonds are refunded, the compliance period with respect to use of the proceeds continues until the last bond that financed or refinanced the facilities is redeemed. This means that issuers or borrowers using tax-exempt debt are signing up for a long compliance period—one that will typically last longer than the persons who were at the closing. Accordingly, every borrower should establish a post-issuance compliance system.

Maintenance of Records

An important component of any post-issuance compliance program is a system for the maintenance of records. But what records should you maintain?

The IRS has posted a "FAQ" on the TEB website concerning record retention requirements. The FAQ generally says that issuers and conduit borrowers should maintain records. (For conduit financings, as a practical matter the borrowers should maintain all records, especially relating to investment and use of bond proceeds and use of bond-financed facilities.) The records required to be maintained are (at a minimum):

i. the transcript of transaction (that is, the "closing binder" or "closing CD" prepared by bond counsel);

ii. documentation evidencing expenditure of proceeds;

iii. documentation evidencing sources of payment of bond; and

iv. documentation pertaining to investment of bond proceeds (including any and all bidding materials).

The FAQ also says you should maintain any other records relating to tax-exempt status. In general, this means you must keep information relating to use and any transfer of bond-financed facilities.

All these records need to be maintained for entire term of bond issue (including any refundings) plus 3 years. The FAQ allows use of electronic storage system that either images books and records or transfers computerized books and records to an electronic storage system.

Electronic storage requirements are detailed in Rev. Proc. 97-22. However, if you keep your records in electronic form, you must be sure that those records will be readable in 30 years. CDs seem pretty good technology today and have been in wide use for more than 10 years. But what about the future?

Allocating Proceeds to Particular Facilities

One of the most important parts of any post-issuance compliance program is monitoring the use of bond-financed facilities. To do that, you need to first allocate your proceeds to particular expenditures for facilities. Then, you need to establish some system for continuing to track the use of those facilities. Also—if you have more than one bond issue outstanding, you need to track the facilities financed and the use of those facilities separately for *each* bond issue.

Under Treas. Reg. §§1.148-6(a)(1) and 1.148-6(d) (and §1.141-6(a)), a borrower may allocate proceeds to expenditures in any reasonable, consistently applied fashion. One allocation method (perhaps the most commonly used) consists of direct tracing of proceeds—i.e., following the flow of the funds. Borrowers that use a direct tracing method must make sure they keep copies of invoices and records showing expenditure from accounts holding bond proceeds. It should be noted that, if your bonds are audited, the IRS agent will early on ask for copies of invoices and records relating to the expenditure of bond proceeds.

Other allocation methods mentioned in the regulations consist of "gross proceeds spent first," a first-in, first-out allocation, and a ratable allocation. These methods all generally would apply to projects that are being funded from bond proceeds and some other source of funds, such as an equity contribution. In addition, the regulations and some rulings clearly allow other forms of allocation. For example, a borrower may spend various sources of funds on multiple projects and later decide what expenditures to allocate to bond proceeds and what expenditures to allocate to other sources. The basic limitation on this post-expenditure allocation rule is that bond proceeds cannot be allocated to an expenditure where there is not some current outlay of cash (e.g., you cannot allocate to an expenditure simply because a contract is entered into). However, you can allocate bond proceeds to an expenditure *even if that expenditure was not made from proceeds*. In addition, Treas. Reg. §1.148-6(d)(1)(iii) requires than any allocation of bond proceeds to an expenditure be made no later than 18 months after the date the expenditure is made or (if later) the date the project financed by the bonds is placed in service. In any event, allocations to expenditures must be made no later than 60 days after the fifth anniversary of the issue date (or, if earlier, the date the bonds are retired). Presumably, if a borrower fails to make an allocation within the time period, it is stuck with a tracing methodology.[3]

The ability to allocate proceeds to expenditures in some fashion other than specific tracing can be very useful for borrowers. Any such allocation would, of course need to be in

[3] About two years ago, Treasury proposed additional allocation and accounting regulations that would provide much more specific rules for allocations to "mixed-use" projects (by which they mean projects that are financed both by bond proceeds and other sources and which has both qualifying uses and non-qualifying uses. Those regulations have not yet been finalized and are expected to have substantive changes before they become effect.

writing **However, even if you are going to use a "direct tracing" method, I strongly urge you to consider doing a written allocation of proceeds to expenditures within the appropriate time period and in consultation with bond or tax counsel to ensure that proceeds have been spent on qualifying assets.** Preparation of the allocation should take into account not only qualifying (and non-qualifying) use, but also the estimated useful life of the assets allocated to bond proceeds. Any written allocation should be retained, together with invoices together with evidence of payment from some source. Typically, you should also retain invoices and contracts relating to the expenditures.

Finally, you should note that if you are going to allocate proceeds to expenditures that took place prior to the date the bonds were issued, there are special, detailed rules relating to allocating bond proceeds to expenditures paid more than 60 days before the bonds were issued—the "reimbursement" rules.

Investment and Expenditure of Proceeds—More Stuff to Monitor

Typically, you will invest the proceeds of your bonds pending their expenditure. In some cases (such as bond reserve funds), proceeds may be invested for the life of the bond issue. Usually, a borrower may invest bond proceeds without yield restriction. However, even if the proceeds may be invested without regard to yield, in most cases the borrower will need to pay "rebate" to the federal government.

The IRS's primary concern with respect to the investment of bond proceeds is that the proceeds be invested at a market yield. This is because they want to make sure that, if rebate is to be paid (or in cases where yield restriction applies), there is no "yield burning"—i.e., diversion of earnings in excess of bond yield to a third party. The requirements that proceeds be invested at market rates does not mean that you have to invest to maximize your earnings. Any investments of bond proceeds should take into account the need for liquidity (i.e., when do you expect to spend the money or need to have the money available), investment objectives (e.g., preservation of principal, return, etc., consistent with normal investment policies), and security of investment. However, within scope of your investment goals, you should make sure you are getting market returns on your bond proceeds and those returns are all reflected in receipts. For example, investing bond proceeds with a particular bank because the borrower will get a higher rate of return on endowment funds will raise questions.

So, how do you establish a market rate of return? As a starting point, if you fail to document what the market rates were at the time of the investment, the IRS may well look to other sources of information that will not be accurate (e.g., rates quoted in the *Wall Street Journal*). Accordingly, it is best to maintain records to show how you determined that you were investing at market rates. The gold standard, from the IRS's point of view is a bona fide bidding process to establish market rates. Bidding is particularly valuable for structured investments (such as GICs) and for purchases of securities. Treas. Reg. §1.148-5(d)(6)(iii) provides the requirements for having a safe harbor bidding process for GICs and investments in a yield-restricted defeasance escrow. If you follow those requirements for other investments, you should

still be ok. Similarly, Treas. Reg. §1.148-5(d)(6)(ii) gives a safe harbor that can be followed for investing in CDs.

However, please note that you are not required to follow the safe harbors (except perhaps for yield-restricted escrows). However, regardless of whether a safe harbor is used or not, the borrower should retain documentation that establishes that the investment was at market price. For example, if an investment is purchased by your treasury department based upon a "screen" showing investment rates, make sure a copy of the screen is kept.

There is also a special rule relating to investments of a type not normally traded on an established market. Treas. Reg. §1.148-5(d)(6)(i) says that purchase of such an investment is rebuttably presumed to be acquired at a price that is not a fair market price. So—keep those records.

Finally, with respect to investments, you may have to deal with rebate. Rebate is a requirement that kicks in if you are actually able to invest your bond proceeds at a yield in excess of the yield on the bonds. This requirement falls on issuers, but typical bond documents relating to conduit borrowings will push the responsibility rebate on the conduit borrower. In either case, do yourself a favor—except in the easiest of cases, hire someone to prepare a rebate report. And, even if no rebate is due, make sure your retention system keeps the records showing rebate calculation or demonstrating that you meet an expenditure exception.

Institutionalizing a Monitoring Process

So, you've allocated your proceeds and you've kept records on investment and expenditures. All done? Not by half.

In addition to maintaining records showing that proceeds have been spent for good purposes and showing rebate compliance, borrowers have to show that bond proceeds continue to be used for qualifying purposes for the entire life of the bond issue. A change in the use of a portion of a bond-financed facility (e.g., because of an unqualified management contract or research contract, because of new activities that are "unrelated trade or business," or because of lease of space to another entity) can cause an issue of bonds to be taxable retroactively. The sale of bond-financed facilities can cause problems as well.[4]

For a start, then you have to continuously monitor the use of your bond-financed facilities to see if changes in use are causing a problem. You must have some procedure in place to track the use and disposition of bond-financed property. In addition, the system must be "institutionalized" so the tracking will continue even with changes in personnel. Ideally, the

[4] There is the ability to "remediate" by the purchase of new qualifying property in the event that bond-financed property is sold for fair market value and for cash. If bond-financed property is leased or otherwise used in a manner that would cause the bonds to become taxable, typically a pro rata amount of the bonds must be redeemed or defeased to the first redemption date within 90 days after the change in use. Records should be maintained of any remedial actions.

system will also create a periodic record to show compliance. And, as mentioned above, for borrowers with multiple bond issues, the system must deal with each bond issue (and the property financed with it) separately, for tax-exempt status is determined on an issue by issue basis, not on an overall basis.

On-going monitoring requires a person whose *position* includes the responsibility for reviewing compliance. The responsibilities with respect to monitoring should be the subject of a written job description and that description should include actions that must be taken and information relating to where and how records are to be maintained.[5] Moreover, proper monitoring requires an up-to-date list of the bond-financed property. Your documentation showing how bond proceeds have been allocated to specific facilities is a starting point. If any bond-financed property is sold and new property is purchased, the list of bond-financed property needs to be updated. If any bond-financed property is used for non-qualifying purposes and the borrower remediates by redeeming bonds, the list must be updated to exclude the property that has been remediated against.

It is important that you establish a process requiring that the list of bond-financed property be consulted prior to the date that any new arrangements are entered into that could cause nonqualifying use or that would result in the sale of property. The fact that property is on the list does not mean that the alternative use cannot be entered into, but does mean that someone will need to calculate the total amount of nonqualified use and may mean that you will have to consider remedial action. For this to work, the people who are responsible for approving new contracts or approving the sale of property must regularly be reminded that they need to consult with the person at the hospital who is responsible for bond compliance.

Remember that, if you have to take remedial action, it must be taken within 90 days after the event that causes nonqualification. Usually, that is the date of the sale, lease, or other arrangement. Accordingly, you need to have a procedure that ensures that you are aware of potential changes in use of bond-financed property.

In addition, it is probably also best to provide for an annual review of the use (and ownership) of all bond-financed property. This should be done by the person responsible for bond compliance, but may involve, for example, surveying operations officers or others. From an operational point of view, it would be best to have a particular time each year when the compliance review takes place. And, as with all other records, you should maintain records concerning the annual compliance review.

Concluding Thoughts

[5] The IRS has sent out a Compliance Check Questionnaire for 501(c)(3) organizations that specifically asks what the title is of the person "primarily responsible for monitoring post-issuance compliance." It also asks where there are written procedures or guidelines. A similar questionnaire is expected to go out to governmental issuers in early 2009.

OK, so maybe your responsibilities regarding the tax-exempt status didn't end when the bonds were issued. However, working with post-issuance compliance shouldn't become an overwhelming problem. Basically, you need three things:

1. You should establish an institutionalized compliance program.

2. That should include making sure that someone's job description includes maintaining the right records.

3. And you need to maintain those records for the term of your bonds plus three years.

If you need help setting up a post-issuance compliance program or would like a review of your procedures, please give me a call at (916) 485-6645.