Post-Issuance Tax Compliance

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Monitoring Private Activity

JUNE 28, 2023

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Basics

- Section 103(a) of the Internal Revenue Code of 1986, as amended (the "Code") provides that gross income does not include interest earned on any State or local bonds
- A State or local bond is an obligation of a State or political subdivision thereof, including obligations issued "on behalf of" any State or local government by constituted authorities, such as CHEFA
- The tax exemption provided by Section 103 of the Code has two significant effects:
  - Reduces the effective interest rate on the obligation
  - Denies income tax revenue to the Federal government

Basics (cont'd)

- Whenever the IRS gives a tax benefit, such as tax exemption, it is limited and subject to many rules and regulations
- The tax exemption does not apply to "private activity bonds" which are not "qualified bonds" or to "arbitrage bonds"
- We will cover the private activity bonds/qualified bonds exception, Dan Kurowski of CHEFA will cover the exception for arbitrage bonds, and the joint panel will discuss post issuance compliance

Private Activity Bonds

- The tax exemption provided by Section 103(a) is generally provided to State and local governments to finance capital needs
    - e.g. schools, roads, water distribution and treatment facilities and other infrastructure
- Not intended to benefit "private users", such as trades or businesses
    - Non-profit use also considered "bad"
    - Generally, only up to 10% of tax-exempt proceeds or facilities financed by tax-exempt proceeds can be used by private users
- Exceptions include "qualified bonds", which include:
    - Exempt facility bonds (airports, docks, affordable housing, electric facilities, others)
    - Small issue bonds (up to $10 million for manufacturing facilities)
    - Student loan bonds
    - Qualified 501(c)(3) bonds (our favorite !)

Private Activity Bond Test

- Tax exemption does not apply to private activity bonds which are not qualified bonds
- 501(c)(3) bonds can be qualified bonds, but special rules apply
  - All property financed must be owned by the 501(c)(3) organization or a governmental unit
  - Proceeds must not be used by 501(c)(3) organization for activities which are classified as unrelated trades or businesses under Section 513(a) of the Code
    - In other words, too much unrelated trade or business use of tax-exempt bond proceeds or financed facilities is “bad”
  - 10% allowance is reduced to 5%
  - 2% generally used for costs of issuance, leaving only 3% for PBU and UTBU

Private Activity Bond Test (cont'd)

- Private activity bond = private business use test **and** private security or payment test
  - Must meet both tests to have private activity
- Private business use test – more than 10% of the proceeds used for any private business use ("PBU")
- PBU is use (directly or indirectly) in a trade or business carried on by a person other than a governmental unit
  - Use by corporations, partnerships, limited liability companies, sole proprietorships, federal government
  - Use includes ownership, leasing, management and service contracts, research contracts, other arrangements that convey special legal entitlements for beneficial use/priority use

Private Activity Bond Test – Exceptions:

- Portion of facility financed by Institution equity, taxable debt, grants, capital campaign
  - Most frequently used exception, especially where PBU is expected prior to issuance
  - “Floating equity” concept
  - Exception for both PBU and unrelated trade or business use (“UTBU”) under Section 513(a)
- Use as a member of the general public
  - Reasonably available for use on the same basis as a natural person
  - No priority rights or preferential benefits
  - Different rates for different classes of users permitted if customary and reasonable (i.e., volume discounts)
  - Arrangements in excess of 200 days, including renewal options, not treated as general public use

Private Activity Bond Test – Exceptions: (cont'd)

- Exceptions for PBU only
- Use for up to 100 days
  - Term of arrangement, including renewals, no longer than 100 days
  - Not general public use because generally applicable and uniformly applied rates not available to natural persons
  - Facility not financed for the principal purpose of providing property to nongovernmental person

Private Activity Bond Test – Exceptions: (cont'd)

- Use for up to 50 days
  - Term of arrangement, including renewals, no longer than 50 days
  - Negotiated arms-length arrangement at fair market value
  - Not financed for the principal purpose of providing property to nongovernmental person

Qualified management contracts (Rev. Proc. 97-13, 2017-13)

- Management, service, or incentive payment contracts can result in PBU
- Different rules for contracts entered into, and not materially modified, prior to August 18, 2017 and thereafter
- No compensation based on a share of net profits
- Burden of losses not borne by service provider
- Service provider and 501(c)(3) don't have a "prohibited relationship" limiting ability to cancel contract (stock ownership, common officers)
- 501(c)(3) exercises significant control over the managed property
- 501(c)(3) bears the risk of loss upon damage or destruction of the managed property
- No inconsistent tax positions (service provider will not take depreciation or rent deductions)

Qualified research contracts (Rev. Proc. 97-14, 2007-47)

- Agreements to sponsor research can result in PBU
- Agreements where sponsor is treated as a lessee or owner of financed property is PBU
- <u>Exceptions</u>:
- Property used for "basic research" if license or other use permitted on same terms as any other unrelated, non-sponsoring party
    - "Basic research" means an original investigation for the advancement of scientific knowledge not having a specific commercial objective (i.e., no product testing)
    - Sponsor must pay competitive price for use
    - Recipient need not permit persons other than the sponsor to use the license, but price paid by the sponsor must be no less than price that would have been paid by non-sponsor

Qualified research contracts (Rev. Proc. 97-14, 2007-47)

- Property used pursuant to a joint industry-governmental cooperative research arrangement
  - Sponsors agree to fund governmentally performed basic research;
  - Research to be performed and manner performed determined by 501(c)(3);
  - Title to patent or product resulting from basic research belongs to 501(c)(3); and
  - Sponsors are entitled to no more than non-exclusive, royalty-free license to use product
  - Rights of Federal government under Bayh-Dole Act will not create PBU

Incidental use

- Uses do not exceed 2.5% of proceeds (aggregate)
- No transfer of possession or control over space that is separated (vending machines, pay telephones okay)
- Not functionally related to other use of facility by same person

- Exceptions above (other than use of equity, taxable debt, grants, capital campaign moneys) only available for PBU, not UTBU

Measuring Private Business Use

- Average % of PBU of property during measurement period
- Measurement period begins on later of issue date or date property placed in service and ends on earlier of last date of expected economic life or last maturity of bonds financing property
- Average % of PBU is average of percentages of PBU for one-year periods during measurement period

Private Security or Payment Test

- Private activity bond = private business use test **and** private security or payment test
  - Must meet both tests to have private activity
- Payment of the principal of or interest on more than 10% of the debt service is directly or indirectly:
  - Secured by an interest in property used for PBU or payments in respect of such property (i.e., mortgage or loan agreement pledging gross receipts) **or**
  - Derived from payments (whether or not to the issuer) in respect of property used for PBU (i.e., loan agreement payments and note)

Private Security or Payment Test

- Private payments and debt service are present valued using arbitrage yield on the bond issue
- Payments do not exceed amount of use (e.g., if 7% of facility used for PBU, present value of payments limited to 7%)
- Payments related to operation and maintenance of financed facility not counted
- Rules for allocation of payments to different sources of financing, equity
- Providing use for free or nominal amount generally okay

Unrelated Trade or Business Use

- For 501(c)(3) organizations, UTBU of tax-exempt bond proceeds or financed facilities is "bad"
  - 10% allowance is reduced to 5%
  - 2% generally used for costs of issuance, leaving only 3% for PBU and UTBU
- UTBU is the conduct of any trade or business which is not substantially related to the 501(c)(3)'s tax exempt purpose

<u>Exceptions</u>:

  - Trade or business where work performed without compensation
  - Trade or business where work is for the convenience of members, students, patients, officers or employees (faculty housing, employee day care facilities)
- Exceptions for PBU above (other than use of equity, taxable debt, grants, capital campaign moneys) not available for UTBU
- Review of Form 990

Examples

- Food service, bookstore contracts
- Summer camps (sports versus academic use; third party versus school employees; students versus general public)
- Naming rights
- Doctor's offices, pharmacy contracts
- Parking facilities used by members of the general public
- Investment Income
- Disposition of bond-financed assets / remedial actions
- Borrower's counsel opines as to use of tax-exempt proceeds for 501(c)(3) exempt purpose

Arbitrage Compliance

JUNE 28, 2023

Dan Kurowski | Manager of Program Development & CHEFA CDC

Arbitrage Compliance

I. Arbitrage Introduction
   - Definitions and Overview
   - Historical Trends
   - Current Changes and Impact

II. Arbitrage Compliance Summary

III. Spending Exceptions

IV. Rebate Calculations

V. Yield Restriction

Introduction: Definitions & Overview

- **Arbitrage** refers to investing tax-exempt proceeds at a different taxable rate without incurring additional risk

- Arbitrage creates opportunities for Investors to profit from the disparity between markets e.g. (positive and negative arbitrage)

- **Example:** Borrowing at 3% and investing those proceeds at 4% creates positive arbitrage

Introduction: Definitions & Overview

Since the issuance of tax-exempt bonds is viewed as lost tax revenue, the U.S. Treasury established regulations to minimize the loss of revenue known as arbitrage rebate regulations.

- ✓ Issuances should be only for the amounts needed
- ✓ Don't issue bonds too early
- ✓ Proceeds should be spent timely, and bonds should not be outstanding longer than needed

Introduction: Definitions & Overview

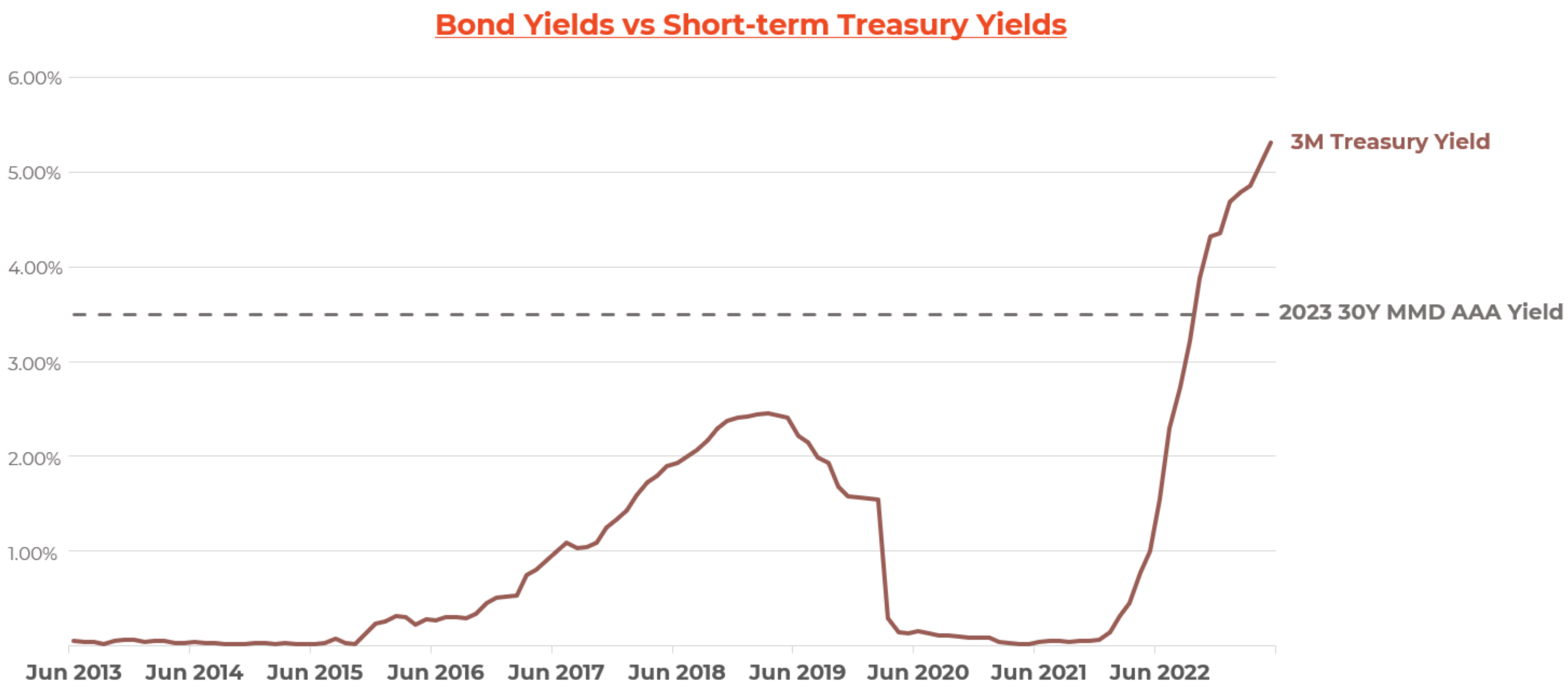
Arbitrage Rebate

- No limit on investment yields
- Payment dues to the IRS for investment earnings on bond proceeds that were earned at a yield higher than the bond yield
- Cumulative calculation required at least every 5 years

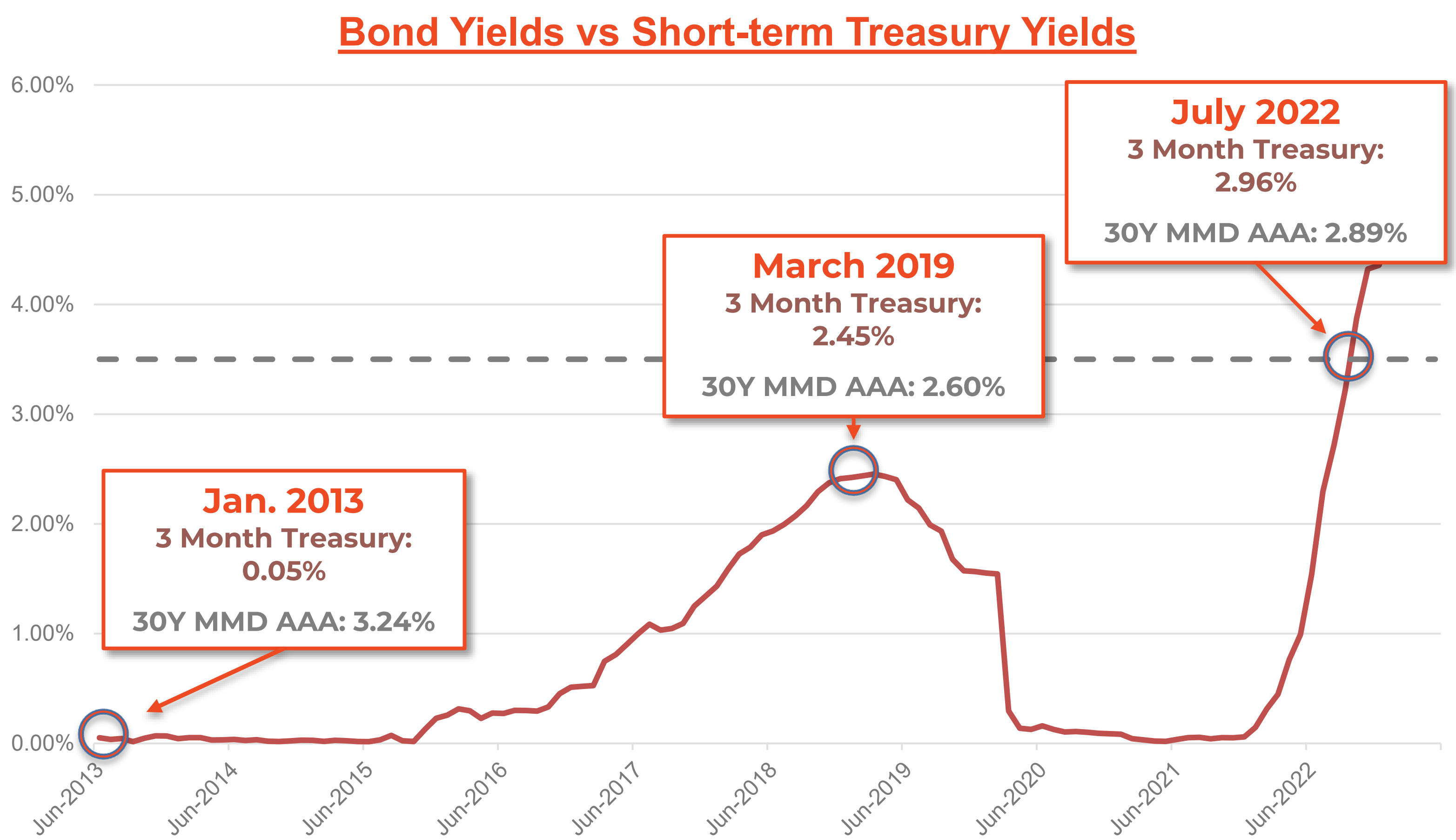
Yield Restriction

- Limits the investment yield on gross proceeds to the yield on the bonds.
- Certain proceeds are restricted to be invested below the bond yield
- Other proceeds may achieve compliance by making yield reduction payments to the IRS

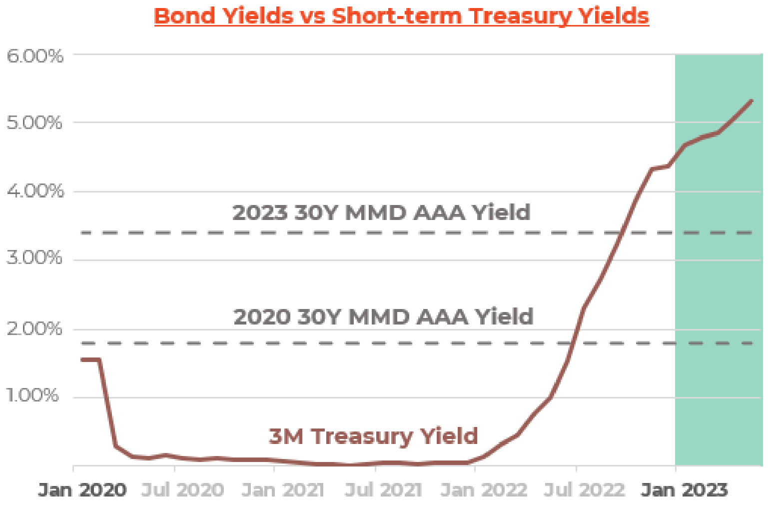
Introduction: Historical Trends



Introduction: Historical Trends



Introduction: Current Changes & Impact



Example: Bond Issuance Dated January 1, 2020

- At issuance, the 30Y MMD AAA yield equaled 1.80%.
- A significant negative arbitrage period during the construction phase
- *On Jan 1, 2023*, any remaining project funds become yield restricted.
  - 3 Month Treasury yielding 4.69%
  - Excess investment yield of 2.89% may be subject to yield reduction payments to the IRS

Borrowers in 2022 and beyond need to be focused on opportunities to maximize investment yield and avoid rebate payments.

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Arbitrage Compliance Summary

- If a borrower fails to meet any of the spending tests or exceptions, earnings on Gross Proceeds in excess of the yield on the Bonds is subject to rebate payment

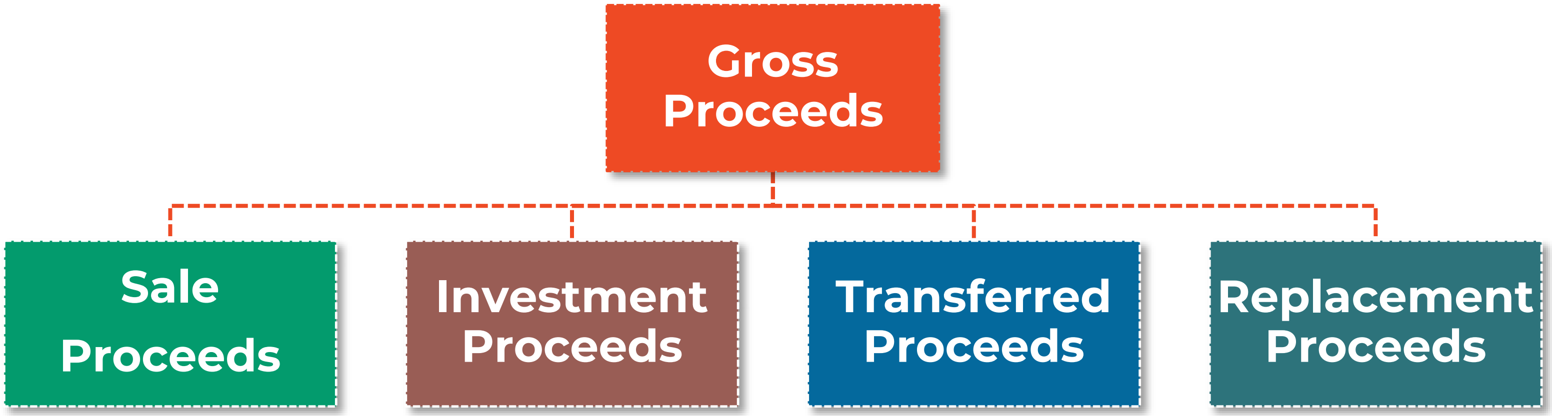
- Rebate calculation is performed to determine if the investment yield over the calculation period is greater than the bond yield, if so payment due

- First rebate calculation is performed no later the 5th anniversary date of issuance, and every 5 years after that date until the final maturity or redemption

Arbitrage Compliance Summary

- Borrowers are required to pay no less than 90% of the liability due no later than 60 days after the required calculation date and 100% of the liability no later than 60 days after the final maturity or redemption
- CHEFA typically performs the rebate calculations on behalf of our borrowers

Arbitrage Compliance Summary



Funds Typically Subject To Arbitrage Restrictions:

- ✓ Construction Funds
- ✓ Debt Service Reserve Funds/Special Capital Reserve Funds
- ✓ Escrow Accounts
- ✓ Debt Service Funds
- ✓ Any accounts pledged to pay Debt Service

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Spending Exceptions

Construction Funds proceeds are exempt from rebate if they meet the requirements of one of the spending exception schedules:

	6 Months Exception	18 Months Exception	2 Year Exception (Construction Issues)
6 Months	95%	15%	10%
12 Months	5%	60%	45%
18 Months	-	100%	75%
24 Months	-	-	100%

- Investment income counts as proceeds that must be spent
- Reserve Funds do not count and will not be exempt from rebate

Spending Exceptions

Timing of Expenditures: CHEFA treats the date the bond proceeds are distributed from the Construction Fund as the date the proceeds are spent to determine compliance.

- ✓ Borrowers can use actual dates the eligible invoices were paid to determine compliance
- ✓ The spending exceptions typically do not apply to draw down bonds

Spending Exceptions

Spending Exception: 2 Year Exception (Construction Issues)

Construction Issues are issues where 75% of available construction proceeds ("ACP") will be used for construction expenditures (Brick and Mortar)

ACP includes bond proceeds other than funds for COI and reserve funds, as well as earnings on ACP

Borrowers can elect to treat the construction portion of a multipurpose issue as a separate issue for spending exception purposes.

Spending Exceptions

Spending Exception: 2 Year Exception (Construction Issues)

Example: a $10M bond issued on June 1, 2023

Costs of Issuance	$200,000
Construction Fund	$9,000,000
Debt Service Reserve Fund	$800,000
Total Proceeds:	**$10,000,000**
Anticipated Earnings on Construction Fund	$100,000
ACP:	**$9,100,000**

Benchmark Date	% of ACP	Minimum Spending Requirement
12/1/2023	10%	$910,000
6/1/2024	45%	$4,095,000
12/1/2024	75%	$6,825,000
6/1/2025	100%	$9,100,000*

**Final benchmark includes actual interest earnings*

There is a De Minimis Exception for failures to meet the requirements of the final payment date: lesser of 3% of the issue price or $250,000

Spending Exceptions

Spending Exception: 2 Year Exception (Construction Issues)

Example: a $10M bond issued on June 1, 2023

Costs of Issuance	$200,000
Construction Fund	$9,000,000
Debt Service Reserve Fund	$800,000
Total Proceeds:	**$10,000,000**
Anticipated Earnings on Construction Fund	$100,000
ACP:	**$9,100,000**

- Only if the borrower meets all of the spending requirements, then all of the ACP would be exempt from rebate
- If Costs of Issuance proceeds are spent within 6 months, they are exempt from rebate
- Only the $800,000 of proceeds in the debt service reserve fund will be subject to rebate

Spending Exception is **not mandatory**, just an incentive to spend proceeds quickly.

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Rebate Calculations

1) Calculate Bond Yield
   - Fixed Rate Yields are calculated at issuance
   - Variable Rate Yields are calculated every computation period
     - Bonds that are fixed through a tender date, are treated as variable rate
     - Calculations must include Qualified Guarantees and Integrated Swaps

2) Determine Gross Proceeds of Bonds and determine if any spending exceptions apply

3) Calculate the Rebate Amount
   - The excess of the future value of all receipts from investments minus the future value of payments for investments determined by using the Bond Yield
   - Future Value = PV x $(1+i)^n$

Rebate Calculations

Example: A Bond Issue has its first computation date as of April 1, 2003

1) Bond Yield: 5.065%

2) Gross Proceeds:
   - Total Receipts from Investments: $5,085,632
   - Total Payments for Investments: $4,475,067

3) Calculate the Rebate Amount

FV of Receipts	$5,806,413
Minus: FV of Payments	$5,746,698
Rebate Amount	$59,715
Minimum Rebate Payment (90%)	**$53,743.50**

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Yield Restriction

Certain funds have a temporary period where the investment yields are unrestricted:

Type of Fund	Temporary Period
Construction Fund	3 years
Cost of Issuance Fund (New Money)	3 years
Cost of Issuance Fund (Refunding)	6 months
Debt Service Reserve Funds	Life of the bond*
Refunding Accounts / Escrow Funds	90 days for current refundings
Bona-Fide Debt Service Fund	13 months
Replacement Proceeds (e.g. Pledge Funds, Sinking Funds)	30 days

*Lesser of 10% of original principal amount of the bonds, maximum annual debt service, or 125% of average annual debt service

Yield Restriction

Following the temporary periods, proceeds of the bonds become yield restricted.

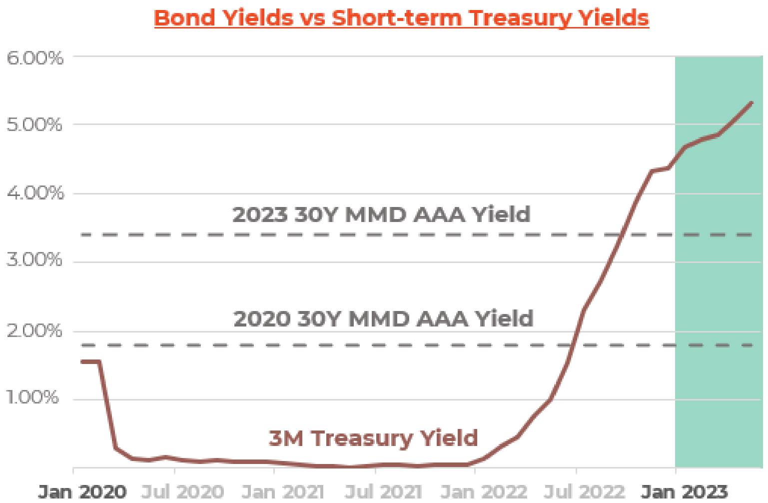
- ✓ Funds cannot be invested at a yield materially higher than the bond yield
  - Construction Funds may not be invested .125% above the bond yield
  - Reserve Funds, Debt Service Funds, Replacement Proceeds may not be invested above .001% above the bond yield

- ✓ Borrowers can make yield reduction payments to comply with yield restriction requirements

- ✓ Payments are similar to rebate payments and can be made within 60 days after the required calculation date. There is no exception to pay 90%, Borrowers must pay 100% of the yield reduction liability

Yield Restriction

Example: Bond Issuance Dated January 1, 2020



- $3M in the Construction Fund after the end of the temporary period on 1/1/2023 is now yield restricted at 1.925%
- 3M Treasury yields are now averaging 4.94%
- Borrower will need make a yield reduction payment to reduce the investment yield to 1.925%
- The costs to lower the yield is about $7,500 a month, which can be paid with proceeds in the Construction Fund

Resources

Have a question related to Arbitrage?

Section 148 of the Internal Revenue Code

The Tax Certificate / Tax Regulatory Agreement & Form 8038 in the Bond Documents

Ask CHEFA

Post-Issuance Compliance

JUNE 28, 2023

Keisha S. Palmer | Partner, Robinson & Cole LLP

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Post-Issuance Compliance

Background

- Bond Counsel, Institution Counsel and others review for compliance with tax rules at time of bond issuance
- Bonds pay tax-exempt interest for the life of the issue, as such there is a need to monitor compliance with tax rules throughout life of the issue
    - The Tax Regulatory Agreement contains covenants that Institution will comply with such rules
- Since compliance requirement can last for 30 years, IRS believes written procedures adopted by the Issuer and the Institution naming personnel (by title) responsible for compliance is the best method for ensuring compliance

Post-Issuance Compliance

- Form 990, Schedule K must be completed for outstanding bond issues annually
- Questions include:
  - PBU (leasing, management contracts, service contracts, research agreements, dispositions of bond-financed property)
  - Arbitrage requirements (spending exceptions, rebate payments)
- Institution generally responsible for monitoring use and ownership of property requirements
- CHEFA generally monitors arbitrage requirements (arbitrage rebate and yield reduction payments)

Written Procedures

- Differ depending on type and size of Institution (universities, hospitals)
- Topics addressed:
  - Due diligence review at regular intervals (at least annual)
  - Identity of official or employee responsible for review
  - Training of responsible individual (NABL, GFOA, Nonprofit associations)
  - Record retention
  - Procedures to timely identify noncompliance
  - Procedures to correct noncompliance

CHEFA Policy

- As borrower, Institution has ultimate responsibility and bears financial consequences of noncompliance with tax requirements
- CHEFA as issuer has adopted procedures to be followed by staff and borrowers

Borrowers

- Provide Schedule K of Form 990 to CHEFA
- Final allocation of bond proceeds
- Confirm use of proceeds requirements complied with TEFRA
- Report proposals to use bond-financed facilities for PBU or UTBU and discuss with CHEFA and bond counsel remedial actions, if necessary, to preserve tax-exemption on bonds
- Maintain records to identify assets or portions thereof financed by bond proceeds
- Monitor use of bond proceeds and bond-financed facilities throughout life of bonds
- Consult with bond counsel and others regarding contracts and other arrangements regarding the use of bond proceeds and bond-financed facilities

Borrowers (cont'd)

- Maintain records and agreements regarding use of bond financed facilities
- Confer annually with personnel responsible for bond-financed facilities to identify existing and planned use to determine compliance with covenants and restrictions in Tax Regulatory Agreement
- If violations discovered, notify CHEFA, bond counsel and other counsel to determine any required remediation
- Retain closing transcript, documents related to expenditure of bond proceeds and reimbursements using bond proceeds (construction contracts, purchase/change orders, invoices, property financed with bond proceeds, including final allocation), contracts and arrangements to use bond-financed facilities, arbitrage rebate reports and supporting documentation

Authority

- Acts as Institution’s rebate specialist to prepare rebate and yield reduction payment calculations
- Investments managed and directed by CHEFA
- Maintain Trustee statements regarding expenditures and investments
- Assure rebate and yield reduction payments are made on time
- Retain records of investments, investment agreements, arbitrage rebate reports, bidding documents, etc.

Questions?

June 28, 2023