NATIONAL ASSOCIATION OF BOND LAWYERS

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General Session: General Tax Law

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I. Introductions and Overview

A. The General Tax Law session presents a general overview of the federal tax law aspects of public finance transactions. Municipal indebtedness enjoys a special status in the investment securities community because most municipal debt qualifies for tax-exemption—that is, the interest paid on most municipal debt is not subject to federal income taxation of the registered owners of the debt securities. However, tax-exemption is based upon strict compliance with federal tax law. Thus, the tax analysis is integral to what we do; otherwise we do not have tax-exempt debt. The following information sets forth the basic federal tax requirements for tax exemption through practical examples. Readers of this outline should also refer to the more complete summary of general tax laws contained in the "Federal Tax Aspects of Municipal Bonds" chapter of NABL's companion book entitled "Fundamentals of Municipal Bonds."

B. General Tax-Exemption Rule: Section 103(a) of the Internal Revenue Code of 1986 (the "Code") provides that the interest on debt of a state or political subdivision is excluded from federal gross income, except in the following cases:

1. A private activity bond unless it is a "qualified bond;" and

2. An arbitrage bond.

There are many technical requirements that have evolved either through statutory amendments or IRS Regulations and rulings. The basic Code provisions relating to tax-exemption are in Section 103 and Sections 141-150.

C. Role of Tax Certificate: Most bond issues include as a closing document a tax certificate prepared by bond counsel, in which the municipal issuer covenants to comply with the various tax requirements that are set forth in the tax certificate and setting forth the facts and expectations required at the time the bonds are issued.

In other bond issues the covenants of an issuer to comply with various tax requirements are included in the authorizing or the financing documents. In such bond issues, the tax certificate is included as a closing document for the purpose of setting forth the facts and expectations required at the time the bonds are issued.

D. Origin of Tax-Exemption: The tax-exemption was part of the 1913 Act levying the modern income tax. It stated "…that in computing net income under this section there shall be excluded the interest upon the obligations of a State or any political subdivision thereof." Tax-exemption is not a constitutional right, rather it is a subsidy extended at the will of Congress. This principle was confirmed in *South Carolina v. Baker*, a U.S. Supreme Court decision from the 1980s. From 1913 until 1968, tax-exemption was unregulated. In 1968, the small issue tax-exempt bond provisions were introduced, in an effort by Congress to control access to and use of the tax-exemption subsidy. The TRA 1986 greatly reduced private activities that may be financed with tax-exempt bond proceeds. It also required that municipal bonds must meet certain additional rules for the interest received by the bondholders to be exempt from federal income tax. IRC § 103(a) is the statutory provision that excludes interest on municipal bonds from federal income tax. However, other rules such as those pertaining to private activity bonds, arbitrage, and hedge bonds are found in sections 141-150, 1394, 1400 and 7871.

II. Very Basic General Rules

Section 103(a) of the Code states that "gross income does not include interest on any State or local bond."

EXAMPLE 1:

A City determines that it must build roads and other infrastructure to serve a rapid expansion of both commercial and residential development. The City Charter and State Constitution require that any debt incurred by the City be subject to voter approval and specify limitations on the amount of debt that may be outstanding. The fact that residents have already begun to complain about the high property taxes makes it unlikely that the City will obtain voter approval of the proposed bond issue. In addition, there are concerns about how quickly the City will be able to complete the roads given the cumbersome bidding and condemnation processes. The financial advisor to the City suggests that perhaps the City can use the local industrial development agency (an "IDA"), a local improvement district or a "63-20 corporation" to avoid the bidding requirements and avoid a pledge of general taxes. Can the City use any of these proposed entities to issue tax-exempt bonds for this situation?

A. Section 1.103-1 of the Treasury Regulations (the "Regulations") says that a state or local government includes States, territories, District of Columbia or any possession of the United States and any political subdivision thereof.

1. The issuing entity must be a political subdivision for federal tax purposes. The mere labeling that is given an entity in state or local statutes is not sufficient. A political subdivision for federal tax purposes is a state or local

governmental unit with a not insubstantial amount of <u>one or more of the three sovereign powers</u> (*i.e.,* taxation, eminent domain and police). There are certain entities other than states, cities and counties that qualify as political subdivisions (*e.g.,* a school district that has taxing power, or a local improvement district that has power of eminent domain).

2. Bonds issued by or on behalf of a state or local governmental unit may also be eligible for tax exempt treatment. This includes bonds issued by <u>constituted authorities</u> and <u>63-20 corporations</u>.

   a. "Constituted authorities" are entities specifically authorized by state law to issue bonds on behalf of political subdivisions of a state to further public purposes. Rev. Rul. 57-187 sets forth the general criteria for determining whether an organization qualifies as a "constituted authority": (i) the issuance of bonds must be authorized by a specific state statute; (ii) the bond issuance must have a public purpose; (iii) the governing body of the authority must be controlled by the political subdivision; (iv) the authority must have the power to acquire, lease and sell property and issue bonds in furtherance of its purposes; (v) earnings cannot inure to the benefit of private persons; and (vi) upon dissolution, title to all bond-financed property must revert to the political subdivision.

In example 1, the industrial development agency is created by State statute and its purposes include issuance of debt to finance infrastructure to facilitate economic development. The IDA does not have the power of eminent domain or the power to tax. However, the directors of the IDA are appointed by the Mayor of the City, which does have such powers. Even though the IDA is not subject to public bidding rules and its bonds are not subject to statutory debt limitations or referendum requirement, it may very well meet the requirements of being a "constituted authority."

The local improvement district is created by State statute when property owners petition a local jurisdiction to form the district. The improvement district has a limited power of eminent domain (the City must make final determination upon recommendation of district) and can levy property taxes on property in the district (a tax in addition to the property tax imposed by the City on all City property owners). Although the improvement district is not subject to public bidding rules and the bonds are not subject to statutory debt limitations or referendum requirement, it may meet the requirements of being a political subdivision because of its taxing power (but probably would not if its only sovereign power was a limited power of eminent domain).

   b. "63-20 corporations" are corporations formed under general state nonprofit corporation law, the obligations of which are treated as issued on behalf of a political subdivision for purposes of Section 1.103-1(b) of the Regulations. The name comes from Rev.

Rul. 63-20, which first provided for such an "on-behalf-of issuer." Today, however, Rev. Proc. 82-26 sets forth the criteria of such on behalf of entities. The criteria are substantially the same as the criteria for constituted authorities described in Rev. Rul. 57-187. The most significant difference is the type of authorizing statute under which each is organized. The formation of the entity (including articles of incorporation) and the actual issuance of the bonds must be approved by action of the governmental unit on whose behalf the bonds are being issued. The property financed by the bonds issued by a 63-20 corporation must vest in the governmental unit no later than the end of the term of the bonds.

A 63-20 corporation does not have the power of eminent domain or the power to levy taxes. Unlike an IDA or local improvement district, a 63-20 corporation does not require special state legislation authorizing or enabling the creation of the entity. It is not subject to the public bidding rules, and its bonds are not subject to statutory debt limitations or referendum requirement.

3. Other Issuers.

   a. Volunteer Fire Departments.

   b. Qualified Scholarship Funding Corporations.

   c. Indian Tribal Governments.

   d. Non-Code Issuers (*i.e.,* tax-exemption permitted under federal law other than the Internal Revenue Code) (pre-1986 bonds only).

B. Bond or obligation required.

1. To be tax-exempt, the obligation of the issuer must be a legally <u>valid</u> exercise of the <u>borrowing power</u>. There are rulings that say that debt issued under a statute authorizing eminent domain where the previous owner must take that debt is not an exercise of the borrowing power, but the taking power.

2. Nonrecourse, conduit or revenue financings are allowed.

3. The obligation must be debt for federal tax purposes. However, it need not be debt for state law purposes.

   a. Installment sales or finance leases are generally treated as debt for federal tax purposes. Note that the sales agreement or lease must have a separately stated interest component for each payment to be made thereunder. *See, e.g.,* Rev. Rul. 72-399.

b. A certificate of participation is not itself a debt. The "debt" which is the basis of a tax-exempt financing with certificates of participation is typically the underlying lease or loan agreement.

c. Equity (*e.g.,* ownership of property) is not debt and, therefore, cannot give rise to tax-exempt interest.

d. There must be a reasonable expectation that the debt obligation will be repaid.

C. Interest includes accrued original issue discount.

III. Private Activity Bond Status

EXAMPLE 2:

A County proposes to acquire an existing office building, including limited parking spaces underground, near a new rapid transit stop. The County has decided that putting employees in space away from the County administration building will allow the County and its employees to provide services more efficiently to outlying areas, will stimulate overall economic development of the area and will alleviate traffic problems. The building has some existing retail space tenants, including a branch of the United States Department of Housing and Urban Development (HUD), which provides needed services to surrounding businesses. The leases will not expire for 3 years, unless the County is willing to buy out the leases. The County will not need all of the office space initially, but expects to use all the space within 5 years. The County is considering putting a medical clinic run by a local nonprofit hospital in the excess space, which will generate some revenues during the five years. The employees that will be moved to the building have requested that the new building include a cafeteria and a health club. The County does not intend to run these services themselves, but will contract them out. The bonds will be paid with general County sales tax revenues.

Can all the building be financed with tax-exempt bonds?

If not, how much can be and how is this determined?

One County Commissioner has also suggested that a portion of the bond issue be used to provide low interest loans to those County employees who want to purchase a home near the satellite office building.

A. Section 103(b) of the Code: Interest on a private activity bond that is not a qualified private activity bond is included in gross income.

1. The focus is on determining whether we have a private activity bond and, if we do, whether it is a qualified private activity bond.

2. Generally, bonds are private activity bonds if either (i) both the 10% private business use test and the 10% private payment or security test of Section 141(b) of the Code are met or (ii) the private loan test of Section 141(c) of the Code is satisfied.

B. Private business use: The only use that is not private business use is use by (i) a state or local government or an instrumentality thereof, (ii) an individual not in a trade or business, or (iii) the general public. Note that use of bond-financed facilities is treated as the use of bond proceeds.

1. Organizations described in Section 501(c)(3) of the Code and the federal government are considered private business users (nongovernmental persons) for this purpose, but there are special qualified private activity bonds for Section 501(c)(3) organizations.

2. A "special legal entitlement" in favor of a nongovernmental person is considered private business use.

a. Ownership by a nongovernmental person is private business use.

b. Leases to nongovernmental persons represent private business use.

c. Measurement of 10% use is calculated over term of bonds using a "space-time" analysis. *See below.*

In example 2, there are existing retail and HUD leases and the proposed lease to the medical clinic.

d. Management and service contracts must be carefully drafted to comply with safe harbors published by the IRS (*see* Revenue Procedure 2017-13, Notice 2014-67, and, for contracts entered into prior to 2017, Revenue Procedure 97-13).

Example 2 includes a health club and restaurant, and perhaps parking, that may have management contracts with nongovernmental persons.

e. Output contracts (special rules quantify use).

f. Research agreements.

g. Other uses that create special economic benefit if there is no general public use. *See* special factors listed in Section §1.141-3(b)(7)(ii) of the Regulations.

h. Naming rights.

Would the housing developers near the office building have a special economic benefit if property values are expected to increase?

3. Exceptions.

a. General public use.

The parking spaces in the County building are open to the general public on a first come/first served basis at generally applicable rates, with no reserved parking for retail business patrons.

b. Short-term use (200-day, 100-day and 50-day use contracts).

One-year agreement for rental of conference room in office building by Chamber of Commerce for monthly meetings (12-days of use).

c. Incidental use.

Pay telephones and vending machines in lobby of County office building that are owned and serviced by private vendors.

d. Temporary use by developer where infrastructure is turned over to governmental unit within reasonable time of completion.

4. Measurement.

a. Private business use is measured over the entire "measurement period," commencing on the later of the date the bonds are issued or the financed facilities are placed in service and ending on the earlier of the end of the useful life of the facilities or the date the last bond is retired.

b. The average amount of private business use in each year is determined and averaged over the entire measurement period. For a facility in which actual government use and private business use occur at different times (for example, different days), the average amount of private business use generally is based on the amount of time that the facility is used for private business use as a percentage of the total time for all actual use. In determining the total amount of actual use, periods during which the facility is not in use are disregarded. In general, for a facility in which government use and private business use occur simultaneously (*e.g.,* use pursuant to a nonqualified management contract), the entire facility is treated as having private business use.

c. In general, you must find a proxy for bond proceeds—*e.g.*, where space costs approximately the same in the building, the amount of private use of the building might be determined by measuring the space that is privately used. However, watch out for situations where proceeds aren't used equally for all assets or spaces.

d. The allocation and accounting rules allow private business use to be allocated first to "qualified equity." *See* Section 1.141-6 of the Regulations.

C. Private payment or security test.

1. Includes all private payments benefiting issuer, regardless of whether the payments are used to pay debt service on the bonds. (Note also that the payment can be a private payment even if it is not a payment made by the private business user!)

For example, private payments would include rent from retail space, HUD office, and nonprofit clinic. Would not include revenues from public parking if parking was being used solely by the general public and the parking facility was not subject to a noncompliant management contract.

2. Limited to an amount corresponding to the amount of private business use.

3. Generally applicable taxes are not private payments.

4. Sports stadium example.

D. Unrelated or Disproportionate Use: The 10% limit changes to a 5% limit if a portion of the bonds are used to financed private business uses that are "unrelated" to the governmental use. Similarly, a 5% limit applies where more than one facility is financed with the same issue and there is "disproportionate" private use.

Is the clinic or restaurant unrelated to the County use of the building so that its use changes the private business use limit from 10% to 5%?

E. Private Loan Financing Test: Separate and distinct test from private business tests that can cause private activity bond status.

1. If the lesser of 5% of the proceeds of an issue or $5,000,000 are loaned to one or more nongovernmental person (including individuals not acting in trade or business), the bonds will be treated as private activity bonds.

For example, the County Commissioner's home loan proposal would involve loans to natural persons and the 5%/$5 million loan test must not be met for the bonds to be tax-exempt.

2. Assessment exception.

a. Governmental tax or assessment of general application is not a private payment.

b. Projects must serve an essential governmental function.

IV. Qualified Private Activity Bonds

If both the private use and private payment tests are met or the private loan test is exceeded, bonds will be tax-exempt only if the financing is for a permitted purpose (meeting many specified rules) and other additional general private activity limitations and rules are met.

EXAMPLE 3:

County plans to acquire land and build a disposal facility that will process municipal solid waste and turn the waste into electricity. The technology is fairly sophisticated, so the County has entered into negotiations with Company to privatize the service. The Company suggests that it may be able to cut costs by acquiring reconditioned equipment. The Company will have a sizable investment in the privatization and determines that the safe harbor management contract provisions are inadequate because the Company will not be able to share in the net profits of the facility. The County and Company agree to enter into a lease of the facility. Even though the lease will cause the bonds to be private activity bonds, the Code permits issuance of private activity bonds for solid waste disposal facilities ("qualified bonds" under Section 142(a)(6) of the Code). An affiliate of the Company may purchase bonds to generate tax-exempt income. How will issuance procedures and tax analysis differ from doing this as a governmental bond deal?

A. 95% Test: A private activity bond is not a "qualified bond" unless at least 95% of the bond proceeds (net of reasonably required reserve funds) are used to provide the specific exempt facility. (*See also* section K below.)

1. Working capital is not a qualified cost.

2. Interest during construction until the facility is placed in service is a qualified cost.

3. Issuance costs of the bonds are not qualified costs.

4. The rules for qualified 501(c)(3) bond vary slightly.

B. TEFRA Hearing and Approval (Section 147(f)): A private activity bond is not a "qualified bond" unless it is the subject of public notice, a public hearing, and approval by highest elected official or legislative body.

1. 7-day notice requirement through various means of publication including newspapers and approving governmental unit website.

2. Required content of notice and approval (insubstantial deviations allowed and proposed regulations provide guidance on what "insubstantial" means and ways to correct deviations that are substantial).

3. Current refunding exception.

4. New rules for posting notice on websites and for holding hearings telephonically.

C. 2% Limit on Bond-Financed Issuance Costs (Section 147(g)): A private activity bond is not a "qualified bond" if more than 2% of the bond proceeds is used to pay the costs of issuing the bonds. (Note that costs for qualified guarantees are not subject to the 2% limit.)

D. Substantial user limitation on tax-exempt interest (Section 147(a)).

Company or an affiliate of Company that buys any bonds will receive interest that is taxable.

1. Usually a caveat in opinion.

2. Not applicable to qualified 501(c)(3) bonds or single-family bonds.

E. Limitation on Land Acquisition (Section (147(c)).

1. No more than 25% of net proceeds of a private activity bond may be used to acquire land.

Would need to make this determination because County plans to acquire land for use by the Company – the land limitation would not apply to governmental bonds.

2. Not applicable to qualified 501(c)(3) bonds or single-family bonds.

3. First-time farmer and environmental airport exceptions.

F. Limitation on Acquisition of Used Property (Section 147(d)).

1. Rehabilitation expenditures must be incurred on a used building acquired with bond proceeds. The amount of rehab expenditures must be at least 15% of the dollar amount of acquisition cost financed with bond proceeds.

2. The rehabilitation requirement increases to 100% with regard to used equipment that is not part of the building acquired.

Our example includes "reconditioned equipment" which would need to be analyzed under tax rulings to determine if treated as used equipment.

3. Not applicable to qualified 501(c)(3) bonds or single-family bonds.

G. Volume Cap (Section 146).

1. A private activity bond is not a "qualified bond" unless it has an allocation of state private activity bond cap.

2. No state cap is required for qualified 501(c)(3) bonds or current refundings.

3. There are also exceptions for certain governmentally owned solid waste disposal facilities, airports, docks and wharves if lease or management agreement is subject to certain limitations.

This bond issue could avoid having to get a volume cap allocation under the solid waste disposal facility exception, but would have to structure lease with Company to meet separate tax ownership rules under Section 142.

H. Useful Life/Maturity Limitation (Section 147(b)).

1. The average maturity of the bonds must not exceed 120% of the weighted average reasonably expected useful life of the facilities financed by the bonds.

If solid waste equipment had an IRS class life of 10 years, but an independent engineer certifies it will have a 25-year life, most bond counsel would rely on the engineer's certificate and the average bond maturity could not exceed 30 years.

2. Not applicable to single family or student loan bonds.

I. Prohibited Facilities (Section 147(e)): None of the proceeds of a "qualified bond" may be used to finance skyboxes, airplanes, gambling facilities, package stores, or health club facilities (the last prohibition doesn't apply to qualified 501(c)(3) bonds).

J. Prohibition against advance refunding of a private activity bond (previously Section 149(d)).

1. 90-day current refunding definition.

2. Tax Cuts and Jobs Act prohibits any tax-exempt advance refunding bonds issued after 12/31/2017.

K. Qualified Private Activity Bond Categories: Generally, 95% of net proceeds must be used for qualifying purposes; qualifying purposes vary depending upon type of financing.

1. Qualified 501(c)(3) bonds.

2. Exempt facility bonds: airports, docks and wharves, mass commuting facilities, water furnishing facilities, sewage facilities, solid waste disposal facilities, low- and moderate-income rental housing, "two-county" electric and gas facilities, local district heating and cooling facilities, hazardous waste facilities, high-speed intercity rail facilities, certain environmental enhancements of hydroelectric facilities, certain public educational

facilities, certain "green building" projects, certain highway or surface freight transfer facilities, qualified broadband projects, and qualified carbon dioxide capture facilities

3. Single-family mortgage revenue bonds (financing mortgage loans for purchasers of principal residence).

4. Small issues (up to $10M) for manufacturing facilities and first-time farmers.

5. Student loan bond issues.

6. Qualified redevelopment bonds.

L. Interest on tax-exempt private activity bonds is an item of tax preference for purposes of the alternative minimum tax on individuals.

1. AMT bonds bear an interest rate that is generally higher than comparable non-AMT bonds.

2. Governmental bonds, qualified 501(c)(3) bonds, qualified residential rental bonds and certain mortgage bonds are not subject to alternative minimum tax.

V. Miscellaneous Rules Applicable to All Bonds (Sections 149 and 150).

A. Reimbursement (a/k/a "pyramid bonds") (Section 1.150-2 of the Regulations).

1. Except for certain "preliminary expenditures" and/or a de minimis amount, cannot finance facility costs paid more than 60 days before municipal issuer adopts a resolution of intent to finance with bonds.

2. Special rules for qualified 501(c)(3) bonds.

3. Note special rule in Section 1.142-4(b) of the Regulations, treating refinancing of non-governmental obligations as a reimbursement for certain purposes.

B. Registration Requirement (Section 149(a)). Bonds generally must be in registered form.

C. Federal Guarantee Restriction (Section 149(b)). Generally, the bonds cannot be both tax exempt and receive a federal guarantee, although there are a number of exceptions.

D. Information Reporting (Section 149(e)).

1. Form 8038, Form 8038-G, or Form 8038-GC.

2. Information compiled from underwriter, issuer and borrower.

3. Filing deadline, late filing procedures.

E. Treatment of Pooled Financing Bonds (Section 149(f)).

1. Defined generally as reasonable expectation that more than $5,000,000 of issue is to be used directly or indirectly to make or finance loans to 2 or more ultimate borrowers.

2. Permitted under the Code, but limits on when loans must be made and when costs of issuance must be paid and special rules for temporary periods and rebate exceptions.

F. Hedge Bonds (Section 149(g)). Generally, issuer must expect to spend at least 85% of proceeds within 3 years. IRS often has 20-20 hindsight.

VI. ARBITRAGE AND REBATE

EXAMPLE 4:

Issuer issues $100 million twenty-year fixed rate tax-exempt bonds. Issuer applies $20 million to build a stadium and invests $80 million balance in twenty-year Treasury securities that, because they bear higher taxable rates, generate enough cash to pay off all $100 million of bonds.

A. Basic concept of arbitrage.

1. For our purposes, arbitrage is borrowing in one market (tax-exempt) and investing in a different market (taxable) at a higher rate. This is generally easy because of the difference between taxable and tax-exempt rates, although in recent years, there has been a substantial compression in the differential.

2. The test is based on “reasonable expectations.”

a. Confirmed by tax or arbitrage certificate.

b. But – subsequent deliberate acts are relevant.

3. Basic questions for Arbitrage and Rebate

a. Arbitrage – Can you earn it?

b. Rebate – Can you keep it?

c. For each dollar of proceeds, for as long as it is “unspent” on the purposes of the issue, the Issuer must either:

(1) Make sure that it will only be invested at a materially higher yield during a temporary period;

(2) Make sure that it is part of a minor portion – lesser of $100,000 or 5% of issue (of minor importance only);

(3) Make sure that it is part of a reasonably required reserve fund (*see* (C)(3) below);

or

(4) Make sure that it is not invested at a materially higher yield or that it is eligible for yield reduction payments.

Note – it must be "invested" at a "market" yield (otherwise there is a diversion of arbitrage profit).

Note – notwithstanding the ability to invest at a materially higher yield, an issuer may be required to rebate the allowable arbitrage profit to the U.S. Government (*see* section G below).

EXAMPLE 5:

A Section 501(c)(3) independent secondary school will be borrowing bonds issued by a conduit issuer to finance the construction of a gymnasium. The construction project is expected to take approximately two years to construct. The school has an endowment, but would like to maintain it rather than use it to build the project. The school has begun a general capital campaign for the project. The school expects to receive some money before the bonds are issued, but a majority of the funds will come in over a specific period of time. The bonds will be sized to cover all the costs of the project except to the extent of amounts received before the bonds are issued. The proceeds from the sale of the bonds will be invested, and the school plans to use investment earnings to pay a portion of interest during construction. A bank has agreed to purchase the bonds, but has asked that the school maintain liquid assets equal to 100% of the loan amount. What will the school need to know about investing these funds under the arbitrage rules?

B. Gross Proceeds: The arbitrage restriction on earning above the bond yield applies to "gross proceeds." Gross proceeds include sale proceeds, investment proceeds, replacement proceeds and transferred proceeds.

1. Sale Proceeds: Amounts actually or constructively received from the sale of the issue (including underwriter's discount). In general, accrued interest may be excluded.

2. Investment Proceeds: Amounts actually or constructively received from investing proceeds.

3. Replacement Proceeds: Amounts with certain nexus to issue.

   a. Sinking Fund: Amounts expected to be used directly or indirectly to pay debt service on an issue (regardless of whether pledged to pay the bonds).

If the debt service payments are expected to be made from investment income from investment of the endowment, the endowment will be a sinking fund.

   b. Pledged Fund: Amounts directly or indirectly pledged to an issue and reasonably expected to be available to pay debt service if needed.

It doesn't sound like the endowment will be pledged as security.

   c. "Negative Pledges": Might be treated as replacement proceeds (an agreement to maintain a minimum amount of assets, even though not pledged to pay debt service).

The liquid asset requirement of the Bank may be a negative pledge.

d. "Other Replacement Proceeds."

The capital campaign creates replacement proceeds by generating funds for the same purpose as the bonds.

4. Transferred Proceeds: Reallocation of unspent proceeds of refunded issue to refunding issue as refunding pays principal on refunded bonds.

C. Temporary Periods: Permitted period for investing above the yield of the bonds.

1. Construction or other capital projects – emphasis on three-part test.

a. At least 85% of net sale proceeds are reasonably expected to be allocated to expenditures ("spent") within 3 years.

b. Within 6 months, issuer incurs substantial binding obligation to spend at least 5% of net sale proceeds.

c. Construction or acquisition of the project and allocation of bond proceeds to those expenditures must proceed with due diligence.

School can invest the bond proceeds to build the project without yield restriction if it has these expectations.

2. Debt service fund ("bona fide debt service fund"): 13-month temporary period for revenues set aside to pay debt service.

3. Replacement proceeds (30 days).

4. Refunding escrow – 90 days for current refunding. Prior to 2018, advance refundings were permitted a 30 day temporary period, which was often waived because the yield on the advance refunding escrow was structured not to exceed the bond yield.

5. Miscellaneous – interest earnings (one year); working capital (generally 13 months).

D. "Reasonably required reserve or replacement fund" or 4R fund.

1. Sizing limits:

a. 10% proceeds – funding limit with bond proceeds.

b. The amount that may be invested above the bond yield cannot exceed the least of (i) 10% of the principal amount of the bonds, (ii) maximum annual bond debt service, and (iii) 125% of average annual bond debt service.

2. The reserve fund must be reasonably required (generally, a reserve fund is not required for a general obligation bond).

E. Yield

1. Calculation methodology – general.

a. Yield is the discount rate that, when computing the present value as of the issue date of all payments of principal and interest on the obligation, produces an amount equal to the issue price of the obligation.

b. Typically rely on underwriter or financial advisor to calculate.

c. Determined at closing if fixed rate issue (if any variable rate bonds, yield is calculated over 1- to 5-year periods for rebate purposes).

2. Issue price of bonds is generally the first price at which 10% of the bonds of each maturity is sold. Special rules for maturities where 10% test is not met ("holding-the-offering price") and for competitive bids. Certifications of underwriters or direct purchasers of bonds are required.

3. Qualified guarantee fees are treated as additional interest on the bonds (*e.g.*, bond insurance premium or letter of credit fees).

4. Single issue rules – separate bonds will be considered a single issue with a single composite yield if:

a. Sold at substantially the same time (within 15 days);

b. Sold pursuant to the same plan of financing; and

c. Reasonably expected to be paid from the same source of funds.

5. Taxable and tax-exempt issues are treated as separate issues.

F. Definition of materially higher yield for yield restricted investments.

1. Generally, 1/8 of 1% (0.125%).

2. 1/1000 of 1% (0.001%) for replacement funds and advance refunding escrow.

3. 1-1/2% for "acquired program obligations."

4. Special rules applicable to loans than finance owner-occupied residences and student loans.

G. Rebate – Can you keep it? If permitted to earn arbitrage, must be rebated to the Federal government.

For example, if School invested funds in construction fund above the bond yield and used all the investment earnings to pay debt service during construction, the School may have to come up with funds later to pay rebate if there is no rebate exception.

1. Exceptions to rebate requirement

   a. Spending exceptions – spend bond proceeds at least as fast as spending schedule set forth in the Code and Regulations (separate rules relating to expenditures within 6 months, 18 months or 24 months).

   b. Small issuer exception – expect to issue no more than $5,000,000 of governmental bonds for the year; special rule for construction of public schools allows increase to up to $15 million.

   c. Earnings on a bona fide debt service fund.

   d. Earnings from investing in non-AMT municipal bonds, 95% tax-exempt mutual funds or demand deposit SLGS.

2. Required to rebate 90% of amount every 5 years, 100% when bonds are fully retired or redeemed.

VII. Post-Closing Events

EXAMPLE 6:

A State issued bonds several years ago to finance the construction of a State office building. The State government has downsized and finds it no longer needs 20% of the space in the building. The State has explored several possible tenants and narrowed it down to two: a Section 501(c)(3) organization that will use the space for a child development center or a for-profit computer services company that will use the space as a business incubator and computer services headquarters. Must the State do anything with its bonds? Does it matter which tenant they select?

A. Change in use of facilities – discuss with issuers the ongoing compliance requirements.

1. Change in use from governmental to non-governmental could cause loss of tax-exemption retroactively to the date of issuance of the bonds.

2. Remedial action under Section 1.141-12 of the Regulations and Rev. Proc. 97-15 or through Voluntary Closing Agreement Program of the IRS

If State leases space and lease payments are paid over time and not as an upfront payment, the State must find money to redeem bonds if lease to computer services business. If lease to Section 501(c)(3) entity, may be able to treat bonds as "reissued" as qualified 501(c)(3) bond pursuant to Section 1.141-12(f) of the Regulations and keep the bonds outstanding.

B. Change in law – Generally, changes in statutes or regulations have not been retroactive, which means that a bond issue typically is subject to the law as it existed on the issuance date.

1. Effect on ability to refund and transition rules – new law applies to new bonds.

2. Reissuance – new law applies to "reissued" (old) bonds.

a. What is a reissuance, what to watch out for – Section 1.1001-3 of the Regulations and Notices 88-130 and 2008-41 (Note that proposed regulations regarding reissuance were issued in 2018, but they have not been finalized).

b. Procedural concerns – new filing of IRS Form 8038 required, arbitrage certifications.

c. Reissuance triggers arbitrage rebate due date.