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A Guide to Tax Compliance after Municipal Bond Issuance

After a governmental entity ("issuer") issues tax-exempt bonds or notes ("bonds"), the issuer is required to comply with rules related to the use of the bond-financed facilities and the arbitrage and rebate rules set forth in the Internal Revenue Code of 1986, as amended (the "Code"), as interpreted from time to time by regulations promulgated by the U.S. Treasury Department and rulings issued by the Internal Revenue Service (the "IRS"). Among other requirements, the issuer's proper use of the bond financed facilities and compliance with the arbitrage covenants will be essential to the ability of owners of the bonds to treat interest on the bonds as exempt from federal income tax. Certain failures in compliance can result in the bonds being declared taxable from the date of original issuance and delivery.

This provides a summary of the basic arbitrage rules applicable to most governmental bonds and is intended to assist the issuer in monitoring its compliance with respect to these rules. This article is not a general treatment of federal tax law and should not be used as a definitive reference on tax matters. The rules summarized below are applicable to governmental bonds only and not private activity bonds, which have unique nuances beyond the scope of this letter. As you work with these rules, we encourage you to call us with any questions you might have.

Use of Bond-Financed Facilities

The treatment of interest on municipal bonds is dependent on proper use of the bond-financed facilities. Issuers need to monitor projects financed with tax-exempt bond proceeds to ensure that they are not sold or changed from a qualifying municipal use to a private business use before the bonds are completely paid off. For governmental bond issues, at least 90% of the proceeds must be used for exempt purposes of the governmental issuer, and not more than 10% of the proceeds can be subject to "private business use" during the life of the bond issue. "Private business use" in regard to tax-exempt financing is use of tax-exempt bond proceeds or bond-financed facilities in the trade or business of a non-governmental unit, including nonprofit organizations and the Federal government. Examples of private use include contracts for parking management, research agreements, food services contracts, and other contracts where a third party is acting on behalf of the issuer. The use does not have to result in unrelated business income to be considered private business use.

Where there is more than 10% private business use, the IRS has established certain "safe harbors" to avoid the loss of tax-exempt status for the bonds. If you are considering changing the use of your bond-financed facility, including selling the facility, or have a contract with a third party that may give rise to private business use, we encourage you to contact bond counsel.

Spending and Investing Bond Proceeds

Most municipal bond issues that finance capital expenditures qualify under IRS rules for a "three-year temporary investment period." During this three-year period following the issuance of bonds, a municipal issuer may invest the bond proceeds at the highest yields available and the investment yield may be higher than the yield on the bonds. The difference is referred to as "arbitrage." Unless the issuer qualifies for one of the rebate exceptions discussed below, if the investment yield is higher than

the yield on the bonds, the general rule is that the issuer will need to pay ("rebate") the difference to the IRS. If the investment yield is not higher than the yield on the bonds, then no rebate will be owed. An issuer should keep track of the investments made with bond proceeds from the date the bonds are issued until all of the bond proceeds are spent. It is important for an issuer to do this even if the issuer believes that it will qualify for one of the three timed rebate exceptions. If none of the exceptions is satisfied, the issuer must compute any rebate payments owed.

A municipal issuer does not have to pay arbitrage rebate if it qualifies for one of the following "rebate exceptions."

Small Issuer Exceptions. If, at the time bonds were issued, the issuer expected to issue $5 million or less of tax-exempt bonds during the calendar year, then the bond issue qualifies for a rebate exception. For school bonds issued in 2002 and later, the $5 million limitation is increased to $15 million, but only for bonds issued for school construction projects. If an issuer fits within one of these exceptions, it is not necessary for the issuer to pay rebate to the IRS.

Six-Month, 18-Month and Two-Year Construction Exceptions. If an issuer does not qualify for the small issuer exception, then three other timed rebate exceptions are available. The issuer does not have to make an election to take advantage of any of these rebate exceptions, but must monitor construction expenditures to see if the bond issue qualifies. The rebate exceptions are related to how fast the bond proceeds (and investment earnings from the proceeds) are spent.

- The shortest rebate exception allows the bonds to escape from arbitrage rebate if all of the bond proceeds are spent within six months of the date the bonds are issued.
- The next-shortest rebate exception allows the bonds to escape from arbitrage rebate if the bond proceeds are spent according to the following schedule: 15% within six months, 60% within one year and 100% within 18 months. All of these periods are measured from the date the bonds are issued.
- The rebate exception allowing the longest period for expenditure of the bond proceeds is available only if at least 75% of the bond proceeds are spent for construction projects. The exception requires that the bond proceeds be spent according to the following schedule: 10% within six months, 45% within one year, 75% within 18 months and 100% within two years (all measured from the date of bond closing).

Failing to meet any one of the targeted expenditure dates results in failure of the entire rebate exception. For example, if an issuer met the 10% and 45% expenditure requirements for the two-year construction rebate exception, but failed the 75% expenditure requirement, the whole rebate exception is failed, and the bonds are subject to rebate from the date of issue.

There are some nuances involved in computing rebate exceptions, so the issuer should review the tax certificate prepared at the time the bonds were issued to determine the exact dates and amounts by which the bond proceeds (and the investment earnings on the bond proceeds) need to be spent.

Qualifying for a rebate exception means that an issuer does not have to pay the IRS the arbitrage earned during the three-year temporary investment period even though the investment yield is higher than the yield on the bonds. However, if bond proceeds remain unspent at the end of that period, the issuer must either "yield restrict" those proceeds (invest the remaining bond proceeds in investments that will yield less than the yield on the bonds) or make yield reduction payments (which requires the

issuer to complete IRS Form-8038-T and periodically pay to the IRS the earnings that exceed the bond yield).

Special Rules for Bond Funds. Reserve Funds. Revenue bonds and local improvement bonds are often issued with reserve funds. Such funds provide money to pay the debt service due on bonds if revenues or assessments are insufficient. Bond proceeds may or may not be deposited into such reserve funds. Reserve funds may generally be invested for the term of the bonds at yields that exceed the bond yield, because the amount of money in the reserve fund does not exceed the smallest of:

- 10% of the principal amount of the bonds,
- An amount equal to maximum annual principal and interest requirements on the bonds, or
- An amount equal to 125% of average annual principal and interest requirements on the bonds.

If money accumulates in a reserve fund in excess of this limitation, the investments in the reserve fund must be limited to the bond yield or else yield reduction payments must be made to the IRS.

Unless the issuer qualifies for one of the small issuer rebate exceptions, reserve funds are subject to arbitrage rebate regardless of whether they are funded with original bond proceeds and regardless of whether such fund qualifies to be invested at yields that exceed the bond yield.

Repair, replacement and revenue funds. Some revenue bonds also have repair, replacement and revenue funds. These funds generally are not subject to the arbitrage rebate rules and may be invested at yields that exceed the bond yield.

Debt service funds. Most bond issues also have bond funds or debt service funds (often containing principal and interest accounts) that are used to make the regularly scheduled debt service payments. Most bond and debt service funds qualify for an exemption to the arbitrage investment and rebate rules because the bonds have an average maturity of at least five years and the bonds have a fixed rate of interest that does not vary over their term, or the average annual debt service is not in excess of $2,500,000. They generally may be invested at the highest rate of return available, and arbitrage rebate is not required.

Paying rebate. If rebate is owed, arbitrage rebate payments are due to the IRS at least every five years from the date the bonds were issued. If the issuer makes the rebate payment once all of the bond proceeds have been spent, it does not have to track making any future computations. Rebate payments are made by filing IRS Form 8038-T. If no rebate is owed, then no filing with the IRS needs to be made. It is important, however, to keep the records of construction expenditures and investments for at least three years from the date all of the bonds are completely paid off (or six years from the date of the record, if longer).

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