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Bonds 201: Tax Compliance

May 18, 2023

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Agenda: Compliance with Federal Tax Law

Arbitrage Rules

Private Use Limitations

Post-Issuance Tax Compliance

Questions

Arbitrage Rules

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Overview

Arbitrage is the ability to earn yield by borrowing money at a lower rate (by issuing tax-exempt bonds) and investing it at a higher rate (in the taxable market)

- Positive arbitrage – earnings above the arbitrage yield
- Negative arbitrage – earnings below the arbitrage yield

Congress enacted rules to ensure tax-exempt bonds are issued for a governmental purpose and not to create arbitrage profits

Two sets of rules:

- Yield restriction – "Can you earn it?"
- Rebate – "Can you keep it?"

Both sets of rules must be applied to each fund containing "gross proceeds" of the bonds

Gross Proceeds

Gross proceeds –

- Sale proceeds
  - Amount received from the sale of the bonds (Issue Price)
  - Includes amounts used for underwriter's discount
- Investment proceeds
- Transferred proceeds
  - Only applies in refundings
  - Tax documentation at closing will describe any expected transferred proceeds
- Replacement proceeds
  - Debt Service Funds
  - Reserve Funds
  - Other amounts that are pledged or expected to be used to pay debt service

General Yield Restriction Rule

Gross proceeds will be:

- Invested at unrestricted yield during an allowable temporary period;
- Invested at unrestricted yield as part of a "minor portion" not exceeding the lesser of $100,000 or 5% of the issue;
- Invested at unrestricted yield as part of a reasonably required reserve fund; or
- Yield restricted—i.e., not invested at a yield that is materially higher than the yield on the bonds

Yield: Bond or arbitrage yield for fixed rate issues is determined at closing and will be included in the tax certificate and on the Form 8038G

Materially higher: definition depends upon the category of funds

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Exceptions to Yield Restriction

Temporary Periods

1. Construction and other capital projects – 3 years *if* test is met:
   - ≥ 85% of net sale proceeds reasonably expected to be spent within 3 years;
   - Within 6 months of issue date, substantial binding obligation to spend ≥ 5% of net sale proceeds; and
   - Construction or acquisition proceeds with due diligence
2. Debt service fund – 13 months
3. Replacement proceeds – 30 days
4. Miscellaneous (working capital) – 13 months
5. Current refunding escrow – 90 days

Reasonably Required Reserve Fund – sizing requirements

Investment in “Tax-Exempt Bonds” that are not considered “investment property”

Yield Restriction

At closing:

- If yield restriction is expected, the tax certificate will describe the funds to be restricted.
- Bond counsel will help structure allowable investments, such as SLGS or open market securities purchased through a bidding process

Post-closing:

- For example, if you have project funds remaining after the 3-year temporary period or if replacement proceeds arise unexpectedly, then yield restriction may be needed
- If you have questions, contact bond counsel or hire a rebate consultant

Yield Reduction Payments:

- In some cases, you can make yield reduction payments to reduce the yield on your investments. This can be easier to manage than constantly monitoring the yield.

Rebate: Exceptions

If an exception applies, rebate may not be required:

- 6 month exception
  - Refundings and new money
- 18 month exception
  - Acquisitions and construction
- 2 year exception
  - Construction only
  - Not available for some types of qualified private activity bonds
- Bona fide debt service funds
  - Full exception
  - Exception $100,000 in earnings

Reserve funds do not have an available exception! Rebate will always apply to excess earnings.

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Rebate Computation and Payments

When?

- Computation Dates
  - There is some flexibility in choosing computation dates, but they cannot be later than 5 years after issue date and every 5 years thereafter
  - Date of redemption or final maturity of the bonds ("final computation date")
- Payment
  - At least 90% must be paid ≤ 60 days after each computation date
  - 100% must be paid ≤ 60 days after final computation date

What?

- Difference between the amount actually earned on nonpurpose investments and the amount that would have been earned if investments had a yield equal to the yield on the bonds

How?

- Form 8038-T
- Rebate consultant can help

Arbitrage Tips

Look to tax certificate and 8038G form for the arbitrage yield and expectations regarding:

- Applicable temporary periods
- Potential rebate exceptions
- Funds subject to yield restriction

Commingled funds complicate tracking. Invest bond proceeds in separate accounts whenever possible.

Proceeds are tracked until expended. Know the rules for when proceeds are considered expended for tax purposes.

Keep records of expenditures and investments.

Arbitrage Tips

Changing interest rate environment:

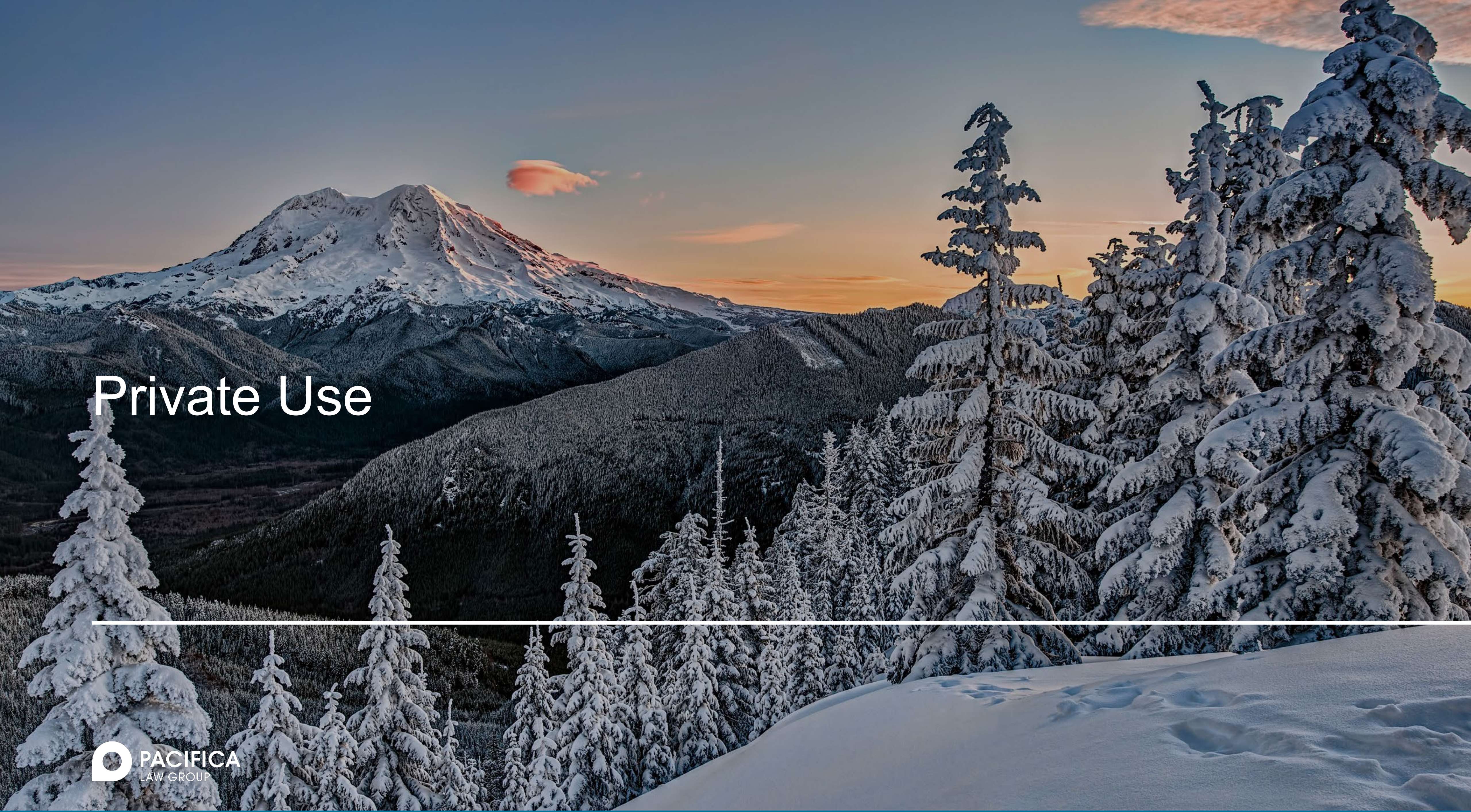
- Possible to earn positive arbitrage
- Investment yield is blended over time* so exceeding the bond yield temporarily may not be a problem.

First rebate calculation is due not later than 5 years after the issue date.

Get help when needed! Hire a rebate consultant or talk to bond counsel if you have questions.

**The blending rules differ for yield restriction and rebate requirements.*

Private Use



Types of Private Business Use (PBU)

Use by a nongovernmental person in a trade or business, including:

- Ownership
- Leases
- Management Contracts
- Output Contracts
- Sponsored Research Agreements
- Other actual or beneficial use – special legal entitlements / priority rights

PBU is generally limited to 10% of the bond proceeds, if the private payments or security test is also met.

- On issue date, based on issuer's <u>reasonable expectations</u> over the life of the bond; *or*
- After the issue date, if issuer takes <u>deliberate action</u>

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Management Contracts

What is a management contract?

- A management, service, or incentive payment contract between a governmental person and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility.

Examples:

- Contract for management of dining services
- Incentive payment contract for physician services at a hospital or retirement facility

Can result in private business use unless:

- The Regulations carve it out, e.g., contracts incidental to the primary function of the facility
- The contract under the "facts and circumstances" does not result in a net profits arrangement or otherwise constitute private business use
- The contract is a "qualified management contract" under Revenue Procedure 2017-13

Private Business Use: Common Exceptions

General public use

- Up to 200 days of use on the same terms as use by natural persons
- Usually free or pursuant to generally applicable rate schedule

Short term use

- < 50 days use under a single lease or use agreement; payments must be fair market value

Incidental use

- Non-possessory use that does not exceed 2.5% of the financed facility
- E.g., kiosks, vending machines, pay phones

Agents

Use incidental to financing arrangements

Temporary use by developers

Measuring Private Business Use

The amount of private business use of property is determined according to the average percentage of private business use of that property during the measurement period.

Measurement Period:

- Begins on the later of the issue date of the bonds or the date the property is placed in service
- Ends on the earlier of the last date of the reasonably expected economic life of the property or the latest maturity date of the bonds.

Steps for calculating 10% limitation:

- Determine the amount of PBU allocable to each financed project on an annual basis
- Determine the PBU allocable to the bonds on an annual basis
    - Based on the proceeds allocated to each project
    - Taking into account any Qualified Equity (next slide)
- Annual PBU is averaged over the measurement period

Qualified Equity (QE)

Qualified equity refers to funds that are:

- Proceeds of non-tax advantaged bonds – i.e., taxable bonds; and
- Funds that are not derived from a borrowing; if
- QE funds are spent contemporaneously with bond proceeds on the same project ("same plan of financing")
- Note: QE does not include equity interests in real estate

In each year, private use will be allocated first to qualified equity and then to bond proceeds.

Tips

- Identify and track sources of QE
- Plan sources and uses to maximize QE

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Examples

1. City is issuing bonds to finance 100% of the costs of new construction of a 20-story office building with a 20 year expected economic life. City wants to lease 3 floors to a nongovernmental person for all 20 years.

- Measurement period?

  20 years

- Average percentage of PBU?

  Years 1-20: 3 floors / 20 floors = 15% PBU

  Average PBU = **15%**

2. City will lease the three floors to the nongovernmental person for only 10 years.

- Average percentage of PBU?

  Years 1-10: 3 floors / 20 floors = 15% PBU

  Years 2-20: 0 floors / 20 floors = 0% PBU

  Average PBU: [(15% * 10 years) + (0% * 10 years)] / 20 years = **7.5%**

Examples

3. City is back to leasing out 3 floors for the entire life of the project. Total project cost is $20M; City will issue $18M bonds, and use $2M qualified equity.

- Allocate private use to QE first:

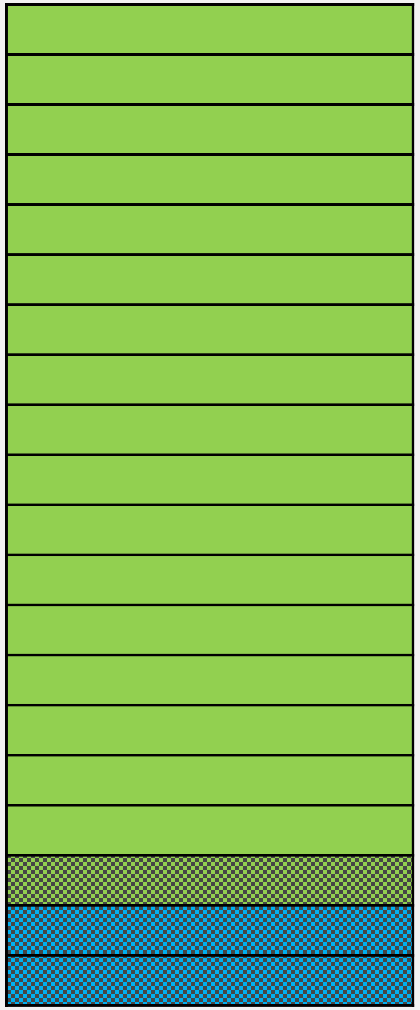
  QE will pay for 10% of the project: $2M QE / $20M total = 10%

  We have 15% PBU, so we can allocate 10% of it to qualified equity

- Then to bond proceeds:

  Remaining PBU = 5%, or $1M

  Allocated to bond proceeds: $1M PBU / $18M bond proceeds = **5.6%**



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Post-Issuance Tax Compliance

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Post-Issuance Compliance

Consult issuer’s compliance policy and bond indenture/ordinance/resolution

Identify responsible person for tax compliance

Track investments / unused proceeds

- Calculate and pay rebate when due

Track spending / use of proceeds

- Note changes from expectations

Monitor private use of the facilities

- Sale of facilities, lease of facilities, management contracts, preference arrangements
- Review proposed contracts / renewals

Maintain records

- General rule: life of the bonds plus 3 years

Questions?

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