BORROWING IN A BAD ECONOMY
LEGAL ISSUES IN NEW BORROWINGS, POST-ISSUANCE TAX COMPLIANCE

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I. American Recovery and Reinvestment Act

On February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act of 2009 (the "Act"). The Act includes a number of favorable provisions relating to tax-exempt bond financing, including provisions that may be of particular interest to public higher education institutions and higher education institutions that are tax-exempt under Section 501(c)(3) of the Internal Revenue Code (the "Code").

Enhanced bank ability to invest in tax-exempt bonds (Act §§ 1501 and 1502)

The Act includes provisions that will make tax-exempt bonds, including bonds for higher education institutions, a more attractive investment for banks and certain other financial institutions.

Under prior law, under Section 265(b) of the Code banks were generally disallowed a portion of their regular tax deduction for interest expense in proportion to the amount of their assets that consisted of tax-exempt bonds. The disallowance did not apply, however, to bonds issued by certain qualified small issuers (i.e., governmental issuers that issue less than $10 million in bonds during the year), commonly referred to as "bank qualified" bonds. Bank qualified bonds ordinarily carry a more favorable interest rate than other bonds because they are a more attractive investment for banks based on the disallowance exemption. Bonds issued by a state or local government issuer for separate 501(c)(3) organizations were aggregated with other bonds of that issuer for purposes of applying the $10 million annual limit. These provisions have effectively limited investment by banks in bonds that are not bank qualified, and have limited the ability of 501(c)(3) organizations to utilized bank qualified bonds.

Provisions in the Act amended Section 265(b) of the Code to:

- Allow banks to invest up to two percent of their assets in tax-exempt bonds (whether or not bank qualified) without losing any portion of their regular interest deductions;
- Increase from $10 million to $30 million the annual limit for issuers of bank qualified bonds; and
- In the case of conduit financings for 501(3) organizations, including pool bond issues, look through to the 501(c)(3) borrower as if it were the issuer for purposes of applying the annual limit for issuers of bank qualified bonds.

For example, assume that a county is a conduit issuer of tax-exempt bonds for two 501(c)(3) conduit borrowers, University A and University B. Under prior law, if the county were to issue $10 million of bonds for University A and $10 million of bonds for University B in a single year, neither issue would be bank qualified because the county was issuing more than $10 million of bonds during the year. Under the Act, on the other hand, for 2009 and 2010 the county can issue $30 million of bank qualified bonds for University A and $30 million of bank qualified bonds for University B in the same year, because the law applies the annual limit, which is increased to $30 million, to each conduit borrower, not the conduit issuer.

These provisions should increase bank investment in tax-exempt bonds. The two-percent rule will increase bank demand for all types of tax-exempt bonds. The new rules for bank qualified bonds will increase the ability of smaller 501(c)(3) organizations and governmental issuers to utilize bank qualified bonds. The provisions are temporary, generally applying only to bonds issued in 2009 and 2010 to finance new projects (as opposed to refinancings).

<u>Build America Bonds (Act § 1531)</u>

The Act includes provisions that will enable issuers of governmental purpose bonds, including public colleges and universities, to reach a broader class of investors by accessing the taxable bond market.

Under new Section 54AA of the Code added by the Act, an option is provided under which an issuer may elect that any bond (other than a private activity bond, such as a 501(c)(3) bond) that would qualify for tax exemption under Section 103 of the Internal Revenue Code could instead be issued as a taxable bond with a tax credit equal to 35% of the interest on the bond. The Act refers to these bonds as "Build America Bonds." The relevant provision applies to bonds issued after the date of enactment but before January 1, 2011.

In light of the lack of tax credit appetite under current economic conditions, for a temporary period an issuer electing the taxable bond option may further elect to receive direct payments from the federal government in the amount of the credit, in lieu of the credit being provided to the bondholders. This refundable credit provision applies only to bonds issued before January 1, 2011, and is available only for issues where 100 percent of the available project proceeds (<u>i.e.</u>, sale proceeds less up to two percent costs of issuance) less amounts deposited in a reasonably required debt service reserve fund are used for capital expenditures. For example, the refundable credit type of Build America Bond is not available to refund prior bond issues or to finance working capital expenditures.

Issues relating to use of refundable credit Build America Bonds:

- Whether taxable debt markets will accept bond terms commonly utilized in municipal bond market, such as serial bonds and optional call rights.

- Treatment of refundable credit payments under particular bond document provisions, e.g., are they "revenues" subject to bond lien? Impact on debt service coverage requirements and additional bonds tests?

- Dealing with risk of late payment of refundable credit by Federal government, or of Congressional action to terminate payments.

- Differences in disclosure practices.

II. Borrowing to cover loss of anticipated expenditures from endowments

The federal income tax laws place significant restrictions on the use of tax-exempt bonds to finance working capital expenditures. Accordingly, it may be necessary to use taxable financing in order to cover working capital shortfalls resulting from loss of anticipated expenditures from endowments.

The arbitrage rules under Section 148 of the Code generally permit the use of tax-exempt bonds to finance working capital expenditures only if the issuer/borrower has no other "available amounts" from which to make the working capital expenditures. See Treas. Reg. § 1.148-6(d)(3). In other words, the issuer/borrower must generally be in a cash-flow deficit situation. In determining the issuer/borrower's "available amounts," the tax rules permit the exclusion of any amounts that are subject to a legislative, judicial, or contractual restriction on use for working capital purposes. The rules also allow the issuer/borrower to exclude any reasonable working capital reserve and, in the case of a 501(c)(3) organization, any "qualified endowment fund" that meets the following requirements: (i) it is derived from gifts or bequests, or the income thereon, that were neither made nor reasonably expected to be used to pay working capital expenditures; (ii) it is designated and consistently operated as a permanent endowment or quasi-endowment fund restricted as to use; and (iii) there is an independent verification that the fund is reasonably necessary as part of the organization's permanent capital.

Even if a sufficient cash-flow deficit exists to permit a tax-exempt working capital financing, difficult issues arise in determining how long a term such a financing may have. The arbitrage rules generally prohibit a tax-exempt bond issue from having a longer term than is reasonably necessary for the governmental purpose of the issue. See Treas. Reg. § 1.148-1(c)(4)(i). Accordingly, it generally is necessary to structure any tax-exempt working capital financing so that it is repaid as soon as there are "available amounts" from which the financing may be paid.

III. U.S. Department of Education financial responsibility requirements

In order to participate in Federal Student Aid (FSA) programs administered by the U.S. Department of Education, a school must demonstrate its financial responsibility. See § 498(c) of the Higher Education Act; 34 CFR 668 Subpart L. The Department determines whether a school is financially responsible based on the school's ability to (i) provide the services described in its official publication and statements, (ii) properly administer the FSA program in which the school participates, and (iii) meet all of its financial obligations. The Department's analysis includes calculation of various ratios with respect to the financial condition of the school, including primary reserve, equity, and net income ratios. Those ratios are combined in an overall "composite score." If the school's composite score falls below certain thresholds, the

Department may require the school to take additional steps, such as posting a letter of credit, to demonstrate its financial responsibility. The incurrence of additional indebtedness by a school could adversely affect its financial ratios and composite score, potentially giving rise to additional conditions on the school's participation in FSA programs or, if the school is unable to meet those conditions, jeopardizing its participation in FSA programs. Accordingly, a school should consider the impact on its financial responsibility ratios when considering incurring any additional indebtedness.

IV. Post-Issuance compliance requirements for tax-exempt bonds

The federal income tax laws impose a number of requirements that must be met in order for the interest on bonds for governmental or 501(c)(3) organizations to be exempt from federal income taxation, including requirements that must be met for the entire period that the bonds are outstanding (e.g., 30 years or longer). These requirements include limitations on use of bond-financed facilities by other than governmental entities or 501(c)(3) organizations (as the case may be), limitations on use of bond-financed facilities in an unrelated trade or business of the 501(c)(3) organization, and limitations on the investment of bond proceeds in investments providing a higher yield than the bonds.

<u>Post-Issuance Compliance – In General</u>

- The meaning of bond counsel's opinion
  - Based on expectations as of the issue date and covenants regarding future compliance
  - Post issuance compliance is generally the borrower's responsibility, consultation with bond counsel may be appropriate from time to time

- Reasons for monitoring compliance and keeping records
  - Compliance with document covenants
  - Preparing for the possibility of a future IRS audit

- New changes to the Form 990 will require annual reporting of information regarding post-issuance compliance with tax-exempt bond rules

<u>Summary of Requirements to be Monitored – Arbitrage/Rebate (Section 148 of the Code; Treas. Reg. §§ 1.148-1 through 1.148-11)</u>

- Investments of bond proceeds; including establishing fair market value of purchased investments
- Expenditures of bond proceeds during "temporary period"
- Possible creation of "replacement proceeds"
- Use of consistent accounting methods
- Reimbursement for prior expenditures
- Post issuance credit enhancement or hedging activities
- Rebate spending exceptions
- Rebate computation and payment

Summary of Requirements to be Monitored – Use of Financed Facilities (Section 141 of the Code; Treas. Reg. §§ 1.141-1 through 1.141-14)

- Monitor expenditure of proceeds on qualifying costs (95% requirement for 501(c)(3) bonds; 2% costs of issuance limit)
- Private Business Use
  - Leases
  - Management Contracts
  - Physician Contracts
  - Sponsored Research
  - Naming Rights
  - Parking Agreements
  - Unrelated Trade or Business

Change in Use (Treas. Reg. § 1.141-12)

- Violation of private business use restrictions may cause bonds to be taxable retroactive to their issue date
- Remedial actions may be available; must be taken within prescribed time limits
- Generally involves redemption or defeasance of nonqualified bonds
- In the case of dispositions for cash, proceeds may be used for new qualifying facilities
- May require that notice be given to the IRS

Elements of a Compliance Policy

- Identify persons responsible for various elements of post-issuance compliance
- Establish procedures for transfer of responsibilities and accumulated information in the event of personnel changes
- Determine policies regarding frequency of review of various elements of post-issuance compliance
- Establish record-keeping system and policies on record retention

Project Construction and Completion Procedures

- Track expenditures of bond proceeds on qualifying project costs, including maintaining records of expenditures (e.g., invoices, receipts, etc.)
- Track compliance with 2% costs of issuance limitation
- Monitor compliance with spending requirements under temporary period rules and rebate spending exceptions
- Maintain any project fund requisitions and/or project completion certificates required under bond documents
- Properly documents any allocations of bond proceeds for reimbursement of prior expenditures

Arbitrage and Rebate Procedures

- Establish procedures for verifying fair market value of investments purchased with bond proceeds, including bidding procedures for GICs and yield-restricted escrows
- Establish schedule for making rebate computations (at least every 5 years) and making any necessary filings with IRS
- Consider whether professional rebate analyst should be retained to make computations
- Regularly determine whether any replacement proceeds have been created, such as sinking funds or pledged funds
- Monitor any post-issuance credit enhancement or hedging activities with respect to the bonds

Monitoring Private Business Use

- Maintain records indicating the amount of bond proceeds used for each facility, and identify the specific bond issues from which the proceeds were derived
- Create an ongoing private use schedule for each bond issue
- Adopt standard forms of contracts (e.g., management contracts, research contracts, physician contracts) that have been reviewed by counsel; require legal review of any contracts that vary from approved forms
- Perform periodic internal audits of facilities to determine whether private business use is occurring

Record Retention

- Limited guidance provided by the IRS to date indicates a very broad interpretation of the record-keeping requirements for tax-exempt bonds, e.g., keep virtually everything until 3 years after the last bond is retired
- IRS has requested comments on the record-keeping burden, and there is some hope for more lenient rules in the future
- Copies of all trustee bank statements and other investment records should be kept (including records relating to any investment bidding procedures utilized)
- Copies of all records verifying expenditures on project costs should be kept
- If possible, keep copies of all contracts relating to use of bond financed facilities. If not practical, at least retain summaries of all such agreements and schedules of time periods to which they relate
- Problem of proving the negative; if there has been no private business use of a facility, retain file memos reflecting periodic internal audits and determination that there has been no private business use
- Until further clarification is provided by IRS, attempt to retain all records until 3 years after final bond of issue is retired (including refunding issues)

Self Audits

- Many borrowers may have outstanding bonds that were issued many years ago
- In anticipation of possible IRS audit, the borrower may wish to perform a self audit to determine whether there are any tax issues that could be raised
- If past records are incomplete, it may be possible to "reconstruct" records through interviews with individuals with personal knowledge of how facilities have been used (but certainly do not attempt to pass these off as contemporaneous records)
- If problems are discovered, it may be possible to remedy them through remedial actions, or through the IRS voluntary compliance program (VCAP)

Conclusions

- IRS audits of tax-exempt bond financings are now routine
- Adoption of internal compliance procedures and record retention policies will make dealing with the IRS much easier
- Contemporaneous records are given much greater weight by the IRS
- Even if there is a need to "reconstruct" records of past uses of facilities, it is better to take such action before being contacted by the IRS