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POST-ISSUANCE COMPLIANCE

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DISCUSSION OUTLINE

- Legislative History/IRS Oversight of Tax Exempt Bonds
- Investment and Arbitrage Compliance
- Exceptions to Rebate Requirement
- Yield Restriction Requirements
- Does Reporting Ever Stop?
- Recovery of Overpayments
- Record Retention Requirements, Compliance Substantiation & Best Practices
- Final Thoughts

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LEGISLATIVE HISTORY/IRS OVERSIGHT

- Tax-Exemption is a federal subsidy
- System Abused
- Laws and Regulations were established to discourage issuers from:
  - Issuing more bonds than needed
  - Issuing bonds sooner than needed
  - Leaving bonds outstanding longer than needed
- Advance Refunding Bonds – two sets of Bonds outstanding simultaneously
- Upon issuance – sign up for compliance with yield restriction, rebate, record retention
- Don't want your bonds considered "Arbitrage Bonds", and potentially declared taxable

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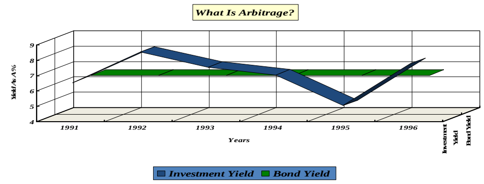
Investment and Arbitrage Compliance

Arbitrage Defined

- Ability to borrow at tax-exempt rates and invest at higher taxable rates without incurring any additional risk
  - Disparity between markets
  - Positive and negative arbitrage
  - Tax-Exemption of bond interest allows for positive arbitrage



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Investment and Arbitrage Compliance

Rebate Requirements

- Governed by Section 148(f) of the Internal Revenue Code
- Requirements were applied to all tax-exempt bonds issued after August 1986 by the Tax Reform Act of 1986
- Issue by issue determination
- Positive arbitrage can be offset by negative arbitrage within a particular bond issue
- Reporting Cycle – every fifth bond year, and at the final maturity date of the bonds
  - Bond Year defined as each 1-year period that ends on the day selected by the issuer
  - First and last bond years may be short periods
- Computation Date Credit offset to defray the cost of the calculation
- Compliance for the life of the bond issue

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Investment and Arbitrage Compliance

Rebate Defined

- The net amount of positive arbitrage required to be remitted to the Federal government
  - "Net amount"- accumulates all arbitrage positions for an issue
- Excess earnings on "non-purpose" investments allocated to gross proceeds
- Non-purpose investment means any investment property that is not a purpose investment
- What is a purpose investment?
- What is the maximum rate of interest I can earn and retain?
- What would you have earned had you invested at the bond yield?
- What did you earn?
- What proceeds are subject to the arbitrage rebate requirements?

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Investment and Arbitrage Compliance

Gross Proceeds
- Sale Proceeds
  - Proceeds derived from the sale of the bonds
- Investment Proceeds
  - Earnings received from Sale Proceeds and earnings on those earnings
- Original Proceeds
  - Includes Sale Proceeds and Investment Proceeds
- Transferred Proceeds
- Replacement Proceeds
  - Sinking & "pledged" funds

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Investment and Arbitrage Compliance

Determining My Allowable Yield
- Fixed Rate Bonds
  - Fixed and determinable at closing
  - Stated coupons, maturities and reoffering prices
  - Super-integrated hedge treated as fixed rate bonds
  - Not recalculated unless bonds redeemed within 5 years of delivery

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Investment and Arbitrage Compliance

Determining My Allowable Yield (cont.)
- Variable Rate Bonds
  - Interest rate will fluctuate based upon underlying basis and will not be determinable at closing
  - Determined on a hindsight basis
  - Utilize yield periods to carve up bond yield for installment computations
    - Interest payments
    - Principal payments
    - Qualified guarantee fees
    - Qualified hedge payments/receipts

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Investment and Arbitrage Compliance

Other Important Considerations of Calculations

- Commingled Funds – fund including variety of sources, invested without regard to source
- Reimbursement – requires official intent
- “Allocate Proceeds to Expenditures” vs. “Spend Proceeds”
- Cash Outlay – allocation of bond proceeds must involve current outlay of cash, reasonably expected to occur within 5 business days of the date the allocation was made
- Reallocation of Bond Proceeds

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Investment and Arbitrage Compliance

Other Important Considerations of Calculations (cont.)

- Final Allocation of Expenditures to Bond Proceeds – must be made no later than 18 months after the later of date paid, or date project placed in service, and in any event not later than the date the first rebate payment would be due
- Universal Cap – bonds outstanding, limits amount of assets that can be allocated to a bond issue
- Working Capital Bonds, TRANS, etc – have their own strict rules/requirements for reserves, spending exceptions, etc.

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Exceptions to Rebate

Small Issuer Exception

- Available in the Code since 1986, finally a part of the Regs in 1993
- General taxing authority
- $5,000,000 per calendar year limitation (subordinate entity debt included)
- Actual Facts vs. Reasonable Expectations
- Public Education limitation
  - $5,000,000 prior to 1998
  - $10,000,000 1998 to 2001
  - $15,000,000 2002 to present
  - no more than $5 million can be used for non-construction purposes
- Private activity bonds - no small issuer allowance
- Is NOT an exception for Yield Restriction or Post Issuance Compliance

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Exceptions to Rebate

Bona Fide Debt Service Fund Exception

- Proper matching of revenues to principal and interest payments within each bond year
- Annual depletion requirement to bring account balance below a reasonable carryover amount
- Reasonable carryover amount is 1/12th of preceding year's debt service payments
- Private Activity bonds have additional $100,000 earnings test
- If bona fide debt service fund earns less than $100,000 in a given bond year it shall not be taken into account for rebate purposes

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Exceptions to Rebate

Six-Month Spending Exception

- 100% in 6 months
- Another six months for de minimis amount (less than 5% of proceeds of issue)
- Only exception available for refundings

Eighteen-Month Spending Exception

- Permitted under 1993 Regulations (not retro-active)
- 15% in 6 months
- 60% in 12 months
- 100% in 18 months
- De minimis allowance of lesser of 3% of issue price or $250,000

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Exceptions to Rebate

Two-Year Construction Spending Exception

- Became available in 1989 Code (not retroactive)
- Fairly limiting as only applies to construction issues (75% or more used for construction purposes)
- 10% in 6 months
- 45% in 12 months
- 75% in 18 months
- 100% in 24 months
- Time extension for reasonable retainage – up to another year, not to exceed 5% of available construction proceeds
- De minimis allowance of lesser of 3% of issue price or $250,000
- Reserve fund and reserve earnings
- Penalty in lieu of Rebate

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Exceptions to Rebate

Invest in other Tax-Exempt Securities

- Similar tax status bonds are not considered “non-purpose investments”
  - governmental to governmental, private activity to private activity
- Cash flow requirements could be mismatched

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Yield Restriction Requirements

- Governed by Section 148(a) of the Internal Revenue Code (came about from Tax Reform Act of 1969)
- Two systems with a single objective of preventing arbitrage abuse
- Separate Requirement
- Issue by Issue Determination
- Restricts Investment Earnings Relating to Yield Restricted Proceeds
  - Temporary Period - 3 Years
  - Certify at closing that reasonably expect to spend more than 85% in 3 years
  - Advance refunding and defeasance escrows
  - Transferred proceeds
  - Amounts in excess of reasonably required reserve funds

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Yield Restriction Requirements

Yield Reduction Payments

- Apply to bonds issued on or after July 1, 1993, or bonds retro-actively applying the 1993 Regulations
- Similar to rebate payments - pay positive arbitrage on yield restricted proceeds
- Pay 90% of yield restriction liability at every fifth bond year, and 100% at the final maturity
- Can owe a yield reduction payment without owing a rebate payment
- Made in the same time and manner as rebate payments
- Does not result in “double” payments

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YIELD RESTRICTION REQUIREMENTS

Summary of Arbitrage Rebate and Yield Restriction Analyses

Issue Date: March 7, 1996
Rebate Computation Date: March 7, 2001

Summary of Arbitrage Rebate Analysis

Fund Reference Number	Fund Description	Current Fund Status	Computation Date Valuation	Gross Earnings	Internal Rate of Return	Excess Earnings
1	Construction Fund	Inactive	$0.00	$8,139,455.99	5.787138%	$1,228,239.38
2	Reserve Account	Inactive	$0.00	$1,002,397.80	4.910626%	($24,694.13)
		Totals:	**$0.00**	**$9,141,853.79**		**$1,203,545.25**

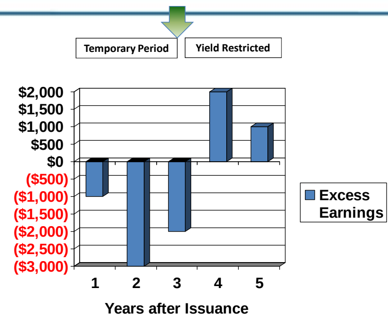
Summary - Rebate	
Arbitrage Yield:	5.011622%
Return on Investments:	5.617297%
Excess %:	0.605674%
Actual Gross Earnings:	9,141,853.79
Allowable Gross Earnings:	7,938,308.55
Excess Earnings:	1,203,545.25
Less Cumulative Yield Restriction Liability:	(311,782.71)
Cumulative Rebate Liability:	891,762.54
Rebate Payment Due:	***$802,586.29***

Summary of Yield Restriction Analysis

Fund Reference Number	Fund Description	Current Fund Status	Computation Date Valuation	Gross Earnings	Internal Rate of Return	Excess Earnings
1	Construction Fund	Inactive	$0.00	$3,267,300.55	5.633640%	$311,782.71
		Totals:	**$0.00**	**$3,267,300.55**		**$311,782.71**

Summary - Yield Restriction	
Arbitrage Yield: [1]	5.136622%
Return on Investments:	5.513400%
Excess %:	0.376777%
Actual Gross Earnings:	3,267,300.55
Allowable Gross Earnings:	2,955,517.84
Yield Restriction Liability:	311,782.71
Yield Reduction Payment Due:	***$280,604.44***

YIELD RESTRICTION REQUIREMENTS



YIELD RESTRICTION REQUIREMENTS

Exceptions to Yield Restriction

- Temporary period
- Materially higher yield allowance
  - Unexpended Construction – 1/8th of 1%
  - Refunding Escrow – 1/1000th of 1%
- Minor portion – lesser of 5% of issue price or $100,000

Waiving Your Temporary Period

Does Reporting Ever Stop?

- Calculations are required every five years and at the final maturity date of the issue
- A refunding may accelerate the final computation date
- Arbitrage requirements may cease for outstanding bonds if all the following criteria is met:
  - All bond proceeds have been spent
  - No Reserve Fund has been funded
  - Debt Service Funds are 100% bona fide (Bona Fide Debt Service Fund Exception) and non-governmentals earn less than $100k in a bond year
  - No other proceeds arise:
    - Replacement
    - Investment type property
    - Transferred proceeds

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Recovery of Overpayments

- Widespread negative arbitrage over the last 5-10 years can lead to opportunities
- Maximum amount you can recover is limited to amount you have paid to IRS
- Identify/quantify the claim amount
- Accumulate documentation to support the claim
  - Initial rebate/yield restriction report indicating amount due
  - Subsequent report(s) showing no further amounts are due
  - Executed IRS Form 8038-T, check and cover letter submitted to the IRS with payment
  - Completed 8038-R

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Recovery of Overpayments

- Don't have to wait until final maturity date of bonds or even until all of proceeds have been expended
- Have up to 2 years statute of limitations after bonds pay off to submit a refund claim
- IRS has been inundated with claims, but has shortened response time

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Record Retention Requirements & Best Practices

What records must be maintained?

- Documents related to the bond transaction (entire transcript)
  - Official Statement
  - Tax Certificate (aka: Arbitrage, No-Arbitrage, and Non-Arbitrage Certificate)
  - Bond Insurance and Surety Bond Payments
  - IRS Form 8038-G or 8038 (Private Activity Bonds, 501(c)(3))
  - Verification Report (Refunding Issues)
  - Reimbursement Agreement (Variable Rate Issues)
  - Swap or Hedge Agreement with Trade Confirmations

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Record Retention Requirements & Best Practices

What records must be maintained? (cont.)

- Documents related to post-closing elections
  - Bond Year Selection
  - Retro-Active or Selective Application of Regulations
- Documents evidencing any investment of bond proceeds
- Trust Bank Statements
- Internal Records (expenditure detail)
- Pool Statements

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Record Retention Requirements & Best Practices

What records must be maintained? (cont.)

- Documents evidencing expenditure of bond proceeds (cash outlay)
- Use of bond financed property by public and private sources
- Sources of payment or security for the bonds
- Arbitrage Reporting – Rebate and Yield Restriction
  - Rebate Reports (anniversary date calculations supporting payment, or lack thereof)
  - Memo to file stating why calculations were not necessary
  - For payments made
    - Copy of cancelled check
    - Copy of IRS Form 8038-T
    - Copies of all correspondence with the IRS
  - Source documents provided to the consultant for calculation purposes
  - Copies of correspondence related to any IRS Audit

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Record Retention Requirements & Best Practices

What records must be maintained? (cont.)

- Section 6001 of the Internal Revenue Code requires the retention of records to support tax positions taken
- If not supported, the IRS can draw its own conclusions based upon the information presented
- Records must be maintained by:
  - Issuers
  - Conduit Borrowers
  - Bondholders

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Record Retention Requirements & Best Practices

What format must the records be kept in?

- Kept in a manner that ensures complete access to the IRS
- Hardcopy or electronic
- If electronic, must have a complete audit trail (Rev Proc 97-22)
- During any examination, the issuer must retrieve and reproduce hard copies of all electronically stored books and records requested by the IRS
- Use of a third party does not relieve the issuer of record retention responsibilities

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Record Retention Requirements & Best Practices

How long must records and source documents be maintained?

- Minimum 3 years after bonds are retired
- Extended to 3 years after refunding bonds are retired, if the bonds were refunded
- Older requirement in most tax documents require a 6 year retention policy
- Advisory Committee on Tax Exempt and Government Entities Report (ACT)
  - Looking to streamline record retention burden
  - IRS has not acted upon this suggestion

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Record Retention Requirements & Best Practices

What if not maintained?

- Loss of tax exemption
- Additional rebate could be due (based upon IRS conclusions)
  - Failure can be corrected through - Voluntary Closing Agreement Program (TEB VCAP) - Must be filed prior to Audit
  - VCAP team up from 5 to 20 agents in last year
  - Streamlined procedures, fill-in-the-blank settlements

Where to find assistance:

- Access NABL/GFOA websites to use as a starting point or for additional support
- Visit IRS Website

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Record Retention Requirements & Best Practices

Best Practices

- Compile a Tax Exempt Bond (TEB) Document Retention Policy and Document Retention Checklist
- Segregate the TEB Documents
- Determine the Storage Medium
  - If electronic, must meet requirements of Revenue Procedure 97-22 and keep technology up to date
  - If paper based, must be kept for the long term
- Identify a Powerful Deletion Approver with Mandatory Sign Off on any TEB Document Destruction
- Override State record retention or record destruction requirements or business practices

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Final Thoughts

"You've been invited to an I.R.S. audit."

- Be prepared - IRS will continue to send out questionnaires and examination letters – not a matter of "if", but of "when"
- Work with your financial advisor, bond counsel and rebate provider - we are here to assist you

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