Post-Issuance Tax Compliance and Continuing Disclosure Responsibilities

for Issuers and Borrowers of Tax-Exempt Bonds

SECOND EDITION

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Contents

CHAPTER 1

Introduction: Why Post-Issuance Compliance?

The tax-exempt bond market is perennially under heightened scrutiny by various regulators, including the Internal Revenue Service (the "IRS"), the United States Securities and Exchange Commission (the "SEC") and the Municipal Securities Rulemaking Board (the "MSRB"). A primary focus of these regulators is on post-issuance compliance.

The purpose of this publication is to summarize the topic of post-issuance compliance for interested parties. It is intended to assist:

- treasurers, finance directors, comptrollers, controllers and other responsible officials of state and local government issuers of tax-exempt bonds ("Issuers"); and
- representatives of private, nongovernmental conduit borrowers (such as nonprofit institutions providing health care and higher education) that are allowed to borrow at tax-exempt rates from Issuers ("Borrowers"),

in developing policies, procedures and systems to ensure that (i) the interest on their bonds will remain tax-exempt, (ii) they are in compliance with their ongoing continuing disclosure obligations, and (iii) they are in compliance with their covenants under their bond documentation so that no event of default will occur on account of technical noncompliance.

The authors are members of the Public Finance and Tax Groups at Orrick, Herrington & Sutcliffe LLP ("Orrick") and a director at BLX Group LLC ("BLX"). Orrick is one of the nation's premier bond counsel firms, ranked number one (in dollar volume) for more than 20 years, with experience in virtually every form of debt offering. Orrick and BLX (a wholly owned subsidiary of Orrick), are among the nation's leading providers in post-issuance compliance services.

Due to its complex nature, post-issuance tax compliance takes up the majority of this publication, as Chapters 2 through 7. Chapter 8 addresses compliance with continuing disclosure obligations. Lastly, Chapter 9 focuses on additional compliance with the covenants contained in underlying bond documentation in a financing. For further information about any of the topics discussed, please contact one of the people listed at the end of the publication.

BLX CAN HELP

The consequences of noncompliance with federal tax law requirements could result in the loss of the tax-exempt status of the bonds. To assist Issuers and Borrowers in meeting ongoing post-issuance compliance responsibilities, BLX offers a wide range of post-issuance services. With financial professionals in offices strategically located across the country, BLX is one of the industry leaders in providing post-issuance compliance services to a growing number of Issuers and Borrowers. Among the services it offers are the following:

- Private Business Use review, analysis and calculation;
- IRS Schedule K completion for 501(c)(3) borrowers;
- Arbitrage Rebate and Yield Restriction calculation;
- Webinars and in-person training regarding post-issuance compliance matters;
- Assistance in developing or analysis of post-issuance tax compliance policies and procedures; and
- Review of tax documentation and recordkeeping procedures.

We hope that you find this publication to be useful and informative.

CHAPTER 2

What Is Post-Issuance Tax Compliance?

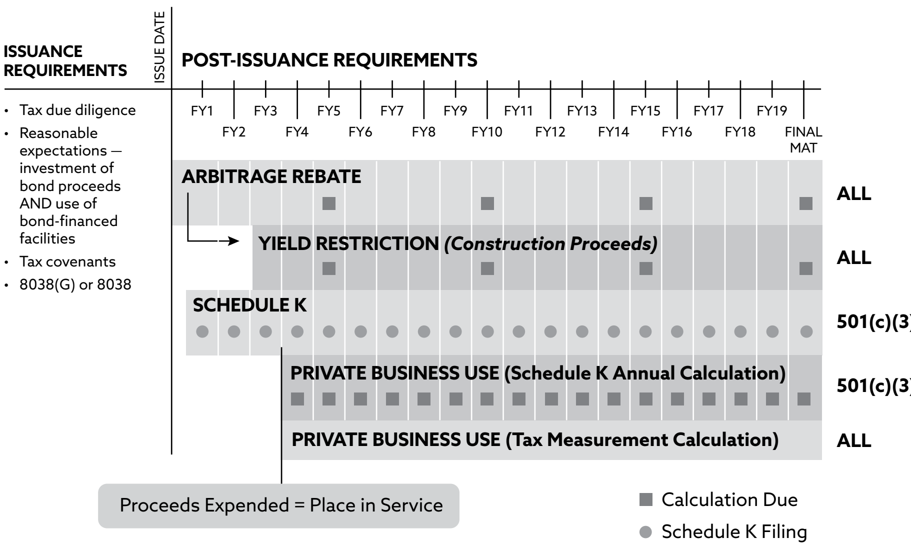
AT ISSUANCE

The closing date of a tax-exempt bond issue is the culmination of weeks of review, due diligence, and planning. The process includes extensive fact gathering and analysis by bond counsel to ensure that the bonds will be in compliance with federal tax law requirements as of the date of issue. On the issue date, various documents are executed, including a document that describes the financing and the federal tax rules applicable thereto (generally referred to as a "Tax Certificate"). At the time the bonds are issued, bond counsel delivers an unqualified opinion that the interest on the bonds is excluded from federal gross income of the bondholders. That opinion is based upon covenants and representations by the Issuer (and the Borrower in the case of a conduit financing) that the applicable federal tax law requirements will be complied with throughout the time the bonds remain outstanding.

TAX COMPLIANCE RESPONSIBILITIES

Post-issuance tax compliance begins with the debt issuance and entails a range of responsibilities to comply with the federal tax rules over the life of the bonds. Post-issuance tax compliance requirements generally fall into two broad categories: (1) qualified use of bond proceeds and bond-financed property and (2) arbitrage rebate and yield restriction. The qualified use requirements include monitoring the uses of bond-financed property over the life of the bonds in order to comply with applicable use rules and limitations. The arbitrage requirements include monitoring certain investments and the expenditure of bond proceeds over the life of the bonds to determine the yield on investments acquired with bond proceeds and whether a rebate payment is required to be made to the U.S. Treasury. While both categories of post-issuance tax compliance require monitoring over the entire life of the bond issue, as shown below, the specific timing for monitoring tasks is different for each category.

TAX-EXEMPT NEW MONEY ISSUE—COMPLIANCE TIMELINE



POST-ISSUANCE TAX COMPLIANCE — CONDUIT BONDS

Bonds that are issued for the purpose of making loans are commonly referred to as "conduit bonds," and Issuers that issue these bonds are generally referred to as "conduit issuers". Generally, in order for the bonds to be tax-exempt, bonds issued by conduit issuers must be either governmental bonds or qualified private activity bonds, such as qualified 501(c)(3) bonds. Under applicable tax rules, the Issuer is legally responsible for the tax-exempt status of the bonds. However, in conduit financings, the bond documents usually delegate most responsibilities to maintain the tax-exempt status of the bonds to the Borrower. As a practical matter, post-issuance tax responsibilities are usually shared between the Issuer and the Borrower.

RISK MANAGEMENT

Although perhaps not obvious, post-issuance tax compliance should be near the forefront of an organizations' risk management considerations for several reasons. One, defending the tax-exempt status of bonds in an IRS audit is stressful, time-consuming and expensive (in terms of both internal and external costs). Two, having a significant tax compliance problem raises the prospects of market disclosure and adverse publicity. Three, most IRS audits are settled by either the Issuer or Borrower agreeing to make a payment to the IRS to protect the interests of existing bondholders. Depending on the severity of the compliance problem, the settlement amount can be significant. A well-maintained post-issuance compliance program can reduce the cost and length of audits and help avoid unpleasant disclosure and expensive settlements.

As further described in this publication, a credible post-issuance tax compliance program will require the adoption of written post-issuance policies, proper reporting systems and identifying people responsible for such matters. Although the focus and details of the program for each Issuer and Borrower will differ, the need for effective policies, procedures, and systems to ensure tax compliance will not.

CHAPTER 3

IRS Enforcement and Tax-Exempt Bonds

Tax-exempt bonds finance the majority of infrastructure in the United States. The benefit of borrowing through the tax-exempt market is significant. Because the interest on tax-exempt bonds is not subject to federal income tax, Issuers (as well as certain eligible Borrowers) may borrow at a lower interest rate than they otherwise would realize in the taxable market.

The benefit derived from the ability to borrow on a tax-exempt basis does not come without a price. A substantial amount of federal tax revenue is forgone every year due to the federal income tax exclusion on municipal bonds. Accordingly, the Treasury Department and the IRS have a strong incentive to limit the volume of tax-exempt debt on the market and to monitor that all applicable federal tax rules are followed over the life of the obligations.

The Tax-Exempt Bond office of the Tax-Exempt and Government Entities Division ("TE/GE") of the IRS is responsible for, among other things, ensuring that tax-exempt bonds are in compliance with the Internal Revenue Code of 1986 (the "Code"). Through bond audits and IRS information returns (IRS Form 8038 and IRS Form 990 Schedule K), the IRS annually gauges levels of compliance among various sectors and targets areas of concern. The consequence of non-compliance with federal tax law requirements could result in the loss of the tax-exempt status of the bonds.

INFORMATION GATHERING — IRS FORM 8038

When a tax-exempt bond is issued, the Issuer is required to file an information return with the IRS. In the case of a governmental bond, the Issuer is required to file Form 8038-G, and, in the case of a qualified private activity bond, the Issuer is required to file Form 8038. In addition to requesting information related to the specifics of the bonds issued, information reporting returns focus on the level and scope of the Issuer's post-issuance compliance program.

Both IRS Forms direct the Issuer to check a box if they have established the following:

- *written procedures to ensure that all nonqualified bonds of the issue are remediated according to the Code and regulations; and*
- *written procedures to monitor the arbitrage requirements.*

The 8038 Forms are closely reviewed by IRS staff and can be the sole basis for the IRS's decision to audit one or more issues of bonds.

INFORMATION GATHERING — IRS FORM 990 SCHEDULE K

Nonprofit organizations are required to file a Schedule K (Supplemental Information on Tax-Exempt Bonds) each year with their Form 990 (Return of Organization Exempt from Income Tax) if they have a tax-exempt bond issue with an outstanding principal amount of $100,000 or more as of the last day of the fiscal year and that was issued after December 31, 2002. More information on Schedule K can be found in Chapter 6.

Schedule K requires nonprofit organizations to provide detailed information about their outstanding tax-exempt debt in the following categories:

Part I - Bond Issues (general information);

Part II – Proceeds (detailed information about how bond proceeds were expended);

Part III – Private Business Use (information about the use of the facilities by outside parties, including detailed calculations of the amount of annual private business use and unrelated trade or business activity occurring in bond-financed facilities);

Part IV – Arbitrage (information on arbitrage rebate payments, calculations, hedges, and guaranteed investment contracts); and

Part V – Procedures to Undertake Corrective Action.

IRS AUDITS OF TAX-EXEMPT BONDS

The IRS's primary method of ensuring that tax-exempt bonds are in compliance with the Code is through its examination process. Generally, the first stages of an audit begin with a request for the bond transcript and investment records. After this initial review, a wide range of additional information may be requested by the IRS, including, but not limited to: (a) management/service contracts involving the use of bond-financed property, (b) arbitrage rebate analysis, (c) comprehensive list of bond financed property, (d) annual private business use analyses, (e) interest rate hedges relating to the bonds, (f) information regarding the users of the bond-financed property, and (g) cancelled checks and invoices regarding the expenditure of the bond proceeds. In the event of an audit, Issuers and Borrowers have the burden of convincing the IRS that the targeted bonds satisfy the applicable federal tax rules. Issuers and Borrowers that do not have adequate post-issuance tax compliance practices will often struggle to provide credible responses to the IRS within the permitted response time frame.

The typical term of the average tax-exempt bond issue often exceeds 20 years. Given this long compliance period and the complex federal tax rules relating to tax-exempt debt, the IRS has focused its resources on post-issuance tax compliance given the high probability for foot faults and missteps.

CHAPTER 4

Federal Tax Rules Applicable to Tax-Exempt Bonds

QUALIFIED USE OF BOND PROCEEDS AND BOND-FINANCED PROPERTY AND PRIVATE BUSINESS USE

Certain federal tax rules aim to limit the types of activities that are financed using tax-exempt bonds. The federal tax rules addressing qualified use of bond proceeds and bond-financed property as applicable to tax-exempt bonds are technical and complex. For purposes of these rules, tax-exempt bonds are generally divided into two broad categories—governmental bonds and qualified private activity bonds. Qualified private activity bonds can be further divided into three subcategories: (i) qualified section 501(c)(3) bonds (bonds issued for the benefit of section 501(c)(3) organizations), (ii) exempt facility bonds (bonds issued for specific purposes for the benefit of for-profit entities), and (iii) bonds to finance loans to certain eligible Borrowers, such as single family mortgage bonds and student loan bonds.

Governmental Bonds

A "governmental bond" is a bond issued as part of an issue, the majority of the proceeds of which are used to finance facilities for governmental use or general public use. Examples of governmental bonds include bonds issued for schools, roads, libraries, bridges, courthouses and similar municipal public improvements.

The federal tax rules for governmental bonds limit "private business use" and require that a certain threshold for "good use" is being met. Private business use generally occurs when a nongovernmental entity (such as a private trade or business) has a special legal entitlement to use bond-financed property ("Private Business Use"). Examples of a special legal entitlement include leases, licenses, certain management and sponsored research contracts and similar use agreements. However, the use of bond-financed property pursuant to management or sponsored research contracts with nongovernmental entities will not result in Private Business Use if the agreement meets the IRS safe harbor rules set forth in Revenue Procedure 2017-13 and Revenue Procedure 2007-47, respectively, set forth in Appendix A hereto (collectively, the "IRS Safe Harbor Contract Rules").

Aside from limits on making loans to nongovernmental entities, a bond will be a governmental bond if either: (a) 10 percent or less of the proceeds of the bond issue are used directly or indirectly in a Private Business Use (the "Private Business Use Test") or (b) the amount of revenues derived (directly or indirectly) from a Private Business Use and payments or property used in a Private Business Use that secures the bond issue is 10 percent or less of the present value of debt service on the bond issue (the "Private Payment/Security Test").

501(c)(3) Bonds

501(c)(3) bonds are tax-exempt qualified private activity bonds issued by state and local governments, the proceeds of which are loaned to section 501(c)(3) organizations to further their charitable purposes. Section 501(c)(3) organizations that benefit from tax-exempt financing include a wide range of exempt organizations such as hospitals, museums and universities.

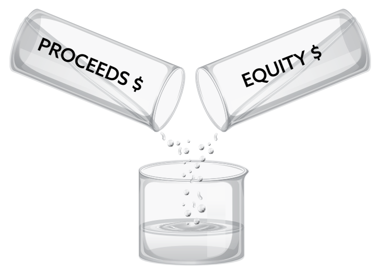
Similar to governmental bonds, the federal tax rules applicable to qualified 501(c)(3) bonds limit Private Business Use but also limit "unrelated trade or business use". Private Business Use in this context occurs when an entity other than a section 501(c)(3) organization or a state or local governmental entity has a special legal entitlement to use bond-financed property. Unrelated trade or business use occurs when a section 501(c)(3) organization uses bond-financed property in a manner which is not related to its charitable/exempt function ("Unrelated Trade or Business Use").

A bond will be a qualified 501(c)(3) bond if either: (a) 5 percent or less of the net proceeds of the bond issue are used directly or indirectly in a Private Business Use or an Unrelated Trade or Business Use or (b) the amount of revenues derived (directly or indirectly) from such Private Business Use or Unrelated Trade or Business Use or property used for such purposes that secure the bond issue is 5 percent or less of the present value of debt service on the bond issue.

Like governmental bonds, the use of property financed with qualified 501(c)(3) bonds pursuant to management contracts or sponsored research agreements will not give rise to Private Business Use if such agreement meets the IRS Safe Harbor Contract Rules.

Qualified Equity

Importantly, the federal tax rules only apply to the portion of the property financed by tax-exempt bonds. It is not uncommon for projects to be financed from tax-exempt bonds as well as from other sources of funding. Under federal tax rules, an "Eligible Mixed-Use Project" is a facility owned by the governmental entity or 501(c)(3) organization that is financed with proceeds of tax-exempt bonds and another source of funds ("Qualified Equity").



ELIGIBLE MIXED-USE PROJECT

Qualified Equity includes proceeds of a taxable borrowing, revenues, fund raising dollars and gifts, as long as such funds are spent concurrently with the proceeds of the tax-exempt bonds on the Eligible Mixed-Use Project. If specific timing and allocation rules are met, the federal tax rules will treat the Eligible Mixed-Use Project as being proportionately financed with tax-exempt bonds and Qualified Equity and, on an annual basis, will allow the governmental entity or 501(c)(3) borrower to first allocate any Private Business Use to the portion of the Eligible Mixed-Use Project that was financed with Qualified Equity. This concept is commonly referred to as "floating equity," and under this methodology, Private Business Use can move anywhere within the Eligible Mixed-Use Project and the Qualified Equity will follow. Qualified Equity can be a powerful tool and provide flexibility for dealing with Private Business Use in Eligible Mixed-Use Projects.

Other Private Activity Bonds

Qualified private activity bonds (other than qualified 501(c)(3) bonds) are tax-exempt bonds issued by state and local governments, the proceeds of which are used to finance certain specified purposes including: (i) facilities such as airports, solid waste disposal facilities, and multifamily housing facilities; (ii) qualified single family mortgages; (iii) qualified small issue bonds; (iv) student loans; and (v) qualified enterprise and empowerment zone facilities.

The chart below compares the primary tax restrictions generally applicable to each type of tax-exempt bond:

Restrictions	Governmental Bonds	Qualified 501(c)(3) Bonds	Other Private Activity Bonds
Private Business Use Test	No more than 10% of the proceeds of the bonds may be used for a Private Business Use.	No more than 5% of the net proceeds of the bonds may be used for a Private Business Use.	Not Applicable
Private Payment/ Security Test	No more than 10% of the present value of debt service on the bonds may be privately paid or secured.	No more than 5% of the present value of debt service on the bonds may be privately paid or secured.	Not Applicable
Private Loan Test	No more than the lesser of 5% of bond proceeds or $5 million may be loaned to nongovernmental entities.	Not Applicable	Not Applicable
Ownership	Not Applicable	All property must be owned by a 501(c)(3) organization or governmental entity.	For certain facilities, governmental ownership is required.
Management Contracts/ Sponsored Research Contracts	Permitted only if IRS Safe Harbor Contract Rules are satisfied.	Permitted only if IRS Safe Harbor Contract Rules are satisfied.	Not Applicable
Arbitrage Rebate	Earnings on the investment of bond proceeds above the cost of funds need to be rebated to the U.S. Treasury every five years.	Earnings on the investment of bond proceeds above the cost of funds need to be rebated to the U.S. Treasury every five years.	Earnings on the investment of bond proceeds above the cost of funds need to be rebated to the U.S. Treasury every five years.
Yield Restriction	Certain funds, such as pledge funds and project proceeds more than three years old, are subject to yield restriction.	Certain funds, such as pledge funds and project proceeds more than three years old, are subject to yield restriction.	Certain funds, such as pledge funds and project proceeds more than three years old, are subject to yield restriction.
Final Allocation of Bond Proceeds	Allocation is required no later than 18 months after the later of the date of expenditure or the placed-in-service date of the project.	Allocation is required no later than 18 months after the later of the date of expenditure or the placed-in-service date of the project.	Allocation is required no later than 18 months after the later of the date of expenditure or the placed-in-service date of the project.
Costs of Issuance	Not Applicable	No more than 2% of the proceeds of the bonds may be used to finance costs of issuance.	No more than 2% of the proceeds of the bonds may be used to finance costs of issuance.
Limits on Acquisition of Existing Property	Not Applicable	Not Applicable	No portion of the bond proceeds may be spent on the acquisition of existing property absent rehabilitation.

Calculating Private Business Use

As described above, for both governmental and 501(c)(3) bonds, limitations exist on the amount of permissible Private Business Use, and Issuers and Borrowers of tax-exempt bonds should monitor the level of Private Business Use in their facilities over the life of the bonds. The following questions can help determine if your bonds satisfy the applicable limitation:

- How were the proceeds of the bond issue expended — buildings/facilities/equipment?
- Was any Qualified Equity used on the project?
- Who is using the facilities — employees, students, outside groups, sponsored research agreements, management contracts, short-term use?
- How are the nonemployee contracts relating to use structured — IRS Safe Harbor-compliant?
- Is any of the bond-financed property leased?
- Has any portion of the bond-financed property been sold?

In addition, it is important to keep in mind that tax compliance relating to Private Business Use is based on the use of proceeds of each individual bond issue.

Common methods of measuring Private Business Use include:

- the net square footage of the space used for the Private Business Use over the total bond-financed square footage;
- the amount of time of the Private Business Use activity with respect to the financed property over the total amount of time that the bond-financed property is otherwise used; and
- the amount of revenue derived from the Private Business Use over the total amount of revenue derived from the bond-financed property (typically utilized in relation to sponsored research).

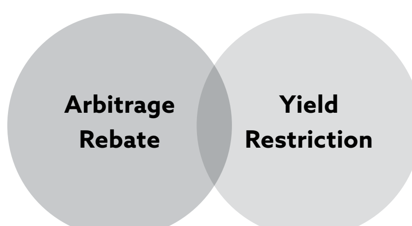
In addition to ongoing monitoring over the life of the bonds, nonprofit organizations must also calculate Private Business Use on an annual basis and report the amount on Form 990 Schedule K.

ARBITRAGE REBATE AND YIELD RESTRICTION

Compliance with the arbitrage rebate regulations relating to tax-exempt bonds is an important aspect of post-issuance compliance for both Issuers and Borrowers. Federal law requires payment of arbitrage rebate at least as often as every five years, and arbitrage compliance is a frequent target of the IRS in audits and other information gathering efforts.

In public finance, arbitrage refers to the ability to borrow at lower tax-exempt rates and invest at higher taxable rates. Arbitrage occurs when an Issuer or Borrower invests tax-exempt debt proceeds in higher-yielding taxable securities, resulting in a profit. In practice, arbitrage is the delta between the tax-exempt borrowing rate (i.e., bond yield) and the overall rate of return on investments (i.e., investment yield).

Technically, there are two separate arbitrage requirements governed by Section 148 of the Internal Revenue Code: arbitrage rebate and yield restriction, both of which apply on a per bond issue basis.



Yield restriction rules stipulate that a bond will not be treated as tax-exempt if tax-exempt bond proceeds are invested at a yield materially higher than the yield on the bonds. The definition of "materially higher" varies for different types of tax-exempt bonds, and there are many exceptions to the yield restriction rules, including (i) exceptions that allow tax-exempt bond proceeds to be invested at a materially higher yield for a limited period of time (temporary period exceptions) and (ii) exceptions that allow certain categories of tax-exempt bond proceeds to be invested at a materially higher yield indefinitely (e.g., reasonably required reserve fund exception, and bona fide debt service fund exception). In certain circumstances, if an Issuer does invest tax-exempt bond proceeds in violation of the yield restriction rules, it can self-remediate the issue by making yield reduction payments, which must be paid no later than 60 days after each 5th bond year (as defined in the tax documents).

Arbitrage rebate rules require that the dollar profit earned from arbitrage be paid back (or rebated) to the federal government. The arbitrage rebate rules also have exceptions, although ones less generous than the yield restriction rules. As a result, a significant portion of the arbitrage that an Issuer might earn under the exceptions to the yield restriction rules will be required to be rebated to the United States government pursuant to the arbitrage rebate regulations.

Frequency of Calculations and Rebate Payments

Federal tax law requires that the arbitrage rebate liability be determined at least once every five years over the life of a bond issue and after the bond issue has been fully redeemed either through refunding or payment. 90% of the total arbitrage rebate liability must be remitted to the IRS no later than 60 days after each 5th bond year (as defined in the tax documents), and 100% of the arbitrage rebate liability must be remitted to the IRS 60 days after the final redemption date. Because arbitrage rebate and yield restriction are cumulative calculations beginning on the issue date of the tax-exempt bond issue, it is advisable to gather investment records on an annual basis to avoid unexpected delays in completing these installment analyses. Also, certain exceptions to the arbitrage rebate requirements are available and should be considered when analyzing the potential arbitrage rebate liability for a bond issue.

Arbitrage rebate and yield reduction payments are remitted to the IRS along with Form 8038-T. If no payments are due, nothing is required to be filed with the IRS. In addition, the arbitrage rebate regulations allow for the recovery of an overpayment, or refund, if all or a portion of a prior rebate or yield restriction payment was offset with subsequently earned negative arbitrage.

Besides the federal requirement relating to calculations every five years, covenants set forth in the bond documents will often stipulate that annual calculations will be performed. Moreover, many auditors may require annual reports.

CHAPTER 5

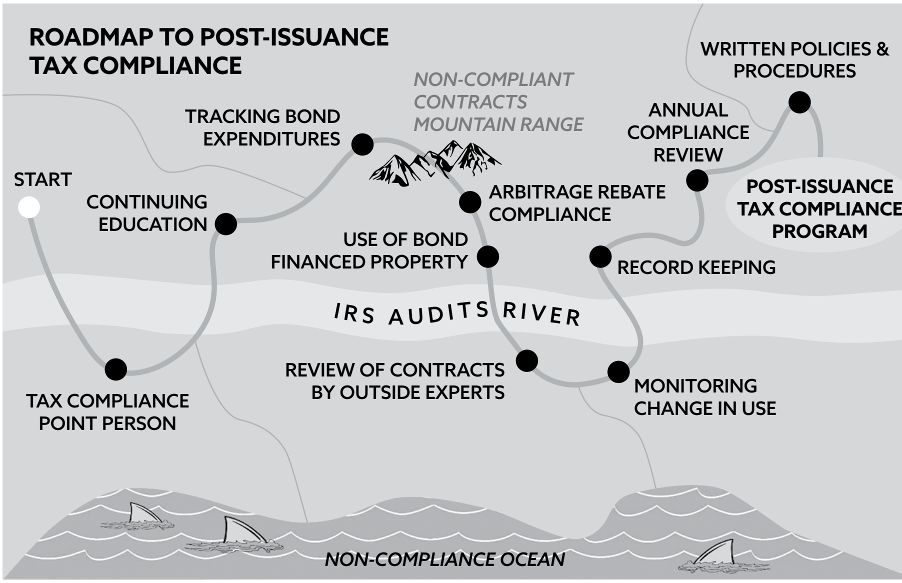
The Essential Elements of a Post-Issuance Tax Compliance Program

Every Issuer and Borrower needs a post-issuance tax compliance program to aid in monitoring compliance with the IRS rules and regulations relating to tax-exempt debt. The consequence of noncompliance with federal tax law requirements could result in the loss of the tax-exempt status of the bonds.

The implementation of a post-issuance tax compliance program requires a focus on hardware, software, policies, culture, staff and resources. Because most tax-exempt bonds will remain outstanding for many years, it is important to have reliable systems, procedures and policies which provide appropriate safeguards for tax compliance and provide accurate and timely data to those parties responsible for such matters. The particular procedures that are appropriate will vary depending on (1) the size of the Issuer or Borrower, (2) the complexity of the financings, (3) the number of bond issues to be monitored and (4) the type of bond issues involved (e.g., governmental bonds, 501(c)(3) bonds or other qualified private activity bonds). An effective post-issuance program will significantly improve the ability of Issuers and Borrowers to both prevent and timely identify tax violations.

Post-issuance tax compliance should be an integral part of an Issuer's or Borrower's debt management process. In some organizations, compliance may be adequately supported by the efforts of a single individual, while for others it will require a coordinated team of individuals. In the case of organizations that frequently issue or borrow on a tax-exempt basis, compliance may be adequately supported by adopting practices which are integrated within the day-to-day practices of such entity.

ELEMENTS OF A POST-ISSUANCE TAX COMPLIANCE PROGRAM



The essential elements of a successful post-issuance tax compliance program include:

- Designating a tax compliance point person(s);
- Communicating with a tax specialist and continuing education;
- Tracking and allocating bond proceeds and qualified equity;
- Monitoring the use of bond-financed property;
- Monitoring investment income and arbitrage compliance;
- Recordkeeping and retention;
- Addressing changes in use of bond-financed property through self-help remediation and the IRS VCAP program;
- Written post-issuance tax compliance procedures; and
- Addressing conduit borrower tax compliance.

DESIGNATING A TAX COMPLIANCE POINT PERSON

Issuers and Borrowers should designate an employee responsible for the overall management of post-issuance tax compliance matters. Depending on the size of the organization and the volume of outstanding tax-exempt debt, such individual could directly address all such matters or do so through a coordinated team or group. Designation, by job title and process, should be memorialized in written post-issuance compliance procedures described below.

"Now, tell me again who our Designated Tax Compliance Officer is..."

COMMUNICATING WITH A TAX SPECIALIST AND CONTINUING EDUCATION

The federal tax rules are complex and frequently change. Maintaining an ongoing relationship and dialogue with a tax specialist who is expert in federal tax law applicable to tax-exempt bonds is a critical component of an effective compliance program. A tax specialist can provide information regarding changes in IRS filing requirements, policies, procedures and enforcement. See Chapter 7 regarding how an outside post-issuance service provider can assist with a wide range of tax compliance matters.

In addition, Issuers and Borrowers should actively seek out educational opportunities (appropriate to their circumstances) to keep abreast of changes and developments in federal tax law. The IRS recommends regular training for individuals responsible for monitoring compliance with the rules and regulations relating to tax-exempt bonds.

TRACKING AND ALLOCATING BOND PROCEEDS AND QUALIFIED EQUITY

The process of tracking the expenditure and allocation of bond proceeds, Qualified Equity (if any) and developing an accurate summary of bond-financed property on an issue-by-issue basis is an important aspect of a tax compliance program. Such process should include the following:

- Determine whether bond proceeds and Qualified Equity are to be spent on an Eligible Mixed-Use Project, and document the plan of finance;

- Identify at issuance the funds and accounts into which bond proceeds and, if applicable, Qualified Equity are to be deposited;
- Document the reimbursement of any pre-issuance expenditures;
- Monitor the expenditure of bond proceeds and, if applicable, Qualified Equity to ensure that all proceeds are spent within applicable time frames; and
- Upon project completion, make a "final allocation" of bond proceeds and, if applicable, Qualified Equity to bond-financed property.

MONITORING THE USE OF BOND-FINANCED PROPERTY

At the core of a post-issuance tax compliance program is the periodic monitoring of bond-financed property to ensure that the use of such property does not violate the applicable federal tax law restrictions relating to Private Business Use. Such process should include the following:

- On no less than an annual basis, identify and review any bond-financed property subject to a lease, license, management contract, sponsored research contract or similar use agreement in order to analyze and measure any potential Private Business Use or unrelated trade or business use impact;
- Establish a protocol for external tax review of management and sponsored research contracts involving bond-financed property on no less than an annual basis for compliance with IRS Safe Harbor Contract Rules;
- Develop an intake process for sponsored research agreements whereby relevant information for each agreement (including, but not limited to, sponsor, term, annual revenue, and location in which the research is occurring) is summarized in a spreadsheet;
- Where appropriate, develop uniform management and sponsored research contracts for use in bond-financed property that satisfy the IRS Safe Harbor Rules; and
- In the case of section 501(c)(3) organizations, establish a protocol for the annual calculation of Private Business Use and Unrelated Trade or Business Use as required by Part III of Schedule K, as more fully discussed in Chapter 6. With increasing frequency, this calculation is undertaken with the assistance of an outside service provider.

MONITORING INVESTMENT INCOME AND ARBITRAGE COMPLIANCE

In addition to restrictions on the use of bond proceeds, the federal tax rules place limits on the investment of bond proceeds and require that Issuers periodically rebate earnings to the U.S. Treasury Department unless one or more rebate exceptions are satisfied. Such processes should include the following:

- Monitor compliance with "temporary period" expectations for the expenditure of project fund proceeds (typically three years for new money bonds), and provide for yield restriction of bond proceeds as necessary;
- Monitor compliance with the 24-month, 18-month and 6-month rebate exceptions;
- Establish procedures to ensure investments acquired with bond proceeds are purchased at fair market value;
- Consult with outside tax counsel before engaging in post-issuance credit enhancement transactions (e.g., bond insurance, letter of credit) or hedging transactions (e.g., interest rate swap, cap);
- Identify situations and establish procedures in which compliance with applicable yield restrictions depends upon later investments, e.g., purchase of 0% SLGS from U.S. Treasury, and monitor implementation;
- Arrange for timely computation of rebate liability and, if rebate is due, for timely filing of Form 8038-T and payment of rebate; and
- Arrange for timely computation and payment of "yield reduction payments," if applicable.

RECORDKEEPING AND RETENTION

The following documents should be retained for the life of the bonds and any refunding bonds (plus three years):

- Transcript of bond transaction;
- Form 8038, Form 8038-G or Form 8038-GC filed with IRS;
- Documentation evidencing use of bond-financed property by the general public and nongovernmental users, including copies of management contracts, leases and sponsored research agreements;

- Documentation evidencing all sources of payment or security of the bonds;
- Documentation pertaining to any investment of bond proceeds, including the purchase and sale of securities, SLG subscriptions, yield calculations for each class of investments, investment income received from the investment of proceeds, guaranteed investment contracts and rebate calculations and reports;
- Documentation regarding the allocation of bond proceeds to expenditures (e.g., allocation of bond proceeds to expenditures for the construction, renovation, or purchase of facilities);
- Documentation relating to the calculation of arbitrage rebate liability, including copies of any cancelled checks and IRS Form 8038-T relating to any rebate payments;
- Documentation relating to the calculation of a Private Business Use percentage;
- Documentation identifying any Qualified Equity allocable to Eligible Mixed-Use Projects, including the source and amount of such Qualified Equity;
- Documentation regarding allocations of bond proceeds to bond issuance costs;
- Copies of requisitions, draw schedules, draw requests, invoices, bills and cancelled checks related to bond proceeds spent during the construction period;
- Copies of all contracts entered into for the construction, renovation or purchase of bond-financed facilities;
- Records of expenditure reimbursements incurred prior to issuing bonds for facilities financed with bond proceeds;
- Asset list or schedule of all bond-financed facilities or equipment; and
- Records regarding the purchases and sales of bond-financed assets.

ADDRESSING CHANGE IN USE OF BOND-FINANCED PROPERTY THROUGH SELF-HELP REMEDIATION AND THE IRS VCAP PROGRAM

Over the term of a bond issue, facts and circumstances can change and reasonable expectations formulated in good faith on the date of issuance turn out to be wrong. In order to preserve the tax-exempt status of the bonds in such circumstances, any tax violations, such as the sale of bond-financed property, must be quickly discovered and remedied. An effective post-issuance tax compliance program should incorporate and acknowledge the following resolution process:

- If an Issuer or Borrower engages in an activity causing bond-financed property to be used in a manner that violates the applicable use limitations, an Issuer may take one or more “self-help” remedial actions. Possible remedial actions include redeeming or defeasing the nonqualified portion of the outstanding bonds or using the amounts realized from the sale of the bond-financed property for another qualifying use; and

Issuers and Borrowers that fail to timely identify noncompliance early enough to qualify for self-help remedial actions or for matters in which self-help is not available can approach the IRS under its VCAP program.

WRITTEN POST-ISSUANCE TAX COMPLIANCE PROCEDURES

Although not specifically required by the Code, written post-issuance tax compliance procedures have historically been a focus of the IRS. IRS bond information returns, Forms 8038, 8038-G, 8038-B, 8038TC and Schedule K (for section 501(c)(3) organizations, discussed in Chapter 6) each contain at least one question regarding whether the Issuer or Borrower has adopted written post-issuance procedures. Similar questions commonly appear in IRS Information Document Requests sent to Issuers in connection with tax-exempt bond audits.

At a minimum, written post-issuance procedures should contain the following:

- Identification of the individual(s) with responsibility for monitoring post-issuance tax compliance;
- A description of the training provided to such responsible individual(s) with regard to monitoring compliance;

- The frequency of compliance checks (most being at least annually);
- The nature of the compliance activities required to be undertaken;
- The procedures used to timely identify and elevate the resolution of a violation when it occurs or is expected to occur;
- A requirement that all nonqualified bonds of an issue are to be remediated if self-remediation is available and an acknowledgement of the availability of the IRS VCAP program if self-remediation is not available; and
- Procedures for the retention of all records material to substantiate compliance with the federal tax law requirements.

ADDRESSING CONDUIT BORROWER TAX COMPLIANCE

Post-issuance tax compliance responsibilities are often shared between the Issuer and the Borrower. In connection with conduit financings, the Issuer should consider the following:

- Designating a particular Issuer official(s) to assist Borrowers in post-issuance tax compliance;
- Requiring Borrowers to identify a particular official or officials responsible for assisting the Issuer with post-issuance compliance monitoring;
- Providing training or other technical support to designated official(s) of the Borrower;
- Requiring the Borrower to demonstrate that it has adopted written post-issuance compliance monitoring procedures before the approval of a bond issue;
- Designating time intervals within which tax compliance monitoring activities will be completed by Borrower; and
- Requiring Borrowers to report and notify the Issuer of the completion of post-issuance compliance monitoring activities and results (including required arbitrage rebate analyses and, in the case of section 501(c)(3) organizations, Schedule K results).

CHAPTER 6

IRS Schedule K and Section 501(c)(3) Borrowers

Schedule K is filed annually by nonprofit organizations as part of their annual IRS Form 990 information return and is the means by which the IRS gathers comprehensive bond-related information on 501(c)(3) organizations which have borrowed on a tax-exempt basis. Schedule K requires section 501(c)(3) organizations to report activities with respect to bond-financed property and related information occurring within the 12 month reporting period.

Schedule K must be filed by 501(c)(3) organizations that have bonds issued after 12/31/2002 with an outstanding principal amount of more than $100,000. Organizations with bonds issued after 12/31/2002 to refund bonds issued before 1/1/2003 must file a Schedule K but need not complete Part III of Schedule K with respect to the pre-2003 debt (which requires detailed calculations regarding the level of Private Business Use and/or unrelated trade or business use of bond-financed assets).

Set forth below is an overview of the various Parts of Schedule K and the related reporting requirements.

PART I — IDENTIFICATION

(a) Issuer name	(b) Issuer EIN	(c) CUSIP #	(d) Date issued	(d) Issue price	((f) Description of purpose

(g) Defeased		(h) On behalf of issuer		(i) Pooled financing	
Yes	**No**	**Yes**	**No**	**Yes**	**No**

Part I requires the Borrower to report basic information with respect to its outstanding bond issues. The primary purpose of Part I is to permit the IRS to cross-reference this basic information relating to the bonds with the IRS information return filed at issuance (i.e., Form 8038). Accordingly, it is important for Borrowers to carefully review the Form 8038 information with respect to each outstanding bond issue regarding the Issuer name, issue date, Issuer employer identification number, CUSIP number, etc., and complete Part I of Schedule K in a consistent manner.

PART II — BOND PROCEEDS AND SPENDING

1 Amount of bonds retired			
2 Amount of bonds legally defeased			
3 Total proceeds of issue			
4 Gross proceeds in reserve funds			
5 Capitalized interest from proceeds			
6 Proceeds in refunding escrows			
7 Issuance costs from proceeds			
8 Credit enhancement from proceeds			
9 Working capital expenditures from proceeds			
10 Capital expenditures from proceeds			
11 Other spent proceeds			
12 Other unspent proceeds			
13 Year of substantial completion			
		Yes	**No**
14 Were the bonds issued as part of a refunding issue of tax-exempt bonds (or, if issued prior to 2018, a current refunding issue)?			
15 Were the bonds issued as part of a refunding issue of taxable bonds (or, if issued prior to 2018, an advance refunding issue)?			
16 Has the final allocation of proceeds been made?			
17 Does the organization maintain adequate books and records to support the final allocation of proceeds?			

Part II of Schedule K focuses on the "total proceeds of the issue," which is defined in the instructions as the amount received at issuance ("Sale Proceeds") plus amounts earned on the investment of Sale Proceeds. Various lines in Part II ask about the different uses to which total proceeds of the issue have been put as of the end of the 12-month reporting period covered by the Schedule K.

A number of specific questions in Part II are worth highlighting:

- Line 3 asks for the "total proceeds of the issue." Although as discussed above, "total proceeds" is defined in the Schedule K instructions to include the interest earnings on Sale Proceeds, the instructions require an explanation in Part VI of Schedule K if the amount of "total proceeds" on Part II Line 3 is different from the "issue price" listed in Part I(e). The "issue price" is the aggregate offering price of the bonds to the public. Hence, the "total proceeds" amount will always be higher than the "issue price" because issue price does not include investment earnings.
- Lines 4 through 12 ask the Borrower to describe the various uses of the bond proceeds. Except in situations described in the next paragraph, the total amounts listed on Lines 4 through 12 should add up to the "total proceeds" of the issue listed on Line 3. Unlike the information requested in Part I, the information requested in Part II is generally current financial information, which will continue to change until all of the proceeds of the bond issue have been spent.
- Line 4 asks for the amount of "gross proceeds" invested in a reasonably required reserve or replacement fund as of the end of each Schedule K reporting period. For federal tax purposes, "gross proceeds" includes funds other than bond proceeds contributed by the Borrower used to fund a reserve fund. The presence of funds other than "total proceeds of the issue" in the reserve fund will cause the totals of Lines 4 through 12 to differ from the total proceeds of the issue in Line 3.
- Line 16 asks if a "final allocation" of the bond proceeds has been made. The allocation of bond proceeds is a primary element of post-issuance tax compliance and speaks to a central question – how were the bond proceeds used? Under applicable tax rules, a final allocation needs to be made no later than the later of: (i) 18 months from the date of expenditure or (ii) 18 months from the placed-in-service date of the project (but in no event can the allocation be later than the 5th anniversary of the issue date).
    - A final allocation is an allocation made in the bond closing documents or the books and records of the organization.

PART III — PRIVATE USE

	Yes	No
1 Was the organization a partner in a partnership, or a member of an LLC, which owned property financed by tax-exempt bonds?		
2 Are there any lease arrangements that may result in private business use of bond-financed property?		
3a Are there any management or service contracts that may result in private business use of bond-financed property?		
3b If "Yes" to line 3a, does the organization routinely engage bond counsel or other outside counsel to review any management or service contracts relating to the financed property		
3c Are there any research agreements that may result in private business use of bond-financed property?		
3d If "Yes" to line 3c, does the organization routinely engage bond counsel or other outside counsel to review any research agreements relating to the financed property?		
4 Enter the percentage of financed property used in a private business use by entities other than a section 501(c)(3) organization or a state or local government.		%
5 Enter the percentage of financed property used in a private business use as a result of unrelated trade or business activity carried on by your organization, another section 501(c)(3) organization, or a state or local government.		%
6 Total of lines 4 and 5		
7 Does the bond issue meet the private security or payment test?		
8a Has there been a sale or disposition of any of the bond-financed property to a nongovernmental person other than a 501(c)(3) organization since the bonds were issued?		
8b If "Yes" to line 8a, enter the percentage of bond-financed property sold or disposed of?		%
8c If "Yes" to line 8a, was any remedial action taken pursuant to Regulations section 1.141-12 and 1.145-2?		
9 Has the organization established written procedures to ensure that all nonqualified bonds of the issue are remediated in accordance with the requirements under Regulations sections 1.141-12 and 1.145-2?		

Part III can be the most difficult part of Schedule K to complete (as it requires calculation of a detailed Private Business Use percentage) and the portion of the Schedule in which most organizations require outside assistance. The focus of Part III is whether any portion of the bond-financed property is being used for a Private Business Use and/or an unrelated trade or business use and, if so, to what degree.

LEASES

Line 2 asks if there are any lease agreements that "may" result in Private Business Use of bond-financed property. With the exception of certain short-term arrangements, a lease agreement to a private trade or business entity will always result in Private Business Use.

MANAGEMENT CONTRACTS AND SPONSORED RESEARCH AGREEMENTS

Line 3(a) asks if there are any management or service contracts that "may" result in Private Business Use of bond-financed property.

Line 3(c) asks if there are any sponsored research agreements that "may" result in Private Business Use of bond-financed property.

Note that the instructions to Schedule K explicitly provide that a Borrower must check "**yes"** to the above questions, **even if** such arrangement satisfies the applicable IRS Safe Harbor Contract Rules and, therefore, is treated as not giving rise to Private Business Use.

If the organization answered "yes" to either of Lines 3(a) or 3(c) regarding the existence of management and/or sponsored research contracts with respect to bond-financed property, Lines 3(b) and 3(d) ask the following:

Does the organization routinely engage bond counsel or other counsel to review any management or service contracts relating to the financed property?

We understand that the reason behind the above inquiry is the IRS belief that the majority of organizations do not have adequate in-house expertise to review such agreements for federal tax compliance. By utilizing outside tax experts for contract review and answering "yes" to this question, organizations put themselves in the strongest position in terms of risk management and overall tax compliance.

MEASURING PRIVATE USE — CALCULATIONS REQUIRED

Line 4 requires the Borrower to quantify to a tenth of a percent the amount of bond-financed property that is used for Private Business Use.

Accurately quantifying the level of Private Business Use is a difficult task. For most organizations, outside tax expertise is required to properly address this question. Importantly, Schedule K requires that the calculation be performed for the specific 12-month filing period and Borrowers should not rely on any Private Business Use calculations completed at the time the bonds were issued. Events and facts change after the date of issuance that will influence such calculations, and, moreover, such calculations are often not as precise as Schedule K requires.

Note, the specific details of the Private Business Use calculation are nuanced and complex. For example, the use of bond proceeds to finance certain "neutral costs," such as bond insurance, letters of credit, a debt service reserve fund and capitalized interest (among others), is excluded from the Private Business Use calculation. The vast majority of Borrowers likely do not have the technical expertise to accurately apply the Treasury Regulations in this regard.

Generally, the process of measuring and quantifying Private Business Use will involve the following steps:

- Accurately trace the bond proceeds of the issue to the financed property taking into account any Qualified Equity, where appropriate.
- Examine all uses of bond-financed property and determine whether there are any contracts with outside parties, such as leases, management or sponsored research contracts or similar agreements, with rights to use such space.
- To the extent that management or sponsored research contracts are found, the Borrower must determine whether such use should be treated as Private Business Use or whether such agreements satisfy the IRS Safe Harbor Contract Rules (set forth in Appendix A hereto).
- If Private Business Use of bond-financed property is identified, a "proper and reasonable" method must be applied to measure the amount of Private Business Use while also taking into account any Qualified Equity.
- The above process is repeated for each Private Business Use, and such amounts are aggregated and reflected on Line 4.

MEASURING UNRELATED TRADE OR BUSINESS USE — CALCULATIONS REQUIRED

Line 5 requires the Borrower to quantify to a tenth of a percent the amount of bond-financed property that is used in an Unrelated Trade or Business Use. Quantifying Unrelated Trade or Business Use generally involves the same measurement process as described above regarding Private Business Use.

OTHER IMPORTANT MATTERS TO CONSIDER IN COMPLETING PART III

- Under applicable tax law, costs of issuance paid out of bond proceeds are treated as Private Business Use. For this purpose, no more than 2 percent of the bond proceeds may be used to finance costs of issuance. However, Part III of Schedule K asks only for the private use percentage of the financed property. The percentage of the bond issue allocable to costs of issuance should not be included in the percentages reported in Part III of Schedule K.
- The fact that Part III of Schedule K does not take into account any pre-2003 bond-financed use of property means that bond issues that include property financed prior to and after 2003 will reflect only the use of the post-2003 property. Depending on the relative portions of the issue that financed pre-2003 and post-2003 expenses, this can lead to a private use percentage that is artificially inflated or deflated from the bond issue's actual private use percentage.
- Lines 8.a, b and c inquire whether there has been a sale or disposition of any bond-financed property (i.e., a change in use), the amount of property sold and whether any "self-help" remedial action was taken under applicable law.

PART IV — ARBITRAGE

	Yes	No
1 Has the issuer filed Form 8038-T, Arbitrage Rebate, Yield Reduction and Penalty in Lieu of Arbitrage Rebate?		
2 If "No" to line 1, did the following apply?		
a Rebate not due yet?		
b Exception to rebate?		
c No rebate due?		
If "Yes" to line 2c, provide in Part VI the date the rebate computation was performed.		
4a Has the organization or the governmental issuer entered into a qualified hedge with respect with respect to the bond issue?		
4b Name of provider		
4c Term of hedge		
4d Was the hedge superintegrated?		
4e Was the hedge terminated?		
5a Were gross proceeds invested in a guaranteed investment contract (GIC)?		
5b Name of provider		
5c Term of GIC		
5d Was the regulatory safe harbor for establishing the fair market value of the GIC satisfied?		
6 Were any gross proceeds invested beyond an available temporary period?		
7 Has the organization established written procedures to monitor the requirements of section 148?		

Part IV focuses on arbitrage and rebate compliance. Arbitrage and rebate matters continue to be a frequent focus in IRS audits. In addition, Part IV contains a range of questions addressing interest rate hedges and guaranteed investment contracts ("GICs"). In recent years, the IRS and other federal agencies have conducted wide-ranging investigations regarding whether interest rate swaps and GICs were priced at a fair market value. It is believed that these questions were added to Schedule K to aid and facilitate such investigations.

Part V focuses on written policies and procedures. Part V asks if the organization has written procedures to ensure that violations of federal tax requirements are timely identified and corrected through the IRS voluntary closing agreement program if self-help remediation is not available.

Part VI provides space for Borrowers to provide additional information. Given that certain questions within Schedule K and the instructions are not clear, it may be beneficial to provide an explanation in certain instances.

Schedule K can be a challenging form to complete and requires knowledge of a complex set of IRS rules and regulations. In filing this form each year as part of the Form 990, nonprofit organizations are providing a lot of detailed information about their tax-exempt bond issues to the IRS and should strive to complete the form accurately and have adequate support for the information being provided.

"When will Schedule K be done... Everyone is waiting!"

CHAPTER 7

The Benefits of Working with a Post-Issuance Tax Compliance Provider

Given the complex nature of the federal tax rules applicable to municipal bonds and the enforcement efforts of the IRS, both Issuers and Borrowers should strongly consider working with an outside service provider who has tax expertise in post-issuance tax compliance matters. In many respects, without outside assistance, the range of post-issuance tax compliance matters requires both Issuers and Borrowers to play the role of "tax lawyer." Given their core mission and lack of internal resources, the vast majority of Issuers and Borrowers are ill-suited to take on this role.

Experience has shown that infrequent Issuers and Borrowers of tax-exempt bonds often find it difficult to become proficient in post-issuance tax compliance matters given limited exposure to the marketplace. On the other hand, frequent Issuers and Borrowers of tax-exempt bonds may find the volume of debt, and the associated tracking of expenditures and use of facilities, to be unmanageable. In both cases, utilizing an external tax expert is a recommended best practice.

GETTING STARTED

A qualified outside service provider can lend assistance in every facet of a post-issuance tax compliance program. An outside service provider can assess current compliance practices, make recommendations regarding policies, procedures and systems, and share industry standards. In addition, an outside service provider can assist with the drafting of written post-issuance procedures that comply with IRS recommendations. Moreover, as part of the review process, individualized checklists and calendars can be developed to support compliance with specific bond document requirements. An outside service provider can also provide an organization with training and periodic educational seminars regarding the federal tax rules, as recommended by the IRS.

ALLOCATING BOND PROCEEDS AND TRACKING PRIVATE BUSINESS USE

An outside service provider can review historical data related to existing bond issues and prepare a comprehensive report regarding how bond proceeds were expended, what facilities were financed and how such facilities are being used. These reports can be quite useful in dealing with an IRS audit and essential to properly completing Schedule K.

If the organization enters into management or sponsored research contracts regarding bond-financed property, an outside service provider can review such contracts and provide a written report summarizing the material provisions of the agreements as well as a determination regarding whether such contracts fall within the applicable IRS Safe Harbor Rules. For Issuers and Borrowers that enter into a high volume of management and sponsored research contracts, an outside service provider can develop checklists and train Issuer or Borrower employees to assist with the review of contracts for compliance with IRS Safe Harbor Rules.

PREPARING IRS SCHEDULE K

As previously discussed in Chapter 6, an outside service provider can assist with the preparation of Schedule K, including any required calculations in Part III of the Schedule concerning Private Business Use and Unrelated Trade or Business Use. Given the complexity of Schedule K, there is a substantial realization among many section 501(c)(3) organizations that some level of outside assistance is required to properly complete the form.

CALCULATING ARBITRAGE REBATE AND YIELD RESTRICTION LIABILITIES

An outside service provider can accurately and efficiently calculate Arbitrage Rebate and Yield Restriction liabilities. In addition, an experienced provider with in-depth knowledge of the intricacies of the relevant regulations will be able to take advantage of certain elections and applications that can benefit the Issuer or Borrower in many ways, including limiting potential arbitrage payments. Working with an outside service provider that also offers a legal opinion with the analysis provides Issuers and Borrowers the assurance that the lowest legally permissible liability has been calculated.

BLX CAN HELP

BLX has been providing post-issuance compliance services to Issuers and Borrowers of tax-exempt debt since 1989. BLX is registered with the SEC and MSRB as a municipal advisor.

In addition, as a wholly owned subsidiary of Orrick, one of the leading bond counsel firms in the United States, BLX benefits from close working relationships with some of the most experienced and highly regarded public finance attorneys in practice today.

The combined firms of Orrick and BLX have the resources and professional expertise to provide all the services detailed in this publication related to post-issuance tax compliance. Legal interpretations, financial/technical modeling and calculations and sophisticated database applications (i.e., customized tickler systems critical to timely compliance and storage of detailed transaction information) are provided between the two firms, resulting in complementary and seamless service to their clients. This combination of the skill set and resources of BLX and the legal expertise of Orrick attorneys provides a strong argument that as a fully integrated team, Orrick and BLX are uniquely qualified to provide recommended Post-Issuance Services.

CHAPTER 8

Continuing Disclosure — Another Post-Issuance Requirement

Besides being subject to the Internal Revenue Code in the case of tax-exempt bonds, municipal bonds, whether tax-exempt or taxable, are also subject to the federal securities laws administered by the SEC. While the SEC does not have authority to directly regulate Issuers or Borrowers with respect to any ongoing reporting requirements, the SEC does directly regulate underwriters, broker-dealers and rating agencies, which can have an indirect impact on the Issuer or the Borrower. An example where the SEC has imposed post-issuance requirements is Rule 15c2-12 promulgated under the U.S. Securities Exchange Act of 1934 ("Rule 15c2-12"). Rule 15c2-12 requires underwriters to cause the ultimate obligor(s) responsible for repaying the bonds to undertake in writing to provide certain post-issuance disclosures to holders of securities. Typically, the obligor(s) will enter into such writing with the trustee or other dissemination agent.[1] Such obligor(s) will be referred to herein as the Issuer or the Borrower, and such writing will be referred to as a Continuing Disclosure Agreement.

Rule 15c2-12[2] requires two types of ongoing disclosure: (1) an annual report (which contains the latest annual audited financial statements and certain other operating and financial data) and (2) notices of certain disclosure events, if and when any occur. The Continuing Disclosure Agreement obligates the Issuer and/or the Borrower to make the ongoing disclosures for the life of the bond issue, and such disclosures are to be filed with the MSRB on its EMMA website ("EMMA").

1 Frequently, the obligor will enter into a continuing disclosure certificate or other undertaking without any dissemination agent where it will covenant to provide ongoing disclosure.

2 The few exceptions to Rule 15c2-12 are for bonds maturing in 270 days or less (typically commercial paper notes) and private placements. Certain short-term securities (with maturities of 18 months or less) are subject to lesser ongoing disclosure requirements.

THE ANNUAL REPORT

As stated above, the annual report is required to contain (1) the Issuer's or Borrower's annual audited financial statements and (2) certain annual financial information and operating data for the Issuer or Borrower of the type contained in the final official statement, all of which should be specified in the Continuing Disclosure Agreement. Most Issuers and Borrowers agree to provide the annual report for a given fiscal year within a certain period of time, often ranging from 150 days to as long as 270 days after the fiscal year-end.

In connection with finalizing the preliminary official statement, the Issuer or Borrower, as applicable, should carefully review the section of the Continuing Disclosure Agreement describing the contents of the annual report and the sections of the official statement (containing financial and operating data) that are required to be updated. The description of the non-audited information to be provided should be specific (as opposed to a general statement requiring the Issuer or Borrower to provide information "of the type included in the Official Statement"). It is also important to be consistent in the description of what is to be updated, as well as to the timing of the filing of the annual report, so that the annual reporting requirements do not vary from one issue of securities to the next. In preparing the annual report, Issuers and Borrowers should carefully review the Continuing Disclosure Agreement's description of the annual report to be certain that all required updates are included in each annual report.

DISCLOSURE EVENT NOTICES

The Continuing Disclosure Agreement also requires the Issuer or Borrower, as applicable, to provide notice "in a timely manner not in excess of ten business days after the occurrence of" certain types of events that are likely to be important to bondholders or potential investors. As set forth below, such events fall into two categories: (1) Events that Always Require Notification and (2) Events that Require Notification if Material.

DISCLOSURE EVENTS

Events that Always Require Notification	Events that Require Notification if Material
• Principal and interest payment delinquencies;	• Unless described in the left-hand column, adverse tax opinions or other material notices or determinations by the Internal Revenue Service with respect to the tax status of the securities or other material events affecting the tax status of the securities;
• Unscheduled draws on debt service reserves reflecting financial difficulties;	• Modifications to rights of holders of the securities;
• Unscheduled draws on credit enhancements reflecting financial difficulties;	• Optional, unscheduled or contingent bond calls;
• Substitution of credit or liquidity providers, or their failure to perform;	• Release, substitution or sale of property securing repayment of the securities;
• Issuance by the Internal Revenue Service of proposed or final determination of taxability or of a Notice of Proposed Issue (IRS Form 5701 TEB);	• Nonpayment-related defaults;
• Tender offers;	• The consummation of a merger, consolidation or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business, the entry into a definitive agreement to undertake such an action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms; or
• Defeasances;	• Appointment of a successor or additional trustee or the change of name of trustee; or
• Rating changes;	• Incurrence of a Financial Obligation of the Issuer/Obligated Person, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a Financial Obligation of the Issuer/Obligated Person, any of which affect bondholders.[3,4]
• Bankruptcy, insolvency, receivership or similar event of the obligated person; or	
• Default, event of acceleration, termination event, modification of terms or other similar events under the terms of a Financial Obligation of the Issuer/Obligated Person, any of which reflect financial difficulties.	

Financial Obligation" shall mean, for purposes of the Disclosure Events listed above, a (i) debt obligation; (ii) derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation; or (iii) guarantee of (i) or (ii). The term "Financial Obligation" shall not include municipal securities (as defined in the U.S. Securities Exchange Act of 1934, as amended) as to which a final official statement (as defined in Rule 15c2-12) has been provided to the MSRB consistent with Rule 15c2-12.

[3] These events apply to bonds issued on or after February 27, 2019.

[4] It is imperative that Issuers and Borrowers establish internal policies in order to determine the materiality threshold for this listed event.

COMPLIANCE

The Issuer or Borrower adopts its own policies and procedures regarding compliance with the applicable Continuing Disclosure Agreement. It is important that Issuers and Borrowers assign responsibility internally with respect to both the preparation of the annual report and any event notices, as well as their filing. It is also important to provide ongoing training to those that assist in the preparation of the annual report. Both the annual report and any event notices are required to be filed in searchable PDF format with the MSRB's EMMA website. Many Issuers' and Borrowers' filings are handled solely by the Issuers' or Borrowers' finance or other staff, while others engage the trustee or other dissemination agent to remind the Issuer or Borrower of the required filings and assist with their submission to EMMA.

BLX CAN HELP

Alternatively, or in addition, outside consultants, such as BLX, Orrick's wholly owned subsidiary, can assist the Issuer or Borrower in establishing policies and procedures for compliance as well as with the actual preparation and filing of annual reports and event notices. BLX was one of the first companies in the industry to provide such services to the Issuer, Borrower and Underwriter communities.

With approximately 30 professionals dedicated to financial and consultative services in offices strategically located across the country, BLX is well qualified to assist and guide Issuers and Borrowers with all elements of continuing disclosure compliance in a cost-effective manner. BLX's services can include: setting up tickler systems; assigning a point person for the continuing disclosure; determining when annual reports are due; assisting Issuers and/or Borrowers in assembling the required disclosure information; comparing the annual report to the Continuing Disclosure Agreements to make sure all required information is included; formatting the annual report; assisting in the preparation of disclosure event notices; and disseminating annual reports and disclosure event notices via EMMA.

CONSEQUENCES FOR NONCOMPLIANCE

Failure to comply with the Continuing Disclosure Agreement may lead to the following consequences:

1. Failure to file the annual report by the date agreed to, failure to include all of the information in the annual report that is required by the Continuing Disclosure Agreement or failure to file an event notice is an event of default under the Continuing Disclosure Agreement. The only remedy is by specific performance (that is, an injunction or other order to perform). However, it may also subject the Issuer or the Borrower that defaulted to liability to bondholders claiming they would not have bought, sold or held the tax-exempt bonds had the required information been provided in a timely manner. In addition, these failures must be disclosed in all official statements of the Issuer and/or the Borrower for a period of five years following such failure. Such disclosure may adversely affect the price and marketability of the Issuer's or Borrower's future debt. Persistent or material failure could also render the underwriters unable to rely on the Issuer's or Borrower's future Continuing Disclosure Agreements and, as a result, unable to underwrite or bid on their bonds.
2. Including only the information required by the Continuing Disclosure Agreement in the annual report may not be sufficient and could result in securities fraud liability under Rule 10b-5 promulgated by the U.S. Securities Exchange Act of 1934 if the information included is materially inaccurate or omits information necessary to make the information included not misleading to investors purchasing, selling or holding the bonds. Furthermore, although Rule 15c2-12 appears to contemplate that the annual report will cover only the preceding year, if an event has occurred since the end of the fiscal year that would make the fiscal year information in the annual report misleading, it could result in securities liability if not included in the annual report.[5]

[5] On February 7, 2020, the SEC issued Staff Legal Bulletin No. 21 confirming its prior guidance as well as its current view that the antifraud provisions of Section 10(b) of U.S. Securities Exchange Act of 1934 and Rule 10b-5 thereunder apply to all statements (whether written or oral) made by Issuers and Obligors in the secondary market, including those that are made pursuant to any filings on EMMA.

MARKET DEVELOPMENTS

In recent years, there has been increased attention to continuing disclosure compliance by the municipal marketplace. Investors, now more than ever, are concerned with an Issuer's or Borrower's ongoing disclosure and in certain sectors require quarterly information in order to make an investment in the bonds. In addition, certain voluntary disclosure filings made by Issuers and Borrowers on EMMA are becoming more prevalent, especially in light of the COVID-19 pandemic.

The SEC has created a specific municipal securities enforcement division that has launched a number of investigations with respect to disclosure. Furthermore, the SEC has been vocal regarding the need to address the inadequacies it perceives with respect to municipal disclosure practices.

As previously stated, the SEC cannot directly regulate the Issuer or Borrower with respect to the provision for any ongoing reporting requirements related to municipal securities.[6] However, the SEC can regulate the underwriters regarding their responsibilities under Rule 15c2-12. In its August 2010 Release No. 34-62184A entitled "Interpretive Guidance with Respect to Obligations of Participating Underwriters," the SEC clarified and reinforced its view of the obligation of an underwriter to consider the record of compliance by an Issuer or Borrower with its Continuing Disclosure Agreements on prior bond issues in determining whether that Issuer or Borrower can be relied upon to comply with its continuing disclosure undertaking on the new bond issue. The SEC went on to say that the underwriters must establish that each annual report and event notice complied with the requirements of the applicable Continuing Disclosure Agreement and was filed in a timely manner with each NRMSIR (prior to July 1, 2009) or on EMMA. The release went on further to state that the underwriter may no longer rely on representations from the Issuer or Borrower regarding its compliance. Rather, the underwriter must conduct its own investigation and make an independent judgment concerning the Issuer's or Borrower's compliance.

As a result of this increased scrutiny, Issuers and Borrowers are increasingly likely be asked by the underwriter about their internal policies and procedures for compliance. Issuers and Borrowers may also be asked to provide proof of filing of the annual reports or event notices and, in some instances, may be asked to engage or pay for an outside consultant to review and

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[6] SEC may seek regulatory authority to do so.

provide a report of such compliance or lack thereof for the underwriter. In addition, if there has been noncompliance, the underwriter will require the Issuer or Borrower to implement procedures so that the underwriter has a reasonable basis to rely on the Issuer's or Borrower's representation that the noncompliance will not reoccur and that they will comply with the continuing disclosure obligation for the new bond deal. It is important for the underwriter to address the noncompliance and the procedures that will be put in place to assure future compliance by the Issuer or Borrower, as applicable, so that the underwriter has a reasonable basis for recommending the bonds to investors. Such procedures may include a written policy assigning a responsible person at the Issuer or Borrower or hiring an outside consultant to assist in the preparation and filing of the annual report and event notices.

CHAPTER 9

Other Bond Document Post-Issuance Compliance

In addition to post-issuance tax compliance and continuing disclosure compliance, the Issuer and the Borrower are also typically subject to ongoing reporting and notice covenants that are contained in the bond documents[7] to which they are a party. Compliance with these requirements is necessary in order to avoid an event of default on the bonds. The particular required post-issuance activities vary widely from transaction to transaction, especially depending on type, complexity and number of parties. Common examples include:

- Payment of principal and interest;
- Payment of annual fees;
- Annual covenant compliance certificates, including rate and other financial covenants;
- Issuer annual compliance forms regarding employees and construction of the project;
- Annual or quarterly reports to Issuers, Trustees and Credit Providers;
- Rebate calculation dates;
- Notice requirements regarding redemptions or amendments;
- Requirements for the maintenance of ratings;
- Completion certificates.

BLX CAN HELP

Issuers and/or Borrowers must review each document in order to determine their ongoing responsibilities. It is important that the Issuer and/or Borrower have a point person who is in charge of the ongoing bond document compliance. Outside consultants, such as BLX, can also assist the Issuer or Borrower in establishing policies, procedures and calendars for compliance. As one of the first and only companies to provide such services in the industry, BLX is uniquely qualified to assist and guide Issuers and Borrowers with all elements of ongoing bond document compliance. BLX's services can include: reviewing the relevant bond documents in order to identify the requirements and compiling a checklist of such compliance issues and responsibilities; setting up a calendar and tickler system to prompt the Issuer or Borrower to comply with its responsibilities; and establishing internal policies and procedures to help insure compliance.

[7] The bond documents may include the Indenture, Resolution, Loan Agreement, Lease Agreement, Installment Sale Agreement, Security Agreement (Pledge Agreement, Mortgage, etc.) and Credit Facility Reimbursement Agreement.

Appendices

26 CFR 601.601: Rules and regulations.
Also: §§ 141, 145, 1.141-3, 1.145-2)

Rev. Proc. 2017-13

SECTION 1. PURPOSE

This revenue procedure provides safe harbor conditions under which a management contract does not result in private business use of property financed with governmental tax-exempt bonds under § 141(b) of the Internal Revenue Code or cause the modified private business use test for property financed with qualified 501(c)(3) bonds under § 145(a)(2)(B) to be met. This revenue procedure modifies, amplifies, and supersedes Rev. Proc. 2016-44, 2016-36 IRB 316, to address certain types of compensation, the timing of payment of compensation, the treatment of land, and methods of approval of rates. Sections 2.11 through 2.14 of this revenue procedure generally describe the modifications and amplifications made to Rev. Proc. 2016-44 by this revenue procedure.

SECTION 2. BACKGROUND

.01 Section 103(a) provides that, except as provided in § 103(b), gross income does not include interest on any State or local bond. Section 103(b)(1) provides that § 103(a) shall not apply to any private activity bond that is not a qualified bond (within the meaning of § 141). Section 141(a) provides that the term "private activity bond" means any bond issued as part of an issue (1) that meets the private business use test and private security or payment test, or (2) that meets the private loan financing test.

.02 Section 141(b)(1) provides generally that an issue meets the private business use test if more than 10 percent of the proceeds of the issue are to be used for any private business use. Section 141(b)(6) defines "private business use" as use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit. For this purpose, any activity carried on by a person other than a natural person must be treated as a trade or business.

.03 Section 1.141-3(a)(1) of the Income Tax Regulations provides, in part, that the 10 percent private business use test of § 141(b)(1) is met if more than 10 percent of the proceeds of an issue is used in a trade or business of a nongovernmental person. For this purpose, the use of financed property is treated as the direct use of proceeds. Section 1.141-3(a)(2) provides that, in determining whether an issue meets the private business use test, it is necessary to look at both indirect and direct use of proceeds. Proceeds are treated as used in the trade or business of a nongovernmental person if a nongovernmental person, as a result of a single transaction or a series of related transactions, uses property acquired with the proceeds of an issue.

.04 Section 1.141-3(b)(1) provides that both actual and beneficial use by a nongovernmental person may be treated as private business use. In most cases, the private business use test is met only if a nongovernmental person has special legal entitlements to use the financed property under an arrangement with the issuer. In general, a nongovernmental person is treated as a private business user as a result of ownership; actual or beneficial use of property pursuant to a lease, a management contract, or an incentive payment contract; or certain other arrangements such as a take or pay or other output-type contract.

.05 Section 1.141-3(b)(3) provides generally that the lease of financed property to a nongovernmental person is private business use of that property. For this purpose, any arrangement that is properly characterized as a lease for federal income tax purposes is treated as a lease. Section 1.141-3(b)(3) further provides that, in determining whether a management contract is properly characterized as a lease, it is necessary to consider all the facts and circumstances, including the following factors: (1) the degree of control over the property that is exercised by a nongovernmental person; and (2) whether a nongovernmental person bears the risk of loss of the financed property.

.06 Section 1.141-3(b)(4)(i) provides generally that a management contract with respect to financed property may result in private business use of that property, based on all of the facts and circumstances. A management contract with respect to financed property generally results in private business use of that property if the contract provides for compensation for services rendered with compensation based, in whole or in part, on a share of net profits from the operations of the facility. Section 1.141- 3(b)(4)(iv) provides generally that a management contract with respect to financed property results in private business use of that property if the service provider is treated as the lessee or owner of financed property for federal income tax purposes.

.07 Section 1.141-3(b)(4)(ii) defines "management contract" as 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, or any function, of a facility. For example, a contract for the provision of management services for an entire hospital, a contract for management services for a specific department of a hospital, and an incentive payment contract for physician services to patients of a hospital are each treated as a management contract.

.08 Section 1.141-3(b)(4)(iii) provides that the following arrangements generally are not treated as management contracts that give rise to private business use: (A) contracts for services that are solely incidental to the primary governmental function or functions of a financed facility (for example, contracts for janitorial, office equipment repair, hospital billing, or similar services); (B) the mere granting of admitting privileges by a hospital to a doctor, even if those privileges are conditioned on the provision of de minimis services if those privileges are available to all qualified physicians in the area, consistent with the size and nature of the hospital's facilities; (C) a contract to provide for the operation of a facility or system of facilities that consists primarily of public utility property, if the only compensation is the reimbursement of actual and direct expenses of the service provider and reasonable administrative overhead expenses of the service provider; and (D) a contract to provide for services, if the only compensation is the reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties.

.09 Section 141(e) provides, in part, that the term "qualified bond" includes a qualified 501(c)(3) bond if certain requirements stated therein are met. Section 145(a) provides generally that "qualified 501(c)(3) bond" means any private activity bond issued as part of an issue if (1) all property that is to be provided by the net proceeds of the issue is to be owned by a

501(c)(3) organization or a governmental unit, and (2) such bond would not be a private activity bond if (A) 501(c)(3) organizations were treated as governmental units with respect to their activities that do not constitute unrelated trades or businesses, determined by applying § 513(a), and (B) § 141(b)(1) and (2) were applied by substituting "5 percent" for "10 percent" each place it appears and by substituting "net proceeds" for "proceeds" each place it appears. Section 1.145- 2 provides that, with certain exceptions and modifications, §§ 1.141-0 through 1.141-15 apply to § 145(a).

.10 Rev. Proc. 2016-44 provides safe harbor conditions under which a management contract does not result in private business use of property financed with governmental tax-exempt bonds under § 141(b) or cause the modified private business use test for property financed with qualified 501(c)(3) bonds under § 145(a)(2)(B) to be met. Rev. Proc. 2016-44 modified and superseded Rev. Proc. 97-13, 1997-1 C.B. 632; Rev. Proc. 2001-39, 2001-2 C.B. 38; and section 3.02 of Notice 2014-67, 2014-46 I.R.B. 822.

.11 Section 5.02 of Rev. Proc. 2016-44 sets forth general financial requirements for management compensation arrangements eligible for the safe harbor. Sections 5.02(2) and 5.02(3) of Rev. Proc. 2016-44 provide that the contract must neither provide to the service provider a share of net profits nor impose on the service provider the burden of bearing any share of net losses from the operation of the managed property. Before the publication of Rev. Proc. 2016-44, previously applicable revenue procedures expressly treated certain types of compensation, including capitation fees, periodic fixed fees, and per-unit fees (as defined therein), as not providing a share of net profits. Questions have arisen regarding whether these common types of compensation continue to be treated in a similar manner under Rev. Proc. 2016-44. Related questions have arisen about whether a service provider's payment of expenses of the operation of the managed property without reimbursement from the qualified user (as defined in section 4.04 of Rev. Proc. 2016-44) affects the treatment of these types of compensation. To provide continuity with the previous safe harbors, this revenue procedure clarifies that these types of compensation and certain incentive compensation will not be treated as providing a share of net profits or requiring the service provider to bear a share of net losses.

.12 Sections 5.02(2) and 5.02(3) of Rev. Proc. 2016-44 also provide that the timing of payment of compensation cannot be contingent upon net profits or net losses from the operation of the managed property. Questions have arisen about the effect of these restrictions on the timing of payment of compensation. This revenue procedure clarifies that compensation subject to an annual payment requirement and reasonable consequences for late payment (such as interest charges or late payment fees) will not be treated as contingent upon net profits or net losses if the contract includes a requirement that the qualified user will pay the deferred compensation within five years of the original due date of the payment.

.13. Section 5.03 of Rev. Proc. 2016-44 provides that the term of the contract, including all renewal options (as defined in § 1.141-1(b)), must be no greater than the lesser of 30 years or 80 percent of the weighted average reasonably expected economic life of the managed property. For this purpose, under Rev. Proc. 2016-44, economic life is determined in the same manner as under § 147(b), but without regard to §147(b)(3)(B)(ii), as of the beginning of the term of contract. Section 147(b)(3)(B)(i) provides that generally land is not taken into account, but § 147(b)(3)(B)(ii) provides that if 25 percent or more of the net proceeds of any issue is to be used to finance the acquisition of land, such land shall be taken into account and treated as having an economic life of 30 years. Questions have arisen about excluding land when the cost of the land accounts for a significant portion of the managed property. This revenue procedure provides that economic life is determined in the same manner as under § 147(b) as of the beginning of the term of the contract. Thus, land will be treated as having an economic life of 30 years if 25 percent or more of the net proceeds of the issue that finances the managed property is to be used to finance the costs of such land.

.14 Section 5.04 of Rev. Proc. 2016-44 provides that the qualified user must exercise a significant degree of control over the use of the managed property. Section 5.04 of Rev. Proc. 2016-44 further provides that this requirement is met if the contract requires the qualified user to approve, among other things, the rates charged for use of the managed property. Section 5.04 of Rev. Proc. 2016-44 also provides that a qualified user may show approval of rates charged for use of the managed property by either expressly approving such rates (or the methodology for setting such rates) or by including in the contract a requirement that service provider charge rates that are reasonable and customary as specifically determined by an independent third party. Questions have arisen about the requirement to approve the rates in various circumstances in which it may not be feasible to approve each specific rate charged, such as for a physician's professional services at a § 501(c)(3) hospital or hotel room rates at a governmentally-owned hotel. This revenue procedure clarifies that a qualified user may satisfy the approval of rates requirement by approving a reasonable general description of the method used to set the rates or by requiring that the service provider charge rates that are reasonable and customary as specifically determined by, or negotiated with, an independent third party.

SECTION 3. SCOPE

This revenue procedure applies to a management contract (as defined in section 4.03 of this revenue procedure) involving managed property (as defined in section 4.04 of this revenue procedure) financed with the proceeds of an issue of governmental bonds (as defined in § 1.141-1(b)) or qualified 501(c)(3) bonds (as defined in § 145).

SECTION 4. DEFINITIONS

For purposes of this revenue procedure, the following definitions apply:

.01 **Capitation fee** means a fixed periodic amount for each person for whom the service provider or the qualified user assumes the responsibility to provide all needed services for a specified period so long as the quantity and type of services actually provided to such persons varies substantially. For example, a capitation fee includes a fixed dollar amount payable per month to a medical service provider for each member of a health maintenance organization plan for whom the provider agrees to provide all needed medical services for a specified period. A fixed periodic amount may include an automatic increase according to a specified, objective, external standard that is not linked to the output or efficiency of the managed property. For example, the Consumer Price Index and similar external indices that track increases in prices in an area or increases in revenues or costs in an industry are objective, external standards. A capitation fee may include a variable component of up to

20 percent of the total capitation fee designed to protect the service provider against risk such as risk of catastrophic loss.

.02 **Eligible expense reimbursement arrangement** means a management contract under which the only compensation consists of reimbursements of actual and direct expenses paid by the service provider to unrelated parties and reasonable related administrative overhead expenses of the service provider.

.03 **Management contract** means a management, service, or incentive payment contract between a qualified user and a service provider under which the service provider provides services for a managed property. A management contract does not include a contract or portion of a contract for the provision of services before a managed property is placed in service (for example, pre-operating services for construction design or construction management).

.04 **Managed property** means the portion of a project (as defined in § 1.141-6(a)(3)) with respect to which a service provider provides services.

.05 **Periodic fixed fee** means a stated dollar amount for services rendered for a specified period of time. For example, a stated dollar amount per month is a periodic fixed fee. The stated dollar amount may automatically increase according to a specified, objective external standard that is not linked to the output or efficiency of the managed property. For example, the Consumer Price Index and similar external indices that track increases in prices in an area or increases in revenues or costs in an industry are objective external standards. Capitation fees and per-unit fees are not periodic fixed fees.

.06 **Per-unit fee** means a fee based on a unit of service provided specified in the contract or otherwise specifically determined by an independent third party, such as the administrator of the Medicare program, or the qualified user. For example, a stated dollar amount for each specified medical procedure performed, car parked, or passenger mile is a per-unit fee. Separate billing arrangements between physicians and hospitals are treated as per-unit fee arrangements. A fee that is a stated dollar amount specified in the contract does not fail to be a per-unit fee as a result of a provision under which the fee may automatically increase according to a specified, objective, external standard that is not linked to the output or efficiency of the managed property. For example, the Consumer Price

Index and similar external indices that track increases in prices in an area or increases in revenues or costs in an industry are objective, external standards.

.07 **Qualified user** means, for projects (as defined in § 1.141-6(a)(3)) financed with governmental bonds, any governmental person (as defined in § 1.141-1(b)) or, for projects financed with qualified 501(c)(3) bonds, any governmental person or any 501(c)(3) organization with respect to its activities which do not constitute an unrelated trade or business, determined by applying § 513(a).

.08 **Service provider** means any person other than a qualified user that provides services to, or for the benefit of, a qualified user under a management contract.

.09 **Unrelated parties** means persons other than either: (1) a related party (as defined in § 1.150-1(b)) to the service provider or (2) a service provider's employee.

SECTION 5. SAFE HARBOR CONDITIONS UNDER WHICH MANAGEMENT CONTRACTS DO NOT RESULT IN PRIVATE BUSINESS USE

.01 **In general.** If a management contract meets all of the applicable conditions of sections 5.02 through section 5.07 of this revenue procedure, or is an eligible expense reimbursement arrangement, the management contract does not result in private business use under § 141(b) or 145(a)(2)(B). Further, under section 5.08 of this revenue procedure, use functionally related and subordinate to a management contract that meets these conditions does not result in private business use.

.02 **General financial requirements.**

(1) **In general.** The payments to the service provider under the contract must be reasonable compensation for services rendered during the term of the contract. Compensation includes payments to reimburse actual and direct expenses paid by the service provider and related administrative overhead expenses of the service provider.

(2) **No net profits arrangements.** The contract must not provide to the service provider a share of net profits from the operation of the managed property. Compensation to the service provider will not be treated as providing a share of net profits if no element of the compensation takes into account, or is contingent upon, either the managed property's net profits or both the managed property's revenues and expenses (other than any reimbursements of direct and actual expenses paid by the service provider to unrelated third parties) for any fiscal period. For this purpose, the elements of the compensation are the eligibility for, the amount of, and the timing of the payment of the compensation. Incentive compensation will not be treated as providing a share of net profits if the eligibility for the incentive compensation is determined by the service provider's performance in meeting one or more standards that measure quality of services, performance, or productivity, and the amount and the timing of the payment of the compensation meet the requirements of this section 5.02(2).

(3) **No bearing of net losses of the managed property.**

(a) The contract must not, in substance, impose upon the service provider the burden of bearing any share of net losses from the operation of the managed property. An arrangement will not be treated as requiring the service provider to bear a share of net losses if:

(i) The determination of the amount of the service provider's compensation and the amount of any expenses to be paid by the service provider (and not reimbursed), separately and collectively, do not take into account either the managed property's net losses or both the managed property's revenues and expenses for any fiscal period; and

(ii) The timing of the payment of compensation is not contingent upon the managed property's net losses.

(b) For example, a service provider whose compensation is reduced by a stated dollar amount (or one of multiple stated dollar amounts) for failure to keep the managed property's expenses below a specified target (or one of multiple specified targets) will not be treated as bearing a share of net losses as a result of this reduction.

(4) **Treatment of certain types of compensation.** Without regard to whether the service provider pays expenses with respect to the operation of the managed property without reimbursement by the qualified user, compensation for services will not be treated as providing a share of net profits or requiring the service provider to bear a share of net losses under sections 5.02(2) and 5.02(3) of this revenue procedure if the compensation for services is: (a) based solely on a capitation fee, a periodic fixed fee, or a per-unit fee; (b) incentive compensation described in the last sentence of section 5.02(2) of this revenue procedure; or (c) a combination of these types of compensation.

(5) **Treatment of timing of payment of compensation.** Deferral due to insufficient net cash flows from the operation of the managed property of the payment of compensation that otherwise meets the requirements of sections 5.02(2) and 5.02(3) of this revenue procedure will not cause the deferred compensation to be treated as contingent upon net profits or net losses under sections 5.02(2) and 5.02(3) of this revenue procedure if the contract includes requirements that:

(a) The compensation is payable at least annually;

(b) The qualified user is subject to reasonable consequences for late payment, such as reasonable interest charges or late payment fees; and

(c) The qualified user will pay such deferred compensation (with interest or late payment fees) no later than the end of five years after the original due date of the payment.

.03 **Term of the contract and revisions.** The term of the contract, including all renewal options (as defined in § 1.141-1(b)), must not be greater than the lesser of 30 years or 80 percent of the weighted average reasonably expected economic life of the managed property. For this purpose, economic life is determined in the same manner as under § 147(b) as of the beginning of the term of the contract. A contract that is materially modified with respect to any matters relevant to this section 5 is retested under this section 5 as a new contract as of the date of the material modification.

.04 **Control over use of the managed property.** The qualified user must exercise a significant degree of control over the use of the managed property. This control requirement is met if the contract requires the qualified user to approve the annual budget of the managed property, capital expenditures with respect to the managed property, each disposition of property that is part of the managed property, rates charged for the use of the managed property, and the general nature and type of use of the managed property (for example, the type of services). For this purpose, for example, a qualified user may show approval of capital expenditures for a managed property by approving an annual budget for capital expenditures described by functional purpose and specific maximum amounts; and a qualified user may show approval of dispositions of property that is part of the managed property in a similar manner. Further, for example, a qualified user may show approval of rates charged for use of the managed property by expressly approving such rates or a general description of the methodology for setting such rates (such as a method that establishes hotel room rates using specified revenue goals based on comparable properties), or by requiring that the service provider charge rates that are reasonable and customary as specifically determined by, or negotiated with, an independent third party (such as a medical insurance company).

.05 **Risk of loss of the managed property.** The qualified user must bear the risk of loss upon damage or destruction of the managed property (for example, due to force majeure). A qualified user does not fail to meet this risk of loss requirement as a result of insuring against risk of loss through a third party or imposing upon the service provider a penalty for failure to operate the managed property in accordance with the standards set forth in the management contract.

.06 **No inconsistent tax position.** The service provider must agree that it is not entitled to and will not take any tax position that is inconsistent with being a service provider to the qualified user with respect to the managed property. For example, the service provider must agree not to claim any depreciation or amortization deduction, investment tax credit, or deduction for any payment as rent with respect to the managed property.

.07 **No circumstances substantially limiting exercise of rights.**

(1) **In general.** The service provider must not have any role or relationship with the qualified user that, in effect, substantially limits

the qualified user's ability to exercise its rights under the contract, based on all the facts and circumstances.

(2) **Safe harbor.** A service provider will not be treated as having a role or relationship prohibited under section 5.07(1) of this revenue procedure if:

(a) No more than 20 percent of the voting power of the governing body of the qualified user is vested in the directors, officers, shareholders, partners, members, and employees of the service provider, in the aggregate;

(b) The governing body of the qualified user does not include the chief executive officer of the service provider or the chairperson (or equivalent executive) of the service provider's governing body; and

(c) The chief executive officer of the service provider is not the chief executive officer of the qualified user or any of the qualified user's related parties (as defined in §1.150-1(b)).

(3) For purposes of section 5.07(2) of this revenue procedure, the phrase "service provider" includes the service provider's related parties (as defined in §1.150-1(b)) and the phrase "chief executive officer" includes a person with equivalent management responsibilities.

.08 **Functionally related and subordinate use.** A service provider's use of a project (as defined in § 1.141-6(a)(3)) that is functionally related and subordinate to performance of its services under a management contract for managed property that meets the conditions of this section 5 does not result in private business use of that project. For example, use of storage areas to store equipment used to perform activities required under a management contract that meets the requirements of this section 5 does not result in private business use.

SECTION 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2016-44 is modified, amplified, and superseded.

SECTION 7. DATE OF APPLICABILITY

This revenue procedure applies to any management contract that is entered into on or after January 17, 2017, and an issuer may apply this revenue procedure to any management contract that was entered into before January 17, 2017. In addition, an issuer may apply the safe harbors in Rev. Proc. 97-13, as modified by Rev. Proc. 2001- 39 and amplified by Notice 2014-67, to a management contract that is entered into before August 18, 2017 and that is not materially modified or extended on or after August 18, 2017 (other than pursuant to a renewal option as defined in § 1.141-1(b)).

SECTION 8. DRAFTING INFORMATION

The principal authors of this revenue procedure are Johanna Som de Cerff and David White of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue procedure, contact David White on (202) 317-6980 (not a toll free call).

Administrative, Procedural, and Miscellaneous

26 CFR 1.141-3: Definition of Private Business Use (Also: §§ 103, 141,145; 1.141-3, 1.145-2)

Rev. Proc. 2007-47

SECTION 1. PURPOSE

The purpose of this revenue procedure is to set forth conditions under which a research agreement does not result in private business use under § 141(b) of the Internal Revenue Code of 1986 (the Code). This revenue procedure also addresses whether a research agreement causes the modified private business use test in § 145(a)(2)(B) of the Code to be met for qualified 501(c)(3) bonds. This revenue procedure modifies and supersedes Rev. Proc. 97-14, 1997-1 C.B. 634.

SECTION 2. BACKGROUND

.01 **Private Business Use.**

(1) Under § 103(a) of the Code, gross income does not include interest on any State or local bond. Under § 103(b)(1), however, § 103(a) does not apply to a private activity bond, unless it is a qualified bond under § 141(e). Section 141(a)(1) defines "private activity bond" as any bond issued as part of an issue that meets both the private business use and the private security or payment tests. Under § 141(b)(1), an issue generally meets the private business use test if more than 10 percent of the proceeds of the issue are to be used for any private business use. Under § 141(b)(6)(A), private business use means direct or indirect use in a trade or business carried on by any person other than a governmental unit. Section 150(a)(2) provides that the term "governmental unit" does not include the United States or any agency or instrumentality thereof. Section 145(a) also applies the private

business use test of § 141(b)(1) to qualified 501(c)(3) bonds, with certain modifications.

(2) Section 1.141-3(b)(1) of the Income Tax Regulations provides that both actual and beneficial use by a nongovernmental person may be treated as private business use. In most cases, the private business use test is met only if a nongovernmental person has special legal entitlements to use the financed property under an arrangement with the issuer. In general, a nongovernmental person is treated as a private business user of proceeds and financed property as a result of ownership; actual or beneficial use of property pursuant to a lease, or a management or incentive payment contract; or certain other arrangements such as a take or pay or other output- type contract.

(3) Section 1.141-3(b)(6)(i) provides generally that an agreement by a nongovernmental person to sponsor research performed by a governmental person may result in private business use of the property used for the research, based on all the facts and circumstances.

(4) Section 1.141-3(b)(6)(ii) provides generally that a research agreement with respect to financed property results in private business use of that property if the sponsor is treated as the lessee or owner of financed property for Federal income tax purposes.

(5) Section 1.141-1(b) provides that the term "governmental person" means a State or local governmental unit as defined in § 1.103-1 or any instrumentality thereof. Section 1.141-1(b) further provides that governmental person does not include the United States or any agency or instrumentality thereof. Section 1.141-1(b) further provides that "nongovernmental person" means a person other than a governmental person.

(6) Section 1.145-2 provides that §§ 1.141-0 through 1.141-15 apply to qualified 501(c)(3) bonds under § 145(a) of the Code with certain modifications and exceptions.

(7) Section 1.145-2(b)(1) provides that, in applying §§ 1.141-0 through 1.141-15 to § 145(a) of the Code, references to governmental persons include § 501(c)(3) organizations with respect to their activities that do not constitute unrelated trades or businesses under § 513(a).

.02 **Federal Government rights under the Bayh-Dole Act.**

(1) The Patent and Trademark Law Amendments Act of 1980, as amended, 35 U.S.C. § 200 et seq. (2006) (the "Bayh-Dole Act"), generally applies to any contract, grant, or cooperative agreement with any Federal agency for the performance of research funded by the Federal Government.

(2) The policies and objectives of the Bayh-Dole Act include promoting the utilization of inventions arising from federally supported research and development programs, encouraging maximum participation of small business firms in federally supported research and development efforts, promoting collaboration between commercial concerns and nonprofit organizations, ensuring that inventions made by nonprofit organizations and small business firms are used in a manner to promote free competition and enterprise, and promoting the commercialization and public availability of inventions made in the United States by United States industry and labor.

(3) Under the Bayh-Dole Act, the Federal Government and sponsoring Federal agencies receive certain rights to inventions that result from federally funded research activities performed by non-sponsoring parties pursuant to contracts, grants, or cooperative research agreements with the sponsoring Federal agencies. The rights granted to the Federal Government and its agencies under the Bayh-Dole Act generally include, among others, nonexclusive, nontransferable, irrevocable, paid-up licenses to use the products of federally sponsored research and certain so-called "march-in rights" over licensing under limited circumstances. Here, the term "march-in rights" refers to certain rights granted to the sponsoring Federal agencies under the Bayh-Dole Act, 35 U.S.C. § 203 (2006), to take certain actions, including granting licenses to third parties to ensure public benefits from the dissemination and use of the results of federally sponsored research in circumstances in which the original contractor or assignee has not taken, or is not expected to take within a reasonable time, effective steps to achieve practical application of the product of that research. The general purpose of these rights is to ensure the expenditure of Federal research funds in accordance with the policies and objectives of the Bayh-Dole Act.

SECTION 3. DEFINITIONS

.01 **Basic research**, for purposes of § 141 of the Code, means any original investigation for the advancement of scientific knowledge not having a specific commercial objective. For example, product testing supporting the trade or business of a specific nongovernmental person is not treated as basic research.

.02 **Qualified user** means any State or local governmental unit as defined in § 1.103- 1 or any instrumentality thereof. The term also includes a § 501(c)(3) organization if the financed property is not used in an unrelated trade or business under § 513(a) of the Code. The term does not include the United States or any agency or instrumentality thereof.

.03 **Sponsor** means any person, other than a qualified user, that supports or sponsors research under a contract.

SECTION 4. CHANGES

This revenue procedure modifies and supersedes Rev. Proc. 97-14 by making changes that are described generally as follows:

.01 Section 6.03 of this revenue procedure modifies the operating guidelines on cooperative research agreements to include agreements regarding industry or federally sponsored research with either a single sponsor or multiple sponsors.

.02 Section 6.04 of this revenue procedure provides special rules for applying the revised operating guidelines under section 6.03 of this revenue procedure to federally sponsored research. These special rules provide that the rights of the Federal Government and its agencies mandated by the Bayh-Dole Act will not cause research agreements to fail to meet the requirements of section 6.03, upon satisfaction of the requirements of section 6.04 of this revenue procedure. Thus, under the stated conditions, such rights themselves will not result in private business use by the Federal Government or its agencies of property used in research performed under research agreements. These special rules do not address the use by third parties that actually receive more than non-exclusive, royalty-free licenses as the result of the exercise by a sponsoring Federal agency of its rights under the Bayh-Dole Act, such as its march-in rights.

SECTION 5. SCOPE

This revenue procedure applies when, under a research agreement, a sponsor uses property financed with proceeds of an issue of State or local bonds subject to § 141 or § 145(a)(2)(B) of the Code.

SECTION 6. OPERATING GUIDELINES FOR RESEARCH AGREEMENTS

.01 **In general.** If a research agreement is described in either section 6.02 or 6.03 of this revenue procedure, the research agreement itself does not result in private business use. In applying the operating guidelines under section 6.03 of this revenue procedure to federally sponsored research, the special rules under section 6.04 of this revenue procedure (regarding the effect of the rights of the Federal Government and its agencies under the Bayh-Dole Act) apply.

.02 **Corporate-sponsored research.** A research agreement relating to property used for basic research supported or sponsored by a sponsor is described in this section 6.02 if any license or other use of resulting technology by the sponsor is permitted only on the same terms as the recipient would permit that use by any unrelated, non-sponsoring party (that is, the sponsor must pay a competitive price for its use), and the price paid for that use must be determined at the time the license or other resulting technology is available for use. Although the recipient need not permit persons other than the sponsor to use any license or other resulting technology, the price paid by the sponsor must be no less than the price that would be paid by any non-sponsoring party for those same rights.

.03 **Industry or federally-sponsored research agreements.** A research agreement relating to property used pursuant to an industry or federally-sponsored research arrangement is described in this section 6.03 if the following requirements are met, taking into account the special rules set forth in section 6.04 of this revenue procedure in the case of federally sponsored research —

(1) A single sponsor agrees, or multiple sponsors agree, to fund governmentally performed basic research;

(2) The qualified user determines the research to be performed and the manner in which it is to be performed (for example, selection of the personnel to perform the research);

(3) Title to any patent or other product incidentally resulting from the basic research lies exclusively with the qualified user; and

(4) The sponsor or sponsors are entitled to no more than a nonexclusive, royalty-free license to use the product of any of that research.

.04 **Federal Government rights under the Bayh-Dole Act.** In applying the operating guidelines on industry and federally-sponsored research agreements under section 6.03 of this revenue procedure to federally sponsored research, the rights of the Federal Government and its agencies mandated by the Bayh-Dole Act will not cause a research agreement to fail to meet the requirements of section 6.03, provided that the requirements of sections 6.03(2), and (3) are met, and the license granted to any party other than the qualified user to use the product of the research is no more than a nonexclusive, royalty-free license. Thus, to illustrate, the existence of march-in rights or other special rights of the Federal Government or the sponsoring Federal agency mandated by the Bayh-Dole Act will not cause a research agreement to fail to meet the requirements of section 6.03 of this revenue procedure, provided that the qualified user determines the subject and manner of the research in accordance with section 6.03(2), the qualified user retains exclusive title to any patent or other product of the research in accordance with section 6.03(3), and the nature of any license granted to the Federal Government or the sponsoring Federal agency (or to any third party nongovernmental person) to use the product of the research is no more than a nonexclusive, royalty-free license.

SECTION 7. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 97-14 is modified and superseded.

SECTION 8. EFFECTIVE DATE

This revenue procedure is effective for any research agreement entered into, materially modified, or extended on or after June 26, 2007. In addition, an issuer may apply this revenue procedure to any research agreement entered into prior to June 26, 2007.

SECTION 9. DRAFTING INFORMATION

The principal authors of this revenue procedure are Vicky Tsilas and Johanna Som de Cerff of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue procedure, contact Johanna Som de Cerff at (202) 622-3980 (not a toll-free call).

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