CHAPTER FIVE

Selected Federal Tax Law Considerations Relating to Loan Origination and Administration Leveraged State Revolving Fund Programs

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Introduction

SRF programs that use the proceeds of tax-exempt bonds of the SRF issuer ("SRF bonds") to fund all or a portion of such issuer's SRF loans are referred to as "leveraged" programs. The proceeds of SRF bonds may also be used to fund the state match requirements and debt service reserve funds pledged to secure the SRF bonds. In most leveraged SRF programs, at least a portion of the proceeds of federal capitalization grants is used as security for the SRF bonds by funding a reserve fund. In most cases, loans are made to entities ("SRF borrowers") which are political subdivisions and able to issue tax-exempt bonds themselves. Thus, whether or not the SRF program is leveraged, the SRF loans may themselves be structured as tax-exempt obligations.

Because of the extensive and complex requirements associated with tax-exempt bonds which must be complied with to maintain tax exemption, the origination and administration of SRF loans should involve consideration by the loan officer of federal tax law relating to tax-exempt debt in leveraged SRF programs or to tax-exempt SRF loans. The applicable federal law includes Sections 103, 141 through 150 of the Internal Revenue Code of 1986, as amended (the "Code"), the federal tax regulations promulgated thereunder (the "Tax Regulations") and applicable published and private rulings, notices and revenue procedures issued by the Internal Revenue Service ("Published Rulings", "Private Letter Rulings" and "Revenue Procedures", respectively, and together with the Code and the Tax Regulations, herein referred to as the "Federal Tax Law").

The process of originating and administering SRF loans is likely to disclose specific facts which have significant implications under Federal Tax Law. **The purpose of this section is to give a general overview of selected common, but significant, considerations under Federal Tax Law so that loan officers may recognize them and take appropriate action.**

Federal Tax Law contains an entirely separate regulatory scheme involving the issuance of any debt by or on behalf of a state or political subdivision and is not superceded by, or integrated with, other federal or state law or regulations which govern the making of SRF loans. Complying with such other state and federal SRF program requirements does not suffice to insure compliance with Federal Tax Laws. Both sets of requirements must be followed where the SRF loan is funded from the proceeds of tax-exempt SRF bonds or the SRF loan itself is intended to be tax-exempt. While various forms of debt obligations of political subdivisions, including a simple loan agreement can be structured as a tax-exempt obligation, many SRF loans

have a formal general obligation or revenue bond evidencing or securing the SRF loan as well as a loan agreement. Either structure is herein referred to as a tax-exempt SRF loan. It should be noted that the presence of a formal bond does not itself mean that the SRF loan was intended to be tax-exempt. Unless all the requirements of Federal Tax Law are followed, such as filing a Form 8038 with the Internal Revenue Service (the "IRS"), interest on the loan will be taxable.

Where Federal Tax Law requirements cannot be met, alternate funding sources available under the SRF programs, such as federal capitalization grants and state matches not derived from bond proceeds, can be used. Likewise, compliance with Federal Tax Law will not relieve an obligation to comply with other legal requirements such as specific state law, the Clean Water Act, the Safe Drinking Water Act or EPA rules and regulations.

Federal Tax Law has requirements which must be met as precondition to the issuance of the SRF bonds or tax-exempt SRF loans and those which must be met at all times such bonds or loans are outstanding. Failure to comply with any such requirements for SRF bonds will result in significant problems for an SRF program including potential IRS enforcement actions and audits on determinations of taxability, and possible law suits from holders of SRF bonds. The IRS currently has an active audit program, which includes random audits, audits of particular types of transactions, and audits resulting from questions arising with respect to a specific issue. Simply responding to an audit can be a time consuming and expensive proposition. The IRS can ultimately declare the interest on specific bonds to be taxable. In many cases, taxability will be retroactive to the date of issue. The IRS also has the ability to enter into closing agreements with issuers to maintain the tax-exemption for bonds which have failed to comply with the requirements of Federal Tax Law. These may often involve the payment of significant monetary penalties by the issuer. In cases where bonds are determined to be taxable, suits by bondholders to recover their damages are likely.

The issuance of the SRF bonds and the origination and administration of the SRF loans may be undertaken by different individuals, often by different state agencies and in many cases at very different times. However, whether made before, after or in conjunction with the issuance of the SRF bonds, the SRF loans all have implications under various provisions of the Federal Tax Law with respect to the SRF bonds. The terms of, and the security for, such SRF loans, the use and investment of the proceeds and repayments thereof, as well as the enforcement and amendment of such loans may affect the tax-exempt status of the SRF bonds.

At the time of issuance of tax-exempt SRF bonds and tax-exempt SRF loans, the requirements of the Federal Tax Law are addressed by specialized legal counsel herein referred to as **"Bond Counsel"**. Such counsel is a specialized, independent counsel, nationally recognized by the financial markets as expert in tax-exempt bonds, and retained to issue an opinion at the time of issuance of tax-exempt SRF bonds or a tax-exempt SRF loan (i) that such bond issue or loan has been validly issued under state law and (ii), assuming continued compliance by the SRF issuer and the SRF borrowers with the requirements of the Federal Tax Law, that interest thereon is not included in gross income of the owner thereof for federal income tax purposes and, in most cases, not subject to state income taxes of the state of issue.

Bond counsel is not retained, and does not undertake, to monitor continued compliance with the requirements of the Federal Tax Law or to update its opinion. In connection with an overall compliance program, each SRF issuer should develop procedures to monitor tax compliance on

an ongoing basis and, if issues arise, have them addressed by bond counsel, as appropriate. In addition to tax considerations, most SRF programs do or should have compliance programs for other financial and operational aspects of their activities, as well as those of SRF borrowers. Leveraged SRF programs have continuing disclosure requirements pursuant to Rule 15(c)2-12 of the Securities and Exchange Commission (SEC) which requires filing of annual reports updating program financial and operating data, as well as filing certain event notices.

Often, the best source of information as to the SRF loans, and thus an integral part of a compliance program, is the loan officer. To be effective, a loan officer should have a general understanding of the Federal Tax Law and familiarity with actions and events which are likely to raise tax issues. The loan officer is the primary audience for this paper.

As discussed in more detail later, the following are certain commonly occurring events or facts which can raise tax issues:

- The use by an SRF borrower of debt other than the SRF loan to initially finance all or a portion of its project can raise questions of compliance with the Federal Tax Law provisions governing refunding bonds.

- The use of an SRF borrower's own funds, not derived from debt, can raise issues of compliance with the reimbursement bond restrictions.

- The use of projects by private business users not constituting governmental users can raise issues of compliance with the private activity bond regulations.

- Restructurings and other modifications of the terms of SRF loans, whether voluntary or in connection with enforcement actions, can raise questions as to whether there has been a reissuance of that SRF loan for federal tax purposes.

- The manner of investment of various monies, including loan proceeds and amounts intended to be used, or used, for repayment can raise issues as to whether the federal arbitrage regulations have been violated.

- Finally, SRF borrowers may have questions as to the effect of the SRF loan on its capacity to issue bank qualified bonds under the Federal Tax Law for other purposes.

Since the purpose of this section is not to make each loan officer an expert in Federal Tax Law, it should not be relied upon as legal advice. All analysis of compliance with the Federal Tax Law is highly fact specific and subject to interpretation and changes in law. Any specific issues should be referred to bond counsel for review.

Federal Tax Law Overview

General. The phrase "tax-exempt bonds" is used to refer to a debt obligation of a state or political subdivision, the interest on which is excluded from gross income of the owner thereof for federal income tax purposes pursuant to Sections 103 and 141 through 150 of the Code.

While there may be some collateral income tax consequences to the owner of the interest, such as inclusion in alternative minimum tax computations, these bonds are still referred to as tax-exempt. Generally, the interest on tax-exempt bonds is not subject to state income tax within the state of issuance. However, interest on tax-exempt bonds from states other than the owners tax residence are generally not exempt from state income taxes.

While the ability of an SRF borrower to issue bonds is dependent upon state law requirements and limitations, the ability to issue bonds which are tax-exempt is entirely dependent upon complying with Federal Tax Law. The federal government has become actively involved in determining what can be financed from the proceeds of tax-exempt bonds and in restricting the issuance and use of proceeds of tax-exempt bonds through the Federal Tax Law. The IRS has an increasingly active tax-exempt bond audit program to monitor compliance.

There are several major themes which are basic to understanding the parameters of Federal Tax Law restrictions. These core concepts include the following:

- Interest on debt obligations is subject to federal income tax unless it is specifically excluded by the Federal Tax Law.

- The availability of tax-exempt financing for private business use, rather than purely governmental purposes, is more restricted. Bonds can be divided into two large classifications: "governmental bonds" and "private activity bonds" and the determination of the classification for a particular issue of bonds is critical.

- The inherent differential between tax-exempt interest rates and taxable interest rates allow many opportunities for a governmental issuer to realize an "arbitrage" profit from issuing tax-exempt bonds. As a matter of federal tax policy, such profit is generally either permitted in limited cases, prohibited depending on the size and charter of the bank and the speed of expenditure of the proceeds, or required be paid, or "rebated" to the federal government.

- Federal Tax Law restrictions apply to bond proceeds until expended and are tied to the use of the property financed. Therefore, tracing or allocating the sales proceeds of tax-exempt bonds to a particular use or asset and determining when such proceeds have been "expended" for federal tax purposes is a necessary part of tax analysis and compliance.

- There are a vast number of very technical requirements that must be satisfied, both prior to the issuance of tax-exempt bonds, and on an ongoing basis after the issuance. Failure to comply with these requirements can result in the debt becoming taxable or the payment of significant amounts of money by the issuer to the federal government to settle the tax dispute and avoid the imposition of tax on the bondholders.

Tax-Exemption – A statutory grant not a constitutional right. It was often thought that the interest on bonds of a state or political subdivision thereof had to be tax-exempt because the federal government had no right under the United States Constitution to tax the powers, operations or property of a state or political subdivision thereof. This position was upheld by the United States Supreme Court in Polluck v. Farmers' Loan and Trust Company decided in 1895 prior to the passage of the Sixteenth Amendment to the United States Constitution in 1913 which expressly authorized the federal government to impose an income tax. Since the exemption of

interest on state and local governmental obligations from taxation was included in the Revenue Act of 1913 and in subsequent income tax legislation in one form or another, the constitutional question was not ultimately resolved until 1988 when the Supreme Court made it clear that the federal government can subject interest on state and local government obligations to federal income taxes in South Carolina v. Regan.

Private Activity and Governmental Bonds. Historically, tax-exempt bonds could be issued for any purpose for which a state or political subdivision was authorized under the applicable state constitution and law. However, when states moved to allow more financings to be done for purely private business purposes through the issuance of bonds, the proceeds of which were loaned by a governmental entity to private companies to build facilities for use in their businesses, the federal government took action to limit the issuance of those bonds and thus to limit the "tax-expenditure" or the subsidy given to the private businesses. Such bonds were referred to as "conduit" bonds because the governmental issuer did not use the proceeds for its own facilities, but rather just passed them through to the private business through a loan. The bonds were generally special limited obligations payable solely from loan repayments from the private business. Under the Internal Revenue Code of 1954, as amended, these bonds were known as **"industrial development bonds"**. Under the Code, the terminology was changed to **"private activity bonds"**, and new restrictions were added. The interest on private activity bonds is not tax-exempt unless such bonds are “qualified bonds” under Federal Tax Law.

A private activity bond means any bond which meets the "private business use test" and the "private security or payment test" or the "private loan financing test" set forth in Federal Tax Law. It is fairly easy to identify a purely private activity bond. However, with increased restrictions, new forms of private use were developed and new rules and restrictions were put into place. There is substantial risk that many arrangements relating to facilities which appear to be governmental will involve sufficient private use to cause the bonds financing those facilities to be taxable.

The **"private business use test"** is met if more than 10% of the proceeds of a bond issue are used for any private business use. The **"private security or payment test"** is met if the payment of more than 10% of the principal of, or interest on, the bonds is secured by, or to be paid from payments in respect of, property, or borrowed money, used or to be used for a private business use. The 10% private use test is reduced to 5% if the proceeds of an issue are to be used for any private business use which is not related and is proportionate to any governmental use of such proceeds. In addition, there are special rules for "output facilities" which are defined under the Federal Tax Law to include water collection, storage, and distribution facilities, but not facilities for the disposal of treated wastewater. The purchase of output from an output facility is taken into account under the private business tests if the purchase has the effect of transferring, to the purchaser, substantial benefit of owning the facility and substantial burdens of paying debt service on the bonds used to finance the facility

The **"private loan financing test"** is met if the proceeds of a bond issue exceeding the lesser of $5,000,000 or 5% of the proceeds are used directly or indirectly to provide loans to private non-governmental entities for any purpose, including purposes which are not related to a trade or business. Thus, for example, loans to individuals to finance the purchase of a home would fall within the private loan prohibition. In most cases, the private use test also precludes loans for business purposes. There is an exception to the private loan financing test for bonds payable

from special assessment, even though the assessed property owner is allowed to pay the assessment over time with interest even though this arrangement constitutes a private loan.

"Use" of a facility or bond proceeds has been very broadly defined to include any actual, beneficial, direct, indirect or intermediate use. A nongovernmental entity can use a facility by ownership, lease, license, actual use with no agreement, or management or control of certain operations or output, or any other arrangement which gives the private entity benefit of the bond issue. Use for the purposes of the Federal Tax Law does not include use by the general public, even if such use is in connection with a trade or business, so long as such use is on the same basis as other members of the general public.

If a facility is used for governmental purposes, but then the use changes to use in a trade or business, the new use can cause bonds financing the facility to become private activity bonds. The Federal Tax Law provides certain specific "remedial actions" which can be taken to preclude the bonds from becoming taxable as a result of a deliberate action which causes the change of use.

There are certain private activity bonds which are expressly made tax-exempt. These are referred to as **"qualified bonds"**. Most of these qualified bonds are not applicable to SRF programs and each has very different technical compliance requirements from governmental bonds. Qualified Bonds include the following:

- an exempt facility bond,
- a qualified mortgage bond,
- a qualified veterans' mortgage bond,
- a qualified small issue bond,
- a qualified student loan bond, or
- a qualified 501(c)(3) bond.

Exempt facility bonds *include some facilities that may be applicable in an SRF Program.*

Exempt facility bonds mean any bond, 95% or more of the proceeds of which are used to provide the following:

- airports,
- docks and wharves,
- mass commuting facilities,
- facilities for the furnishing of water,
- sewage facilities,
- solid waste disposal facilities

- qualified residential rental projects,
- facilities for the local furnishing of electric energy or gas,
- local district heating or cooling facilities,
- qualified hazardous waste facilities,
- high-speed inter-city rail facilities, or
- environmental enhancements of hydroelectric generating facilities.

While it is possible that an SRF loan may be an exempt facility bond for either water or sewage facilities, there are extensive requirements and limiting regulations, the discussion of which is beyond the scope of this section. It is unlikely that any SRF bonds for wastewater loans would be structured as exempt facility bonds because borrowers are political subdivisions and facilities are governmental owned and used for governmental purposes rather than owned by a private business or used in a private activity. However, with the ability to finance privately owned drinking water projects with SRF loans, there may be some attempt to use exempt facility bonds.

A more detailed discussion of relevant private activity bond restrictions is set forth below under the heading "Private Activity Bonds".

<u>Arbitrage and Rebate</u>. The concept of arbitrage, relating to investment of tax-exempt bond proceeds, is such a vast and complex topic that a detailed analysis of all arbitrage regulations is beyond the scope of this discussion. However, the concept of arbitrage itself is fairly simple and there are few basic rules that should be mastered.

Arbitrage general refers to taking advantage of the differential between tax-exempt and taxable interest rates. If an issuer can borrow at a tax-exempt rate which is usually lower than a taxable rate, and invest the proceeds of the borrowing at a taxable rate, it is possible to obtain an "arbitrage" profit (i. e. , the difference between the cost of borrowing and the return on investment). Federal Tax Law prohibits issuing bonds for the purpose of obtaining arbitrage profit and has many restrictions to eliminate or limit the potential for arbitrage profit. If a bond issue is found to violate these restrictions, the interest is taxable. Thus, the term "arbitrage bond" is commonly used to describe a bond which was intended to be tax-exempt but has become taxable as a result of violating the arbitrage regulations.

As a general rule, the Federal Tax Law prohibits investing any proceeds at a yield materially higher than the yield on the tax-exempt bond issue. As a working rule, materially higher can be viewed simply as higher than the yield on the bonds. This prohibition has certain exceptions which are characterized as **"temporary periods"** during which investments may be made at a higher yield, such as a three-year temporary period for construction issues. Otherwise investments must be **"yield restricted"** to the yield on the bonds.

The difference between unrestricted investment during a temporary period and yield restricted investment has been blurred since the introduction of the requirement to "rebate" substantially all arbitrage profit on bonds issued after August 31, 1985, with certain exceptions. Rebate refers to the obligation of the issuer to calculate and pay the difference between the investment return and

the bond yield to the federal government. Thus, temporary periods really only allow investment flexibility rather than an opportunity to make arbitrage profit, except for certain small issuers or spending exceptions. The issuer does not have to limit its choice of investments to only those which have a yield equal to or less than the bond yield, which may, from time to time, depending on market changes and restrictions on the types of investments under state law or in the bond documents, be difficult. This distinction has been further reduced with the introduction of the concept of "yield reduction payments" in the Federal Tax Law. While essentially the same concept as rebate, it allows the issuer to make any investment for most, but not all, yield restricted funds and then to make yield reduction payments to the federal government to reduce the yield to the permitted level. There are very precise regulations on how an issuer must calculate the yield on both its bonds and its investments and the rebate amount. There are also exceptions to the applicability of the rebate requirements for certain small issues and for certain issues meeting specified spend down requirements. Because of the complexity involved in many rebate calculations, it has become common to hire an experienced rebate analyst to do the actual calculations.

Part of the complexity of the arbitrage restrictions and rebate is establishing the "yield" on investments. There are specific rules which apply and the yield for federal tax purposes may be different from other various measurements of yields used in the market place. Recently, there have been a number of *"yield burning"* cases where the IRS questioned the yield on investments relating to bond issues primarily because of the price at which the dealer sold the investments and the mark-up or profit received by the dealer. The concept is that one cannot buy investments at an inflated price to lower the yield to comply with arbitrage yield restrictions. The Federal Tax Law addresses this topic with, among others, rules and procedures commonly referred to as market price rules relating to the determination of the price of an investment for federal tax purposes in connection with computing the yield on that investment.

Perhaps the most important concept for the loan officer to understand is that the arbitrage restrictions apply not only to the investment of what is normally thought of as bond proceeds, but also to investment of any **"gross proceeds"** as described below, and to investment in *"purpose obligations"*. Purpose obligations are obligations purchased from bond proceeds to accomplish the purpose of the bond issue. For example, the purpose of SRF bonds is to construct or acquire wastewater or drinking water facilities. This is not accomplished by the SRF issuer building the facilities itself and using the bond proceeds to pay the contractors. Rather, the SRF issuer uses the proceeds to make loans to SRF Borrowers to accomplish such purpose and in the process acquires the SRF Loan, which, under Federal Tax Law, is the acquired purpose obligation. The yield on a purpose obligation must generally be limited to the yield on the bonds, plus 1/8 of 1%. This restriction normally does not come into play in an SRF program since SRF loans are usually made at a subsidized rate which is less than the rate on the SRF bonds.

Gross proceeds includes much more than the original proceeds derived from the sale of the bonds. It includes all monies which are deemed to be, or treated as, proceeds under Federal Tax Law. All gross proceeds are subject to the arbitrage regulations. Monies not deemed gross proceeds are not subject to arbitrage restrictions. Thus, the determination of what are gross proceeds is a critical first step to any arbitrage analysis.

Gross proceeds include all sale proceeds together with all monies that are expected to be used and available to pay debt service, whether or not actually pledged, including the replacement proceeds. Sale proceeds are the monies actually received from the sale of SRF bonds, they

remain proceeds while held by the SRF issuer or the SRF borrower until actually expended. In addition, SRF loan repayments received by the SRF issuer to be used to pay the SRF bonds, any federal capitalization grants pledged and restricted to the payment of debt service, any fund segregated on the books of the borrower where revenues are accumulated to make SRF loan repayments and interest earnings on any of these funds count as gross proceeds. Thus, it is important to note that any monies, related in any way to a tax-exempt bond issue and from whatever source, could be gross proceeds and subject to arbitrage restrictions if there is a connection or relationship to a tax-exempt bond issue.

Gross proceeds is the broadest classification of bond proceeds under Federal Tax Law. Included within the scope of gross proceeds are classification subsets as follows:

- Sales Proceeds
- Investment Proceeds
- Transferred Proceeds
- Replacement Proceeds
- Sinking Fund Proceeds
- Pledged Fund Proceeds
- Other Replacement Proceeds

The distinctions among the types of proceeds is not that important in spotting facts which may raise arbitrage compliance questions, but rather are used in determining the specific different arbitrage restrictions and limitations applicable to different types of proceeds.

The concept of **replacement proceeds** is an example of the reach of the "gross proceeds" concept. Federal Tax Law regulates the use of bond proceeds to "replace" monies used to purchase higher yielding securities. For example, leaving a capital improvement fund funded from invested tax revenues while borrowing to fund capital projects could cause the tax revenue on deposit in the capital improvement fund to become gross proceeds. While there is no express requirement that all funds of a borrower must be spent to allow borrowing, if there is a "sufficient direct nexus" of monies to the bond issue, such monies can become replacement proceeds and thus gross proceeds subject to arbitrage rules and rebate.

Sinking funds, pledged funds and negative pledges are relatively common examples of replacement proceeds. Any monies reasonably expected to pay debt service on tax-exempt bonds are gross proceeds, whether or not such monies are legally pledged to such use. Monies, other than bond proceeds, directly or indirectly pledged to the payment of bonds may also become gross proceeds, even if they are not expected to be used to pay the bonds, so long as there is a reasonable assurance that such funds will be available to pay debt service if needed. If such funds can be used, and are expected to be used, to pay expenditures other than debt service, they may not constitute gross proceeds. Indirect pledges include pledges to the issuer of a letter of credit, bond insurance or other credit enhancement, even when the bonds themselves are not secured by a direct pledge of such funds. Negative pledges with certain exceptions may also result in monies becoming proceeds where there is a requirement to maintain such unpledged funds at specified levels.

The Tax Regulations, § 1.148-1(c), defines replacement proceeds as follows:

(c) **Definition of replacement proceeds**

(1) ***In general.*** *Amounts are replacement proceeds of an issue if the amounts have a sufficiently direct nexus to the issue or to the governmental purpose of the issue to conclude that the amounts would have been used for that governmental purpose if the proceeds of the issue were not used or to be used for that governmental purpose. For this purpose, governmental purposes include the expected use of amounts for the payment of debt service on a particular date. The mere availability or preliminary earmarking of amounts for a governmental purpose, however, does not in itself establish a sufficient nexus to cause those amounts to be replacement proceeds. Replacement proceeds include, but are not limited to, sinking funds, pledged funds, and other replacement proceeds described in paragraph (c)(4) of this section, to the extent that those funds or amounts are held by or derived from a substantial beneficiary of the issue. A substantial beneficiary of an issue includes the issuer and any related party to the issuer, and, if the issuer is not a state, the state in which the issuer is located. A person is not a substantial beneficiary of an issue solely because it is a guarantor under a qualified guarantee.*

(2) ***Sinking fund*** *includes a debt service fund, redemption fund, reserve fund, replacement fund, or any similar fund, to the extent reasonably expected to be used directly or indirectly to pay principal or interest on the issue.*

(3) ***Pledged fund***

(i) ***In general.*** *A* ***pledged fund*** *is any amount that is directly or indirectly pledged to pay principal or interest on the issue. A pledge need not be cast in any particular form but, in substance, must provide reasonable assurance that the amount will be available to pay principal or interest on the issue, even if the issuer encounters financial difficulties. A pledge to a guarantor of an issue is an indirect pledge to secure payment of principal or interest on the issue. A pledge of more than 50 percent of the outstanding stock of a corporation that is a conduit borrower of the issue is not treated as a pledge for this purpose, unless the corporation is formed or availed of to avoid the creation of replacement proceeds.*

(ii) ***Negative pledges.*** *An amount is treated as pledged to pay principal or interest on an issue if it is held under an agreement to maintain the amount at a particular level for the direct or indirect benefit of the bondholders or a guarantor of the bonds. An amount is not treated as pledged under this paragraph (c)(3)(ii), however, if –*

(A) The issuer or a substantial beneficiary may grant rights in the amount that are superior to the rights of the bondholders or the guarantor; or

(B) The amount does not exceed reasonable needs for which it is maintained, the required level is tested no more frequently than every 6 months, and the amount may be spent without any substantial restriction other than a requirement to replenish the amount by the next testing date.

Expended for Federal Tax Purposes

Gross proceeds remain proceeds until expended or, in some cases, until the bonds are no longer outstanding. Once allocated to an expenditure, funds are free of arbitrage and other restrictions. It is important to understand when proceeds are expended because expenditure defines the outside parameters of a compliance program.

Proceeds, such as original sale proceeds of an issue intended to fund SRF loans, are expended for federal tax purposes only when applied or allocated to their ultimate use – which usually occurs by the SRF borrower paying a third party vendor for the capital items being purchased. **Proceeds are not deemed expended when loaned to the SRF borrower until the SRF borrower in turn uses such funds to make actual payments.** In the case where an expenditure has actually been made from other funds of the SRF borrower, and the proceeds are being used to reimburse the borrower for the expended money, the SRF borrower, assuming such reimbursement is permitted under the Federal Tax Law, and a declaration of official intent is in place, the borrower must "allocate" the proceeds to the reimbursed expenditure. Section 1. 150-2(c) defines such allocation to an expenditure as follows:

> ***Reimbursement allocation*** *means an allocation in writing that evidences an issuer's use of proceeds of a reimbursement bond to reimburse an original expenditure. An allocation made within 30 days after the issue date of a reimbursement bond may be treated as made on the issue date.*

A second aspect of the expenditure of bond proceeds is the association of particular tangible property with the proceeds, since the use of the property is restricted by the Federal Tax Law if the tax-exempt nature of the bonds is to be established or maintained. It may become important to determine if bond proceeds were used to finance a specific piece of equipment in a large project financed from multiple sources of funds if, for example, there is private, non-governmental use of that equipment but not other parts of the project. While certain accounting and allocation methods can be adopted, direct tracing is often used to associate given dollars of proceeds to particular bricks and mortar. A further discussion of allocation methods is set forth under the heading "Private Activity Bonds – Measurement of Private Activity. " Once proceeds are expended for a purpose, or allocated to an expenditure, such proceeds cannot be reallocated.

It therefore becomes important that the SRF borrower keep accurate records as to the exact expenditures paid from SRF loan proceeds or follow an acceptable and established allocation and accounting procedure.

In certain cases, unexpended gross proceeds cease to be proceeds when no longer related to a tax-exempt bond issue. For example, amounts on deposit in a reserve fund, not funded from bond proceeds but pledged to secure a bond issue, cease to be proceeds when the pledge is released or when the bonds secured by the pledge are no longer outstanding.

Technical Requirements

In addition to the requirements discussed elsewhere in this section, the Federal Tax Code contains many technical requirements, some of which apply to all bonds and many of which apply just to private activity bonds. For background, the following is a quick overview of some of those technical requirements.

Generally, Section 149 of the Code, (i) requires all bonds to be in registered form, and not to be federally guaranteed, (ii) requires certain information to be reported to the Internal Revenue Service, and (iii) imposes certain restrictions on pooled loan financing bonds and hedge bonds.

Each bond, other than those of a type not offered to the public, having a maturity at issue of not more than one year, or which is reasonably designed not to be sold or resold to a United States citizen or resident or domestic corporation, partnership, estate or trust, must be in registered form. The various reasons stated for this requirement, in connection with the legislation adopting it, included the creation of records which can provide useful information as to the payment of interest and sale of obligations, the reduction of the ability of taxpayers to conceal income and property and the reduction of substitutes for cash available to persons engaged in illegal activities.

A federally guaranteed bond is not tax-exempt. The federal guarantee restriction was based upon the position that there should not be a double federal subsidy of tax exemption and federal credit enhancement and that the federal government should not create tax-exempt securities to compete with its own taxable securities. An obligation is federally guaranteed not only if the obligation is directly guaranteed by the United States, but also if 5% or more of the proceeds are used in making loans which are guaranteed in whole or in part by the United States, are invested directly or indirectly in federally insured deposits or accounts, or are guaranteed indirectly in whole or in part by the United States. There are numerous exceptions for certain federal insurance programs and certain investments such as temporary investments of bond proceeds. However, the requirement is so broad on its face that any bond issue that involves subsidies, guaranties or payments from the federal government must be analyzed. In fact, there was so much concern that SRF bonds would be considered federally insured that the IRS published a notice in 1988 (Notice 88-54, 1988-19 I. R. B. 25) that regulations to be issued would provide that SRF bonds would not be considered federally guaranteed solely because of debt service reserve funds funded with capitalization grants under the federal water pollution control program.

In order to monitor the issuance and use of tax-exempt bonds and to assist in enforcement of Federal Tax Law, each issuer must file certain information about the issue with the Internal

Revenue Service shortly after the issuance of the bonds. Failure to timely file such information results in the bonds being taxable, although relief is routinely granted by the IRS for valid reasons. The information is required to be filed on prescribed forms (either Form 8038, 8038-G or 8038-GC).

Pooled financing bonds are not tax-exempt unless certain requirements are met. Since a **"pooled financing bond"** is any bond issue more than $5 million of the proceeds of which are reasonably expected to be used directly or indirectly to make or finance loans to two or more ultimate borrowers, **SRF bonds are pooled financing bonds**. The requirements that must be met are (i) that the issuer reasonably expects that 95% of the net proceeds will be used within 3 years from the date of issue to actually make loans to ultimate borrowers and (ii) that the payment of legal and underwriting costs are not contingent and that at least 95% of those costs are actually paid within 180 days of the date of issue. The pooled financing restrictions were imposed to stop the issuance of hedge pools (bonds issued to protect against increases in rates or changes in law, rather than for current projects).

A **hedge bond** is any bond unless (i) the issuer reasonably expects to spend 85% of the spendable proceeds within 3 years from the date of issue and (ii) not more than 50% of the proceeds are invested in non-purpose investments (temporary investments prior to expenditure) having a substantially guaranteed yield for four years or more. A hedge bond may still be tax-exempt if (i) the issuer expects that 10% of the spendable proceeds will be spent within one year, 30% within two years, 60% within three years and 85% within five years and (ii) costs of issuance are not contingent and 95% are paid within 180 days. The hedge bond restrictions were imposed to prevent early issuance of bonds to lock in favorable interest rates before a use of the proceeds was established because it was felt by the federal government such purposes were not proper and represented a potentially significant "tax expenditure".

Private activity bonds have further restrictions. There is a state-by-state annual volume cap to limit the amount of private activity bonds issued within the state. Interest on private activity bonds is not tax-exempt for any period when the bond is held by a substantial user of the bond financed facility. The average maturity of a private activity bond cannot exceed 120% of the reasonably expected economic life of the financed facility. Subject to certain exceptions, no more than 25% of the proceeds of an issue can be used to acquire land, no proceeds can be used to acquire farm land, no proceeds can be used to acquire existing property (except any building and the equipment therefore if certain required rehabilitation expenditures are made within two years) and no proceeds may be used to provide any airplane, skybox, other private luxury box, health club facility, gambling facility or store for the sale of alcoholic beverages for consumption off premises. In addition, private activity bonds can be issued only after a public hearing pursuant to specified public notice and approval by the "applicable" elected representative. Further, no more than 2% of the proceeds of an issue can be used to pay costs of issuance.

The following case examples discuss Federal Tax Law considerations which arise from facts which could be encountered in the origination or enforcement of SRF loans.

Refunding Bonds

Facts Discovered

In the process of originating an SRF loan, it is discovered that the SRF borrower issued short term tax-exempt bond anticipation notes to provide interim financing until the SRF loan was finally approved. When the SRF loan is finally approved, it is funded from SRF bonds issued six months ago. The SRF borrower indicated that it would reimburse itself from loan proceeds for the prior expenditures, deposit that money in its bond fund and use it in four months to pay the short-term financing when it matures.

Possible Problems

Since the SRF loan is being funded from SRF bonds issued more than 90 days before the proceeds are used to pay the short-term debt, a portion of the SRF bonds become advance refunding bonds. The investment of proceeds of advance refunding bonds must be restricted to the yield on the refunding bonds. The alternative of making yield reduction payments is not available for a refunding escrow. If the proceeds were invested at a rate higher than the yield on the SRF bonds before it is known that a portion of the issue are advance refunding bonds, the SRF issuer will not be able to comply with the yield restrictions. In addition, since advance refundings are limited to just one, the SRF issuer will not be able to advance refund that portion of the SRF bonds which are advance refunding bonds if it desires to do so in the future.

What is a refunding bond?

Under the Federal Tax Code, a refunding bond is a bond the proceeds of which are used to pay principal and interest of another bond issue. A bond issue is not a refunding bond if the obligor on the refunding issue is not the same as the obligor on the refunded issue. Where you have a conduit borrower such as an SRF borrower, the obligor of the portion of the bonds used to fund the loan is treated as the obligor rather than the actual issuer. What does this mean? If a city is the SRF borrower from an SRF issuer, and the SRF issuer funds the SRF loan from its SRF bonds, the SRF borrower is deemed to be the obligor of that portion of the SRF bonds rather than the actual SRF issuer, because the SRF loan constitutes a "purpose obligation" and the use of bond proceeds to fund the loan constitutes an investment in that purpose obligation.

The definition of a refunding bond set forth in Section 1.150-1(d) of the Tax Regulations is included as <u>Appendix L</u> hereto.

Refunding bonds are treated separately and differently from bonds issued to finance project expenses ("new money bonds") under the Federal Tax Law. One bond issue can have both new money and refunding portions. Therefore, it is important to know prior to the issuance of bonds whether the proceeds are to be used for new money purposes or for refunding purposes so that

the different rules can be followed. If the rules or refundings are not followed, a portion of a bond issue could become taxable at some time after the issuance, retroactive to the date of issue.

The Federal Tax Code divides refunding bonds into two types: **current refunding bonds and advance refunding bonds**. A bond is a current refunding bond where the proceeds of that bond are used within 90 days to actually pay the principal of and interest on the prior bond. Use of the proceeds to fund a defeasance escrow by which the prior bonds are deemed no longer outstanding under the authorizing resolution or indenture does not constitute payment of the prior bonds for the purpose of determining whether it is a current refunding or an advance refunding.

Advance refunding bonds are refunding bonds, the proceeds of which are used more than 90 days after the date of issue to pay the prior bonds. This is usually done by establishing a defeasance escrow, but an escrow is not required to be an advance refunding.

The IRS does not favor advance refundings since it results in two issues of tax-exempt bonds outstanding for the same project generating tax-exempt interest at the same time. Thus, the Federal Tax Code limits the number of advance refundings to only one. This means that if an SRF issuer issues SRF bonds to advance refund a prior issue of SRF bonds, it cannot again advance refund those advance refunding bonds.

There is no limit on the number of current refundings. However, most long-term fixed rate tax-exempt bonds are issued with a no call period, usually eight to ten years from the date of issue. Thus, during that no-call period it is not possible to do a current refunding and the ability to do an advance refunding may be very valuable. If bonds are in fact issued for a second advance refunding, even if it is not known at the time of issuance that the bonds being refunded were themselves advance refunding bonds, the refunding portion of the latest issue will be taxable. Where an SRF borrower issues its own debt to finance a project and then uses the proceeds of an SRF loan to pay the prior debt more than 90 days after the date of issue of the SRF bonds, a portion of the SRF bonds may be advanced refunding bonds where the proceeds of an SRF loan are used to pay the prior debt more than 90 days after the date of the funding of the loan, a portion of the SRF bonds will be advance refunding bonds.

Another concern with a refunding is the different arbitrage yield restrictions and temporary periods for new money bonds and refunding bonds. The proceeds of a new money issue may be invested at an unrestricted yield for a temporary period (normally three years but only 6 months at the pool level and only 90 days for a current refunding) and thereafter must be invested at a yield not in excess of the yield on that bond issue, subject to the availability of yield reduction payments to reduce the yield. The proceeds of advance refundings must be invested at a yield not in excess of the yield on the advance refunding bonds and yield reduction payments are not available. Thus, it is possible that SRF bond proceeds could be invested at too high a yield if what was expected to be a new money issue turns out to contain advance refunding bonds.

An SRF issuer should ask each SRF borrower whether it has issued any of its own debt to finance the project costs. It is important to pursue this question further even if the SRF borrower states that it is not going to use the proceeds of the SRF loan to refund its bonds. On occasion, SRF borrowers have developed a theory that they are not refunding the prior issue because (i) under the EPA regulations they can use the proceeds of an SRF loan to reimburse itself for expenditures previously paid, (ii) they are using the SRF loan for such reimbursement, (iii) upon

reimbursement such amounts are no longer the proceeds of an SRF loan but are rather general funds of the borrower and (iv) the use of general funds rather than bonds proceeds to pay off the prior issue is not a refunding. Unfortunately, this theory does not work under the Federal Tax Law and the transaction will constitute a refunding.

Reimbursement Bonds

Facts Discovered

Upon funding an SRF loan, it is discovered that the SRF borrower has already paid for certain expenditures, such as architectural and engineering fees, land acquisition, and the first two construction draws. The SRF loan is funded from SRF bonds issued six months ago. The architectural and engineering fees were paid about a year ago. The land was paid for seven months ago and the first two construction draws were paid one and two months ago. The SRF borrower first applied for the SRF loan six months ago and had not taken an action prior to that with respect to financing the project.

Possible Problems

Since some payments were made prior to the SRF bonds being issued or the SRF borrower declaring official intent to finance the project, the Federal Tax Regulations relating to reimbursement bonds must be followed. Since the architectural and engineering fees are preliminary expenditures, they can be reimbursed up to an amount not exceeding 20% of the total project costs. Land costs are not preliminary expenditures and thus cannot be reimbursed. The first two construction draws can be reimbursed since they were paid after the bonds were issued and the loan was applied for.

What is a reimbursement bond?

Under the Federal Tax Law, a reimbursement bond is simply that part of an issue of bonds the proceeds of which are used to reimburse an original expenditure for a project that was actually paid before the bonds were issued. The use of bond proceeds to reimburse previously made expenditures will not be deemed an expenditure of the bond proceeds for federal tax purposes, unless the expenditure was made after the bonds were issued or in compliance with Section 1. 150-2 of the Tax Regulations (the "Reimbursement Regulations") which provides an exception for reimbursement of certain previous expenditures if there is a declaration of official intent, the expenditure is made no more than 60 days prior to such declaration, and the reimbursement is made within prescribed reimbursement period. Such amounts will continue to be treated as bond proceeds subject to the general arbitrage and rebate requirements, among others, of the Federal Tax Law. **If the Reimbursement Regulations cannot be satisfied, an alternate source of funds, such as capitalization grants or states matches which are not bond proceeds, should be used to fund reimbursement expenditures.**

What facts should you look for?

Any indication that a borrower may have actually paid expenditures prior to the origination of the SRF loan should be immediately investigated. For example, the fact that construction of a project commenced prior to the date of the issuance of the bonds to be used to fund a loan should be enough to raise the issue.

Reimbursement bond problems arise only in the context of actual payments, and not the mere incurrence of an obligation to pay. Thus, the signing of a noncontingent construction contract prior to the date of issue of the bonds does not itself, cause a problem. Work can actually have been done under such a contract. If the SRF borrower does not pay for such work until after the bonds have been issued, there is not a reimbursement bond issue.

The fact that reimbursements of previously paid expenditures may be permitted under EPA rules for state revolving funds or under state law applicable to the state revolving fund does not excuse or override compliance with the requirements of the Federal Tax Code.

Once it is determined that there were actual expenditures made before the date of issue of the bonds, further investigation is still necessary to determine if the Reimbursement Regulations can be complied with.

Federal Tax Regulation (Section 1.150-2(g)(1)) states a general rule of "once financed, not reimbursed". If a borrower borrowed funds to finance the expenditure, so long as that borrowing complied with the Reimbursement Regulations and thus, was not itself an impermissible reimbursement, the expenditure of SRF bond process is not treated as a reimbursement, but rather is analyzed as a refunding. This analysis is true whether the borrowing was done on a taxable or tax-exempt basis.

A next inquiry is whether the SRF borrower had given official notice of intent to finance. Pursuant to the Reimbursement Regulations, if a borrower adopts a notice of official intent to finance within 60 days of making the expenditure, such expenditures can be reimbursed within the allowed reimbursement period. The general rule is that reimbursement must be within 18 months after the later of the date of the original expenditure or the date the project is placed into service, but in no event more than 3 years after the date of the original expenditure.

Even though the requirements for official intent are not burdensome, they are expressly set forth in the Tax Regulations and must be followed. It is no longer acceptable to prove intent to finance from circumstantial evidence such as budget reports or past conduct such as interfund borrowing.

If there is no official intent, one additional inquiry is necessary. Certain preliminary expenditures are not required to have an official intent. These include architectural, surveying, soil testing, bond issuance expenses and similar costs incurred prior to commencement of acquisition, construction or rehabilitation, other than land acquisition, site preparation, and similar costs incident to commencement of construction. These preliminary expenditures can be reimbursed without a declaration of official intention, up to an amount not in excess of 20% of the aggregate issue price of the bonds or loan reasonably expected to finance the project. Issue price generally means the price at which the loan were made or bonds were sold by the underwriters to the first purchasers thereof. The reimbursement period restrictions do not apply

to such qualifying preliminary expenditures. Preliminary expenditures in excess of the 20% can be reimbursed pursuant to an official intent. However, the reimbursement period limitations would apply.

General Background

Generally, the federal government does not favor the early issuance of bonds because they are outstanding for a longer period, creating more tax-exempt interest, and there is more potential for arbitrage (investment income exceeding the cost of borrower). Reimbursement bonds are just the opposite of early issuance. Paying costs first and then issuing bonds later would seem to minimize the time the bonds would be outstanding. However, the IRS had two concerns. First, except within limited parameters, the Federal Tax Law does not permit borrowing for working capital. Most tax-exempt financing must be used to pay for capital items. To circumvent these restrictions, borrowers needing working capital would finance prior capital expenditures, including routine annual capital expenditures, paid from available funds without a specific view to finance them in the future. Borrowers could also use this type of financing to pay for projects which they were not allowed to finance under state law. Second, when borrowers issue bonds to reimburse prior expenditures they seek to have the bond proceeds deemed expended for tax purposes immediately upon issuance of the bonds, even when the funds will be held for a period of time prior to subsequent expenditure. This would permit the proceeds to escape arbitrage restrictions and rebate requirements and thus may allow the borrower an opportunity to earn arbitrage that would not have been permitted if the current needs were financed directly.

If a project cost is paid prior to the date of the issue of bonds and the proceeds of that issue are to be used to reimburse the issuer for the project costs, the federal tax regulations impose three general requirements (§1.150(d)(1), (2) and (3)) which must be met for the reimbursement to qualify as an "expenditure" of the bond proceeds. There must be "official intent"; the reimbursement must be made within the "reimbursement period" and the expenditure must be for a capital expenditure or certain other specified expenditures.

Official Intent. To be treated as an expenditure, the issuer needs to adopt an official intent for the original expenditure within 60 days after payment of the original expenditure. The Tax Regulations provide that it may be in any reasonable form. For purposes of governmental bonds, "issuer" means the actual issuer, or if the proceeds are loaned to another entity (a "conduit borrower"), that conduit borrower. Thus, in an SRF program, the SRF borrower, rather than the SRF issuer, may declare official intent.

The declaration of official intent must be properly authorized. It can be in the form of a resolution of the governing body of the borrower (e.g., a city council). However, this procedure tends to be burdensome and the declaration of official intent may be made by an authorized representative. A city council may adopt a resolution authorizing an officer such as a mayor, city manager, treasurer or public works director to make the declaration on behalf of the city.

The official intent must generally describe the project for which the expenditures are made or are to be made and must state the maximum amount of obligations to be issued for the project. The Tax Regulations expressly state that a description such as "highway capital improvement program" is an adequate description and also allow for a description by function fund or account such as "parties and recreation fund – recreational facility capital improvement program". Thus,

descriptions such as "sewer system capital improvement program" or "sewer fund – capital improvements programs" should be adequate descriptions.

Declarations of official intent must be reasonable to be relied upon. An inquiry should be made of an SRF borrower as to whether declarations are made as a matter of course or in amounts substantially in excess of those needed for the project, or whether there has been a pattern of failing to reimburse original expenditures covered by official intents. Each of these facts is evidence of unreasonableness.

Reimbursement Periods. Even if there is official intent, any reimbursement (other than certain preliminary official intent) must be made within the reimbursement period which is specified as "not later than 18 months after –

- the date the original expenditure is paid; or
- the date the project is placed in service or abandoned, but in no event more than 3 years after the original expenditure is paid. "

There are certain exceptions for small issuers and long construction projects.

Exceptions. The official intent and reimbursement requirements do not apply to a de minimus amount or to preliminary expenditures. A de minimus amount is defined as an amount not in excess of the lesser of $100,000 or five percent of the proceeds of an issue. Preliminary expenditures are limited to an amount not in excess of the aggregate amount of bonds that finance that project and apply to such items as architectural, engineering, surveying soil testing, bond issuance costs and similar cost incurred prior to commencement of acquisition construction or rehabilitation of a project.

The Regulations

A copy of Section 1.150-2 of the Tax Regulations relating to reimbursement bonds is attached hereto as Appendix M.

Private Activity Bonds

Facts Discovered

During the origination process of an SRF loan for a waste water treatment plant improvement resulting in increased capacity, it is discovered that the SRF borrower has signed a five year contract with a private management company to manage the treatment plant for an annual fee based upon cost savings achieved while meeting certain performance standards. The manager holds up the closing of the SRF loan until an agreement is signed between the SRF borrower and a new industrial company, which is hooking into the public treatment system. Since the SRF borrower did not have an established rate for heavy industrial users, it negotiated rates with the company and in the rate agreement also had the company guarantee a certain level of payment,

regardless of usage. The increased capacity of the plant resulting from the project was needed primarily to accommodate anticipated residential growth rather than to serve private businesses.

Problems Created

The management contract does not comply with the safe harbor requirements of the Federal Tax Law and thus may cause the SRF bonds to be private activity bonds. In addition, the special rates with, and the guaranty of, the private company may cause the bonds to be private activity bonds if the private business use of the bond financed facilities by the company is greater than 10% and the private business payments under the contract are expected to be greater than 10% of the debt service on the SRF bonds, without regard to the need to provide increased capacity for non-business residential use.

Measurement of Private Activity

In general, the private business use test is met if private business use exceeds 10% of the proceeds of the issue over the measurement period. The unrelated or disproportionate use test reduces the 10% allowance to 5%. This test requires a three step analysis. The first step is to determine whether the private use or uses are related to a governmental use. The second step is to examine the private business use to determine whether it is disproportionate to its related governmental use. Third, all unrelated private business uses and disproportionate related uses are aggregated to determine whether the 5% threshold has been exceeded.

Unrelated use is determined on a case-by-case basis emphasizing the operational relationship between the government use and the private business use. In general, a related privately used facility is required to be located within, or adjacent to, the governmentally used facility. Two other special rules provide some additional guidance. The first rule provides that a private business use is related to a governmental use if the uses of the facility are for the same purpose and the government use is not insignificant. The second rule provides that use of a facility in the same manner, for both related and unrelated private business uses, will not result in unrelated private business use if the related use is not insignificant.

Use of facilities by natural persons (not using the facilities in a trade or business), use by state or local governments and use by private business persons of the financed property on the same basis as the general public <u>are</u> <u>not</u> treated as meeting the private business use test. Use pursuant to special legal entitlements <u>is</u> treated as private business use unless the exceptions discussed below apply. In addition, use by private business users receiving "a special economic benefit" is also private business use, if the financed facility is not available for general public use. Special legal entitlements to use property can result from ownership, a lease, a management or incentive contract, a take or pay contract, an output contract, a research agreement, or any other arrangement which conveys special legal entitlements comparable to the foregoing, *e.g.*, arrangements conveying priority rights to the use or capacity of a facility.

If the financed property is not available to the general public then any "special economic benefit" should be counted as private business use. The Tax Regulations provide that special economic benefit is to be determined based on all the facts and circumstances including one or more of the following factors: (a) the functional relationship and physical proximity of the property financed

to other property used by a nongovernmental person; (b) a small number of nongovernmental persons receive the special economic benefit; and (c) a nongovernmental person depreciates the financed property.

As a general rule, the amount of private business use of property is measured according to the average percentage of private business use of the property during the measurement period. The measurement period is the period beginning on the later of the issue date of the issue or the date the property is placed in service and ends on the earlier of the last date of the reasonably expected economic life of the property or the latest maturity of the issue financing the property. The average percentage of private business use is the average of the percentages of private business use during the 1-year periods within the measurement period. The percentage of private business use for any 1-year period is the average private business use during that year calculated and expressed as the ratio of private business use during the year to the total private business use and non-private business use ("governmental use") during that year.

The amount of private business use resulting from private ownership is calculated differently. In cases of private business ownership a special rule provides that the amount of private business use is determined according to the greatest percentage of private business use in any one-year period.

Other significant special measurement rules eliminate the consideration of facility downtime in calculating the average percentage of private use, but permit, under certain circumstances, a discrete portion of a facility to be treated as a separate facility. In addition, if private business use as of the issue date is reasonably expected to have a significantly greater fair market value than governmental use, the average amount of private business use must be determined according to relative reasonably expected fair market values of use rather than by another measure, such as average time of use. Further, if private business use and actual governmental use of a facility is on the same basis and occurs simultaneously, the average amount of private business use may be determined on a reasonable basis that reflects the proportionate benefits to each user.

There are a number of exceptions for certain types of private business use that may have otherwise been counted toward satisfaction of the private business use test. These exceptions include private business use resulting from:

- certain management or service contracts involving expense reimbursement, incidental services or de minimus services;

- use of facilities by nongovernmental persons solely in their capacity as agents of a government person;

- certain incidental private business users;

- contracts not reasonably available to natural persons with rates set by general tariffs and a term not longer than 100 days;

- negotiated arm's-length contracts with terms not longer than 50 days;

- use under arrangements on the same basis as natural persons not engaged in a trade or business; and

- use of a developer during the development period under certain conditions.

Revenue Procedures 97-13, 97-14 and 2001-39 provide exceptions for management agreements, service agreements and research agreements meeting certain safe harbor guidelines.

The management contract rules are focused on the concept that private business use can occur in ways other than ownership, leases or the right to occupy all or a certain portion of the facility. For example, the contractual right to manage a facility for an extended period of time, to exercise control over the use of the facility and to be paid a portion of the revenues or net income, is the equivalent of transferring significant incidents of ownership to the manager.

The critical facts which the guidelines use in the determination of the safe harbor are (1) the type of service being provided, (2) the duration of the contract and (3) the basis of determining the managers fees.

Generally, all arrangements with private parties relating to bond financed facilities are suspect. However, several types of contracts are not treated as management contracts which may give rise to private business use. These include (1) contracts that are solely incidental to the primary governmental functions of the facility such as janitorial services, equipment repair and billing services and (2) contracts for the operation of public utilities if the only compensation to the service provider are reimbursement of actual and direct expenses and reasonable administrative overhead expenses.

The permitted terms of the management contracts range from two years to twenty years depending upon the type of compensation arrangement and the type of property being managed.

Compensation arrangements first must be reasonable and second cannot be based upon net income or a share of the profits of a facility. Compensation can be a fixed fee, adjusted for inflation; a fee based upon a percentage of revenues or expenses, but not both; or a capitation or per-unit fee.

The acceptable compensation arrangements with permissible contract durations are as follows:

- If the fee is at least 95% of a periodic fixed fee, the contract cannot exceed the lesser of 80% of the reasonably expected useful life of the facility or 15 years. A one-time incentive award is permitted. The 15-year limit is increased to 20 years for public utility property.

- If the fee is at least 80% of a periodic fixed fee, the contract cannot exceed the lesser of 80% of the reasonably expected useful life of the facility or ten years. The ten-year limit is increased to 15 years for public utility.

- If the fee is at least 50% of a periodic flat fee or 100% a capitation or combination capitation and flat fee, the term of the agreement cannot exceed 5 years.

- If the fee is 100% based upon a per unit fee or a combination per unit and flat fee, the term of the agreement cannot exceed 3 years, terminable by the governmental unit at the end of the second year without penalty.

- If the fee is based on a percentage of fees charged or a combination of per-unit fees and a percentage of revenues or expenses, the term of the contract must not exceed two years. During a start-up period, fees may be based entirely on percentages of revenues or expenses and thus provision is applicable only to contracts where the service provider primarily provides service to third parties and during the initial start-up period of the facility.

The term of the contract restrictions includes all renewal option periods.

The full texts of Revenue Procedures 97-13, 97-14 and 2001-39 are set forth in Appendix N hereto and should be reviewed because of the detailed requirements. These Revenue Procedures are safe harbors, meaning that arrangements outside of the requirements set forth therein are not absolutely bad. However, the best practice is to strictly follow the rules. No deviation is recommended without careful review of the specific arrangement by bond counsel.

Perhaps the best way to get a general understanding of the concept of private use is specific examples. Set forth in Appendix O hereto are the examples contained in Section 1.141-3(f) of the Tax Regulations. The examples of measuring private use contained in Section 1.141-3(g)(8) of the Tax Regulations are set forth in Appendix P hereto.

The private payment portion of the test generally takes into account payment of debt service derived from payments (whether or not to the issuer or a related party) in respect to property or borrowed money used or to be used for a private business use. The private security portion of the test generally takes into account payment of debt service directly or indirectly secured by an interest in property used or to be used for a private business use, or payments in respect of such property.

The security for an issue and the payment of debt service on the issue are determined both from the documents and on the basis of an underlying arrangement between the parties. An underlying arrangement can result from separate agreements between the parties or may be inferred from all the facts and circumstances in connection with the issuance of the bonds or notes, as applicable.

The private payment portion of the test generally takes into account payment of debt service derived from payments in respect to property or borrowed money used or to be used for a private business use. The private security portion of the test generally takes into account payment of debt service directly or indirectly secured by an interest in property used or to be used for a private business use, or payments in respect to such property. For purposes of the private security or payment test, payments taken into account as private payments and payments taken into account as private security are aggregated. However, the same payments are not taken into account as both private payments and private security.

Present values are determined by using the yield on the issue as the discount rate for a fixed yield issue. Variable yield issues may assume the then current interest rate to be the discount rate over

the term of the issue. A subsequent deliberate action will cause a recalculation of the variable yield.

Generally, payments made by any nongovernmental person that is treated as using proceeds of the issue, are taken into account. Payments are taken into account only for the period of time the property is being used for the private business use. Payments for use of the financed property include payments in respect of such property even if not made by a private business user (only to the extent available to be used directly or indirectly for debt service). Payments are not made in respect of financed property if those payments are directly allocable to other property being directly used by the person making the payment and those payments represent fair market compensation for that other use.

Payments from a nongovernmental person are not counted to the extent such payments exceed the present value of debt service allocable to the proceeds used by such private business user. Payments for use of proceeds do not include the portion of any payment properly allocable to the payment of direct operating expenses of the financed property used by the private business user. A special rule generally characterizes payments of debt service on a refinanced issue as private payments in the same proportion as private payments bear to total payments on the refunding issues.

There are special rules for allocating private payments when property is financed from multiple funding sources (*e.g.*, taxable, tax-exempt or equity). As a general rule, payments for the use of property are allocated to the source or different sources of funding of property based on all the facts and circumstances, including whether an allocation is consistent with the purposes of Section 141 of the Code. In general, a private payment for the use of property is allocated to a source of funding based on the nexus between the payment and both the financed property and the source of funding.

Payments for the use of a discrete facility (or discrete portion of a facility) are allocated to the source or sources of funding of that discrete property. Payments made for the use of property financed with two or more sources of funding are allocated in a manner that reasonably corresponds to the relative amounts expended on the property by each source. If an issuer has not kept records of expenditures, an issuer may use reasonable estimates of amounts expended on property. A common method of allocation for buildings is to allocate by square footage and average per square foot costs, assuming the respective portions are reasonably equivalent in square foot cost. Costs of issuance and other neutral costs are allocated ratably among expenditures for this purpose. Allocations may be made according to relative amounts of debt service if such allocation method reasonably reflects the economic substance of the arrangement.

Two other special allocations rules are in the nature of anti-abuse rules. Under the one rule, private payments under an arrangement entered into in connection with the issuance of the bond or note, as applicable, are generally allocated to that issue. Whether an arrangement is entered into in connection with the issuance of the issue is determined under the facts and circumstances. An arrangement is ordinarily entered into in connection with the issuance of the issue if (i) the issuer entered into the arrangement during the three-year period beginning 18 months before the issue date and (ii) the amount of payments reflects all or a portion of the debt service on the issue. Under the other rule an issuer may not allocate a private payments to reimburse itself for equity contributions unless, not later than 60 days after the date of expenditure of those amounts, the issuer adopts an official intent resolution comparable to that required by for reimbursement

bonds and reimburses itself not later than 18 months after the later of the date the expenditure is made or the date the project is placed in service.

As a general rule, private security consists of financed property used by a private business user as well as payments in respect of that property if any interest in that property or payments secures the payment of debt service on the bond or note, as applicable. Under this rule the applicable payments in respect of privately used property can be counted even if they are from the general public (only to the extent available to be used directly or indirectly for debt service). A special rule provides that private security is taken into account only to the extent it is provided by a user of the proceeds of the issue. Generally, proceeds of a bond issue are not taken into account prior to expenditure or loan to the private user.

Consistent with the rules concerning payments, private security is not taken into account (i) for the period of time the property is not being used for private business use or is not serving as security, and (ii) to the extent it exceeds the amount of allocable private business use. Private security is generally taken into account with respect to refunded issues in the same proportion as private security bears to total payments on the refunding issue.

Finally, a special rule provides for the allocation of private security or payments (from the disposition of such property securing the issue) among multiple issues secured by such property or payments. The rule provides that such security or payments are allocated on a reasonable basis that takes into account bondholders' rights to the payments or property on default.

For purposes of the private security or payment test, taxes of general application are not taken into account. The Tax Regulations say that a "generally applicable tax is an enforced contribution exacted pursuant to legislative authority in the exercise of the taxing power” to raise revenue for governmental purposes. The tax must have uniform rate applicable to all persons of the same class in the jurisdiction and a generally applicable manner of determination and collection. A special rule permits payments in lieu of taxes to constitute generally applicable taxes under certain circumstances.

The examples of the private security or payment test in Section 1.141-4(g) of the Tax Regulations are set forth in Appendix Q hereto.

Bonds or notes, as applicable, meet the private loan financing test if more than the lesser of 5% or $5 million of the proceeds of the issue is to be used (directly or indirectly) to make or finance loans to persons other than governmental persons. The issuer's reasonable expectations and subsequent deliberate actions are taken into account. The amount actually loaned to a nongovernmental person is not discounted to reflect the present value of loan payments.

For purposes of this test, a private loan is any transaction characterized as a loan for federal tax purposes. In addition, a loan can arise from the direct lending of bond proceeds or from transactions that convey indirect benefits that are the economic equivalent of a loan. Loans that are non purpose investments do not cause the private loan financing test to be met.

A special rule affirms that a grant is not a loan. Whether a transaction is characterized as a grant or a loan is determined based on all the facts and circumstances. Generally, a grant made from proceeds of an issue secured by generally applicable taxes attributable to improvements made with the grant, is not treated as a loan. Certain impermissible agreements entered into with the

grantee, however, could cause a grant to be treated as a loan, e.g., an agreement to be personally liable on a tax that does not generally impose personal liability.

The examples relating to the private loan financing test in Section 1.141-5(e) of the Tax Regulations are set forth in Appendix R hereto.

A summary to understanding the private activity bond considerations in the context of SRF programs, is Private Letter Ruling 200026020, dated April 3, 2000, which address a number of issues in an interesting fact situation. The full text of this letter ruling is set forth in Appendix S hereto.

Reissuance of Bonds

Facts

This situation involves a troubled loan. Two years after a 20-year SRF Loan was made, the SRF borrower is having financial difficulties and contacts the SRF issuer with several requests. First, it requests that the SRF issuer defer enforcement of the SRF loan for a period of two months after the next payment date to allow the SRF borrower additional time to accumulate revenues to make the required payment. During that period it also requests that it and the SRF issuer enter into an amendment to the SRF loan reducing the interest rate by 2% over the life of the loan and changing the principal amortization schedule to reduce principal payments over the next five years.

Problems Presented

The reduction of the interest rate would be a significant modification under Federal Tax law and result in a deemed reissuance of the loan. The temporary deferral of interest and changing the amortization schedule may not result in a reissuance of the loan, if within the parameters of the de minimus rule, but changing the final maturity date would.

General Discussion

A reissuance occurs when there is a negotiated change to the terms of a bond of such a type or magnitude that it is the equivalent of issuing a new bond. It is important to determine if a reissuance has occurred for federal tax purposes because if it has, a current refunding will be deemed to have occurred. A significant effect of a current refunding is that the "reissued" bond is governed by the law in effect at the time of the reissuance, absent a transition rule for the law change. Provisions of the Federal Tax Law have been changed or reinterpreted frequently and thus the reissuance could have a material effect on the tax-exemption of the bond. Even if the bond does not become taxable, there may be new requirements for ongoing compliance to maintain tax-exemption.

A careful reissuance analysis has a second benefit. Many modifications are also reissuances under state law and require formal action of the issuer of the debt. There is also the same risk of

change of state law. The criteria for determining a reissuance under state law may be different from those under Federal Tax Law and bond counsel should be consulted.

Reissuance considerations often arise during enforcement or workout situations where attention is most focused on the business considerations. However, when changes to the interest rate, the security or source of repayment, or the maturity or principal amortization are discussed or contemplated, there should be consideration as to whether these changes, or any others, would cause a reissuance.

In 1988, the IRS published a notice (Notice 88-130) setting forth the circumstances under which a bond will be considered reissued. This notice came after the IRS addressed the issues in several private letter rulings.

Under Notice 88-130 the general rule for determining when a bond, other than a "qualified tender bond," is treated as retired, and thus reissued, is if any of the following occur:

> *(i) there is a "change" in bond terms which results in a disposition of the bond for purposes of Section 1001 of the Code;*
> *(ii) the bond is purchased or otherwise acquired by or on behalf of the issuer or a true obligor which is a governmental unit or an agency or instrumentality thereof; or*
> *(iii) the bond is otherwise retired or redeemed.*

A "qualified tender bond" is one that has tender features which otherwise may cause an issuance on each tender and remarketing, but the policy decision was made to not trigger reissuances.

The Tax Regulations under Section 1001 of the Code are the principal source of detailed rules for determining whether there is a reissuance in the case of bonds that are not qualified tender bonds. The general rule is that a "significant modification" of a debt instrument will be treated as an exchange of the original for the modified instrument and thus will be a reissuance.

Two determinations are required. Is there a "modification?" Is the modification "significant?" Not all changes or alterations are modifications and not all modifications are significant.

A "modification" means any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or the holder, whether evidenced by express agreement (written or oral), conduct of the parties or otherwise. An alteration is not a modification if it occurs by the terms of the instrument (such as the periodic resetting of an interest rate on a variable rate instrument based upon factors outside of the control of the issuer or the holder or pursuant to predetermined agreement) except changes in the obligor or co-obligor, in the recourse nature, or as a result of an option of the issuer or the holder which is not unilateral are modifications even if they occur by the terms of a document. Failure to perform and temporary forbearance in enforcement are not alterations.

A modification is "significant" only if, under the facts and circumstances of the transaction, the legal rights modified and the degree of modification are economically significant. The Tax Regulations go on to specify the degree of change which is significant in certain circumstances. A change in the yield of an obligation by at least the lesser of (i) one-fourth of one percent or (ii) five percent of the annual yield is significant. The extension of the final maturity by at least the

lesser of 5 years or 50% of the original term is significant. The addition of a right to call the instrument, the substitution of a new issuer, a change in collateral of a non-recourse instrument are significant. A change in collateral for a recourse obligation is not significant.

Section 1.1001-3 of the Tax Regulations is set forth in full as Appendix T hereof and should be reviewed for a further description of the details of the determination of a reissuance. The examples contained in Section 1.1001-3(d) and (g) give a good overview of common fact situations.

Bank Qualified Obligations

Question Presented

During the application process for a $9 million SRF loan, the potential SRF borrower asks the loan officer whether the SRF borrower can still designate the $2 million of tax-exempt bonds it intends to issue that calendar year as "bank qualified" since its SRF loan is not structured as tax-exempt. While this situation is a collateral issue and not necessarily a part of a compliance program, it is presented to explain the concept of *"bank qualification"* for background since the question occasionally arises and the answer may be different if the SRF issuer requires tax-exempt loans, rather than taxable loans.

SRF issuer Response

This issue should be addressed by the SRF borrower's bond counsel and is not the responsibility of the SRF issuer. The answer may be uncertain. If the SRF loan was structured as tax-exempt, the SRF borrower would not qualify as a small issuer and therefore could not designate its loan or the bonds as bank qualified. Taxable debt does not count against the SRF borrowers bank qualification limit. However, the SRF issuer may not want to take a position on taxable loans because there is an argument that a taxable SRF loan could count, since it is funded from the proceeds of a tax-exempt bond issue. One option to avoid any question as to bank qualification for other bonds of the SRF borrower in the year of the SRF loan is to fund the loan from capitalization grant proceeds or any other funds which are not proceeds of tax-exempt SRF bonds.

What is a bank qualified obligation?

Under Section 265(a)(2) no deduction is allowed for interest expense on indebtedness incurred or continued, to purchase or carry tax-exempt bonds. The reasoning behind this rule is that one should not be able to obtain both the tax benefits of tax-exempt interest and a tax deduction for interest expense.

For financial institutions, such as banks, Section 265 mandates that there is a pro rata allocation of interest expense to the institution’s tax-exempt interest. Banks are financial institutions and generally have significant interest expense paid to deposits and thus significant deductions. The disallowance of these deductions in proportion to its tax-exempt interest income is a significant

deterrence to the investment by such banks in tax-exempt obligations. Banks were likely purchasers of tax-exempt bonds, especially those local banks located in smaller communities. Thus, banks were important sources of capital for small political subdivisions.

Section 265(3) provides an exception to this non-deductibility rule for "qualified tax-exempt obligations" of "qualified small issuers". Many small issuers are particularly interested in using this exception because qualified bonds generally carry interest rates slightly less than non-qualified bonds for the same issues and thus result in real savings in the cost of borrowing. Small SRF borrowers are therefore often interested in whether their SRF loan affects their ability to issue bank qualified bonds for other purposes.

The Rules

A "qualified tax-exempt obligation" means a tax-exempt obligation

- which is issued after August 7, 1986, by a qualified small issuer,
- which is not a private activity bond as defined in Federal Tax Law, and
- which is designated by the issuer as a qualified bond.

For the purposes of Section 265, qualified 501(c)(3) bonds (conduit bonds issued to finance facilities for charitable corporations such as hospital bonds for a private non-profit hospital) are not considered private activity bonds, together with certain limited refunding obligations.

A "qualified small issuer" means, with respect to obligations issued during any calendar year, any issuer if the reasonably anticipated amount of tax-exempt obligations (other than private activity bonds, certain transitioned bonds and certain refunding bonds) does not exceed $10,000,000.

What questions might an SRF Borrower raise?

The small SRF borrower may inquire as to whether the principal amount of the SRF loan will count against its $10,000,000 limit for the calendar year in which the SRF loan is made. If the SRF loan is structured as a tax-exempt obligation it is quite clear that it would. If the SRF loan is structured as a taxable issue, many SRF borrowers assume that it will not. However, Section 265(b)(3)(c)(iii) indicates that in the case of an issue under which more than one governmental entity receives benefits, the governmental entities may allocate the amount of that issue among themselves on a reasonable basis to determine the amount of the issue which counts against the limit for the purposes of Section 265. Thus, there is a possibility that this SRF loan funded from tax-exempt bond proceeds may count against an SRF borrowers $10,000,000 limit whether or not it is structured as a taxable or tax-exempt obligation.

If the SRF loan is made in one year and the SRF bonds were issued in the preceding year, in which of these two years is the principal amount of the SRF counted for purposes of Section 265? If the SRF loan is structured as a draw down loan where for other federal tax purposes each draw constitute a new issue, how much in which calendar years applies to the limit? There

are arguments for various results. From the perspective of the SRF issuer, these are not its concerns, but rather concerns for the SRF borrower. These questions should be referred to the SRF borrower's bond counsel.

Final questions that arise are whether the SRF borrower must designate the SRF loan as a bank qualified bond and whether the SRF bonds can pass the bond qualified benefit through to the holders of those bonds. The question of requiring designation is a policy question for the SRF issuer, but generally requiring designation does not detrimentally affect the SRF borrower where the SRF loan counts against the $10,000,000 limit. In most SRF bond issues, the bank qualification cannot be passed through to the bondholders.