

Post-issuance compliance with the Internal Revenue Code Local government bonds

By **Kevin P. McManimon**

One of the more attractive features of investment in obligations issued by governmental bodies, such as state or municipal bonds, is that interest earned on such investments is excluded from an investor's calculation of gross income for federal income tax purposes. 26 U.S.C. § 103(a).

Typically, governmental bodies issue debt in order to finance projects that serve the general public, such as the repair of roads and other infrastructure, and the construction of public parks and buildings. Governmental bodies may also issue tax-exempt debt for other purposes, including loaning proceeds to 501(c)(3) organizations, who may use the funds to undertake projects deemed beneficial to the general public. The purpose of the exclusion of interest earned on investment in such debt is to encourage investment in governmental obligations and, thus, increase the borrowing power of governmental bodies. See, e.g., *Drew v. U.S.*, 551 F.2d 85 (5th Cir. 1977).

Limiting uses of debt

Because the exemption from taxation of interest income deprives the federal government of significant tax revenues, numerous sections of the Internal Revenue Code and regulations promulgated by the Department of Treasury, Internal Revenue Service

(IRS) (collectively, the "Code"), limit the uses for which proceeds of such debt may be used. Moreover, other sections of the Code require governmental bodies issuing tax-exempt debt to spend the proceeds of such debt within certain time frames and limit the ways in which such proceeds may be invested prior to expenditure. For example, subject to certain exceptions, the Code prohibits a governmental body from depositing the proceeds of tax-exempt bonds in investments that yield a higher return than that borne by the tax-exempt bonds. Subject to a separate set of exceptions, the Code also requires a governmental body pay, or rebate, to the federal government any arbitrage it earns. Generally, arbitrage is the excess of the amount that a governmental body earns from investing the proceeds of its tax-exempt bonds over the amount which the governmental unit would have earned if the proceeds had been invested at the bond yield. These restrictions are designed to prevent local governmental bodies from issuing debt on a tax-exempt basis and using the proceeds to generate interest income.

As with many provisions of the federal tax laws, however, there are exceptions to the restrictions described above and to the requirement the local government rebate arbitrage to the federal government.

For example, a governmental body may deposit proceeds of tax-exempt bonds in an investment earning a higher return than the return on its bonds if it expects to spend such proceeds on capital projects within three years. Moreover, if the governmental body actually earns arbitrage on such an investment, it must pay, or rebate, such earnings to the federal government unless it spends such proceeds for the governmental purpose of the bonds in accordance with various spend down schedules prescribed by the Code. The governmental body must pay 90 percent of its unpaid rebate liability every five years and pay the entire amount within 60 days of the payment of the bond issue.

There are also requirements as to the use of the proceeds of the bonds. The most significant restriction is that such proceeds not be used in such a way that the bonds would be "private activity bonds." In addition to assuring the anticipated use of the proceeds complies with these private activity bond rules, certain remedial steps must be taken if there is a change in the use of the bond-financed facilities after the bonds have been issued. This could occur, for example, if the bond-financed facilities are sold to a private business user.

Stepped-up audits

The federal government has an obvious interest in ensuring local governmental bodies issuing tax-exempt debt comply with the many requirements and limitations contained in the Code. To enforce such compliance, the IRS has, in recent years, stepped up its program of examinations, or audits, of outstanding bond issues. The IRS may randomly select certain tax-exempt bond issues for audit, or it may select such bond issue for audit because of some specific concern.

If the IRS conducts an audit of a tax-exempt bond issue and finds the governmental issuer failed to comply with applicable requirements of the Code, it may ultimately determine that the financing is taxable, meaning the interest earned on the purchasers' investment must be included in their calculation of gross income, both retroactively — to the date of issuance of the debt — and prospectively. Alternatively, the governmental body may agree to pay a monetary penalty to the IRS, which will usually result in the continued exclusion of interest from investors' income calculations. In either event, the IRS may also require that the governmental body redeem the remaining outstanding bonds on the next possible date. Clearly, the ramifications of a governmental body's failure to comply with applicable laws and IRS regulations governing tax-exempt bonds can be severe.

The IRS recently announced it will send out questionnaires to between 200 and 500 state and local governmental bond issuers around the country this summer in an effort to gather information and evaluate efforts such issuers undertake to ensure compliance with tax laws and regulations. While it is unclear whether the questionnaires will request actual production of any documents, they will certainly require the issuer to: confirm whether it has written procedures in place to ensure compliance with applicable tax laws and regulations; confirm whether it retains records relating, for example, to the investment and expenditure of bond proceeds; confirm the manner in which, and the length of time for which, it retains certain records; and state whether it directs specific personnel to retain relevant records and monitor post-issuance compliance with the applicable tax laws and regulations.

Non-profit compliance

The IRS recently undertook a similar program to evaluate compliance procedures employed by 501(c)(3) organizations that borrowed funds from governmental issuers, where such issuers acted as conduit issuers of tax-exempt bonds to provide such funds. Similarly, the questionnaires purport to be part of the IRS's effort to gather information and make preliminary determinations regarding governmental debt issuers' compliance with the Code. It appears as though the IRS is seeking information as to the extent to which issuers of tax-exempt debt endeavor to comply, and self-monitor such efforts to comply, with the many regulations that govern such financings. Accordingly, an issuer who receives and responds to a questionnaire will not necessarily be subjected to a more thorough examination, such as an audit. This information gathering process should, however, serve as a notice to all governmental issuers of tax-exempt debt and, in particular, to those that do not have, or have but do not follow, written procedures to help ensure compliance with laws and regulations applicable to tax-exempt financings.

The certificate

Attorneys advising a governmental body issuing tax-exempt debt (Bond Counsel) usually prepare a certificate to be executed by appropriate local officials, setting forth the steps that the governmental body must have taken, and outlining steps it must take in the future in order to ensure compliance with applicable laws and regulations and preserve the tax-exempt status of the debt. As noted above, such regulations govern how and when an issuer must ultimately spend the proceeds of tax-exempt debt issues, how the issuer may invest the proceeds prior to spending them, what types projects may be financed with tax exempt bond proceeds, arrangements the issuers may and may not enter into with respect to bond financed property, and actions to be taken if there is a change in the use of bond financed property. The certificate serves the following three purposes: (1) it sets forth certain facts and expectations of the issuer with respect to the bond issue as required by the applicable

tax regulations; (2) it is the foundation for Bond Counsel's legal opinion, issued in connection with the tax-exempt financing, that interest on the debt is and will be excludable from investors' calculation of gross income for federal income tax purposes; and (3) it serves as a roadmap for the governmental body, outlining, among other things, actions the governmental body must take, how and when it may spend the financing proceeds, how it may invest the financing proceeds, how it must treat earnings on such investments, the use of bond proceeds and bond financed property, and the nature and extent of the records the governmental body must retain in connection with the expenditure and investment of the financing proceeds.

Conclusion

It is more important than ever for governmental bodies to review the manner in which they maintain records detailing the expenditure and investment of the proceeds of their tax-exempt debt issues. Governmental bodies that have not yet done so should consult with their Bond Counsel to establish and implement a formal post-issuance compliance program to ensure the issuer has in place the procedures to comply with the tax law requirements applicable to their bond issues.

Kevin P. McManimon is an associate in the law firm of McManimon & Scotland in Newark. He practices municipal finance and securities law, acting as bond counsel, representing various municipalities and New Jersey county and municipal authorities in general obligation and revenue bond financings. Reach him at (973) 622-4869; kmcmanimon@mandslaw.com.