

POST-ISSUANCE COMPLIANCE FOR GOVERNMENTAL ISSUERS AND 501(C)(3) BORROWERS

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In recent years, the Internal Revenue Service (IRS) has announced that post-issuance tax compliance will be among its highest priorities. This is evidenced by the recently imposed annual reporting requirement on nonprofit corporations (in the form of Schedule K, to be filed with IRS Form 990) regarding the application and use of tax-exempt bonds issued for their benefit. Also, in 2007 the IRS distributed several hundred questionnaires to nonprofit corporations regarding their post-issuance tax compliance with various requirements for maintaining federal tax exemption of interest on their bonds, and in January 2009, the IRS distributed several hundred questionnaires to state and local governments regarding post-issuance compliance. A December 29, 2009 article titled “Beefed-UP IRS is Ready to Roll,” published in *The Bond Buyer*, reported that only 87% of the governments surveyed responded to the IRS questionnaire, compared to 98% of the nonprofit corporations. Steve Chamberlin, senior manager of the IRS tax-exempt bond office compliance and management program, was quoted in the article as follows: “That’s pretty significant, and is potentially indicative...as to how [governments] view post-issuance compliance.” The article also stated that “initial indications show that a ‘significantly lower’ percentage of governments than charities have written procedures to ensure post-issuance compliance, Chamberlin said.” Such post-issuance compliance matters include internal compliance procedures and record keeping functions.

Governmental issuers of tax-exempt bonds often spend weeks, or even months, working toward the successful closing of a tax-exempt bond financing. The finance process includes, among other things, detailed analysis by bond counsel to ensure that the bonds will be in compliance with federal tax law requirements. When such bonds are issued to finance a loan to another entity as part of a conduit financing, like a 501(c)(3) borrower, the analysis extends to the 501(c)(3) borrower. Certain closing documents executed by governmental issuers at the time of issuance of tax-exempt bonds include covenants by such issuers, and their 501(c)(3) borrowers, that tax

law requirements will be complied with throughout the life of the bonds. And, the opinion of bond counsel rendered in connection with a tax-exempt bond issuance (opining that interest on the bonds is excluded from the gross income of bond holders) is based upon, and qualified by, the reasonable expectation of the issuer that tax law requirements will be complied with throughout the time the bonds remain outstanding. In addition, governmental issuers, and their 501(c)(3) borrowers, may be required to comply with certain disclosure requirements, or other reporting requirements as set forth in the bond finance documents, throughout the life of the bonds.

Because most tax-exempt bonds may remain outstanding for many years, and governmental issuers and any 501(c)(3) borrowers must comply with federal tax laws, securities laws and other document requirements during the life of the bonds, it is important for any governmental issuer and 501(c)(3) borrower to have procedures in place to ensure continued compliance, even as responsible officials change. An effective compliance program should help the issuer or the borrower identify matters – whether tax or otherwise – which may require further analysis.

Post-issuance compliance programs may vary, depending on such factors as the size of the governmental issuer or 501(c)(3) borrower, the number of bond issues to be monitored, the complexity of any financing and the type of bond financing. Resources are available to assist governmental issuers and 501(c)(3) borrowers in the development of a post-issuance compliance program. For instance the National Association of Bond Lawyers and the Government Finance Officers Association have jointly developed a checklist to assist in identifying post-issuance compliance matters. (The checklist is available at www.gfoa.org/downloads/PostIssuanceCompliance.pdf.) Issuers and borrowers may also seek guidance in preparing a post-issuance compliance program from bond counsel or their accounting firm.

The following constitutes a summary of topics to

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address in any post-issuance compliance program. This is not meant to serve as a complete list but rather should constitute a general guide, which may be refined for each particular governmental issuer or 501(c)(3) borrower.

1. Designate a post-issuance compliance coordinator.

First and foremost, each governmental issuer or 501(c)(3) borrower should designate a person or department to undertake responsibility for the post-issuance compliance program. The coordinator may be able to undertake all post-issuance compliance monitoring or may designate one or more persons to undertake various components of the monitoring activity, as may be determined by the size of the governmental issuer or the 501(c)(3) borrower and the complexity of the financings being monitored. The coordinator should, among its various responsibilities, determine the frequency of review of post-issuance compliance matters.

2. Address Post-Issuance Tax Compliance. Any post-issuance compliance program must discuss, among other things, appropriate record retention and include a plan for keeping relevant books and records as to the investment and expenditure of bond proceeds. Further, the post-issuance compliance program must address arbitrage and the private use of bond proceeds

Issuers of tax-exempt debt must comply with two separate requirements, though related, pertaining to the investment of the bond proceeds. First, proceeds from tax-exempt borrowings are not permitted to earn a yield materially higher than the yield on the bond issue. Pay careful attention to the investment and spending of the bond proceeds in order to ensure compliance with these Yield Restriction Requirements. The IRS has provided certain “temporary periods” during which time an issuer does not need to monitor the yield on investments quite as closely. However, any excess earnings generated from the investment of bond proceeds are typically due to be rebated to the IRS as a 100% tax.

Second, at a minimum of every five years that a tax-exempt debt issue is outstanding, an issuer is required to prepare an arbitrage rebate calculation. This calculation determines whether earnings were generated from the investment of bond proceeds in excess of the

yield currently being paid to the bondholders. These earnings, called arbitrage, must be rebated to the IRS. This calculation must be prepared every five years that the bonds are outstanding and are due 60 days after the end of the five year anniversary date. The IRS provides several exceptions to and exemptions from the rebate requirements. It is important at post issuance to monitor adherence to any elections made at the time of issuance. Failure to comply to these complex requirements can result in the loss of the tax-exempt status of the financing, which not only impacts the reputation and bond rating of the issuer but also results in the taxability of the interest earned by the bondholder.

3. Address reporting requirements, if applicable. For 501(c)(3) borrowers, particular focus should be made as to the new reporting requirements under Schedule K to revised Form 990 in developing a post-issuance tax compliance plan. The new Schedule K requires significantly more information regarding bond financings. Generally, Schedule K asks for information on the use of bond proceeds, arbitrage and private business use for post-2002 bond issues, including private business use calculations.

4. Address post-issuance disclosure requirements. Each governmental issuer and 501(c)(3) borrower should determine the applicability of continuing disclosure requirements for purposes of SEC Rule 15c2-12. A post-issuance compliance program should describe the nature and frequency of any continuing disclosure requirements, including the immediate reporting of the occurrence of any of the specific required reporting events listed in the continuing disclosure certificate or the discretionary reporting of other material events. Rule 15c2-12 compliance is particularly important as the need for transparency and disclosure in the secondary market for tax-exempt bonds has recently been the subject of renewed focus by the SEC. The SEC has recently proposed changes to the Rule that would, among other things, add to the list of required disclosure events and impose new time limits for disclosure of required items.

5. Address other bond document requirements.

The bond documents may contain other reporting requirements or may otherwise set forth certain

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responsibilities to be undertaken by the governmental issuer or the 501(c)(3) borrower. These reporting requirements may include providing audited financial statements or periodic certifications of insurance. Certain information may need to be filed at specific times with entities, such as paying agents/trustees, bond insurers and credit enhancers. Further, the governmental issuer or 501(c)(3) borrower may be required to comply with rate covenants or other financial tests. A post-issuance compliance program should work to ensure the undertaking of all such reporting requirements or responsibilities.

Issuers and borrowers that have effective post-issuance compliance programs in place will more likely be able to respond to an IRS inquiry on a successful and cost-effective basis. On the other hand, failure to undertake a post-issuance compliance program may place the governmental issuer and 501(c)(3) borrower at risk of violating tax rules, which could result in the loss of the tax-exempt status of the bonds, impose liability to the IRS or bond holders and cause reputational damage. Violation of securities laws or existing document requirements could also expose any governmental issuer or 501(c)(3) borrower to unnecessary liability or potential bond document defaults. ■



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McNeese Wallace & Nurick LLC regularly represents governmental issuers and 501(c)(3) borrowers in the issuance of general obligation bonds and revenue bonds for financing the development, construction and operation of a variety of capital projects and debt refinancings. Reinsel Kuntz Leshner LLP provides arbitrage rebate computation services as well as bond verification services in conjunction with the advanced refunding of debt issues for issuers of tax-exempt debt. Together the professionals of McNeese Wallace & Nurick LLC and Reinsel Kuntz Leshner LLP, are available to counsel governmental issuers and 501(c)(3) borrowers in crafting and implementing post-issuance compliance programs.

