

Post-Issuance Tax Compliance and Continuing Disclosure Responsibilities



for Issuers and Borrowers of Tax-Exempt Bonds

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CHAPTER ONE

Introduction: Why Post-Issuance Compliance?

Over the past few years, the tax-exempt bond market has been under heightened scrutiny by various regulators, including the Internal Revenue Service (“IRS”), the United States Securities and Exchange Commission and the Municipal Securities Rulemaking Board. These regulators have called for increased regulation as well as transparency, with a large part of their focus on post-issuance compliance.

The purpose of this booklet is to introduce interested parties to the topic of post-issuance compliance. It is intended to assist:

- treasurers, finance directors, comptrollers and other responsible officials of state and local government issuers of tax-exempt bonds (“Issuers”) and
- private, non-governmental conduit borrowers (such as nonprofit institutions providing health care and higher education and for-profit developers of exempt facilities) which are allowed to borrow at tax-exempt rates from Issuers (“Borrowers”),

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

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

Due to its complex nature, post-issuance tax compliance takes up the majority of this booklet—Chapters 2 through 7. Chapter 8 addresses compliance with continuing disclosure obligations. Lastly, Chapter 9 focuses on compliance with the underlying bond documentation in a financing. For further information about any of the topics discussed, please contact one of the people listed at the end of the booklet. We hope that you find this booklet to be useful and informative.

CHAPTER TWO

What is Post-Issuance Tax Compliance?

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

Primary Post-Issuance Tax Compliance Responsibilities

Post-issuance tax compliance begins with the debt issuance and entails a range of responsibilities to comply with the federal tax rules over the life of the bonds. Post-issuance tax compliance requirements generally fall into two broad categories: (1) qualified use of bond proceeds and bond-financed property, and (2) arbitrage rebate and yield restriction. The qualified use requirements include monitoring the uses of bond-financed property over the life of the bonds in order to comply with applicable use rules. The arbitrage requirements include monitoring certain investments over the life of the bonds to determine the yield on investments acquired with bond proceeds and whether a rebate payment is required to be made to the U.S. Treasury.

Post-Issuance Tax Compliance – Conduit Bonds

Bonds that are issued for the purpose of making loans are commonly referred to as “conduit bonds” and Issuers that issue these bonds are generally referred to as “conduit issuers.” Generally, in order for the obligations to be tax-exempt, bonds issued by conduit issuers must be either governmental bonds or qualified private activity bonds, such as qualified 501(c)(3) bonds. Under applicable tax rules, the Issuer is legally responsible for the tax-exempt status of the bonds. However, in conduit financings, the bond documents usually provide for the delegation of certain responsibilities to the Borrower. For example, under the bond documents, the Borrower will also be obligated to maintain the tax-exempt status of the bonds. In reality, post-issuance tax responsibilities are generally shared between the Issuer and the Borrower.

Post-Issuance Tax Compliance – Risk Management

Although perhaps not obvious, post-issuance tax compliance should be near the forefront of an organization’s risk management considerations for a variety of reasons. One, defending the tax-exempt status of bonds in an IRS audit is stressful, time consuming and expensive. Two, having a significant tax compliance problem raises the prospects of market disclosure and adverse publicity. Three, most IRS audits are settled by either the Issuer or Borrower agreeing to make a payment to the IRS to protect the interests of existing bond holders. Depending on the severity of the compliance problem, the settlement amount can be significant.

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

CHAPTER THREE

IRS Enforcement and Tax-Exempt Bonds

Tax-exempt bonds finance the majority of infrastructure in the United States. Thomson Financial reports that in 2011, the amount of outstanding tax-exempt bonds was nearly three trillion dollars. The benefit of borrowing through the tax-exempt market is significant. Issuers (as well as certain eligible Borrowers), may borrow at a lower interest rate than they otherwise would realize on the taxable market because the interest on tax-exempt bonds is not subject to federal income tax.

The benefit derived from the ability to borrow on a tax-exempt basis comes with a price. The Congressional Research Service estimates that up to \$309 billion in federal taxes will be forgone for fiscal years 2012 through 2016 due to the federal income tax exclusion on municipal bonds. Accordingly, the Treasury Department and the IRS have a strong incentive to limit the volume of tax-exempt debt on the market and to monitor that all applicable federal tax rules are followed over the life of the obligations.

Created in 1999 as part of the IRS's reorganization efforts, the Tax-Exempt Bond office of the Tax-Exempt and Government Entities Division of the IRS is responsible for, among other things, ensuring that tax-exempt bonds are in compliance with the Internal Revenue Code of 1986 (the "Code"). Through bond audits, tax compliance check questionnaires and IRS information returns, the IRS continually gauges levels of compliance among various sectors and targets areas of concern. The consequence of noncompliance with federal tax law requirements could result in the loss of the tax-exempt status of the bonds.

IRS Audits of Tax-Exempt Bonds

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

On average, there are approximately 400 tax-exempt bond audits initiated by the IRS each year. According to recent statistics, IRS monetary sanctions imposed on Issuers and Borrowers for noncompliance was approximately \$85 million for fiscal years 2005 through 2010. The typical term of the average tax-exempt bond issue often exceeds 20 years. Given this long compliance period, the IRS has focused its resources on post-issuance tax compliance given the high probability for foot faults and mistakes.

Tax Compliance Check Questionnaires

A tax compliance check questionnaire is a review conducted by the IRS that is neither an audit nor an investigation. To date, compliance check questionnaires have been sent to a range of Issuers and Borrowers. The IRS uses compliance check questionnaires to monitor compliance with federal tax law requirements by gathering information from different segments of the municipal market. Compliance check questionnaires generally ask simple, yes/no questions. Although a recipient is technically not required to respond to a compliance check questionnaire, the IRS does warn that failure to do so may result in an audit. In addition, compliance check questionnaires that raise questions about compliance may be referred for audit. Accordingly, Issuers and Borrowers may want to contact outside tax professionals to advise them on how best to respond to a compliance check questionnaire.

A list of recent IRS tax compliance check questionnaires is set forth below:

- IRS Form 13907 was sent to over 200 section 501(c)(3) organizations that have borrowed on a conduit loan basis;
- IRS Form 14002 was sent to over 200 governmental bond issuers that have issued tax-exempt bonds;
- IRS Form 14127 was sent to over 50 governmental bond issuers that issued direct-pay Build America Bonds;
- IRS Form 14246 was sent to over 270 governmental issuers and section 501(c)(3) organizations benefitting from advance refunding bonds; and
- An online questionnaire was sent to over 100 governmental issuers of qualified school construction bonds.

Additional Information Gathering – IRS Form 8038

When a tax-exempt bond is issued, the Issuer is required to file an information return with the IRS. In the case of governmental bonds, the Issuer is required to file Form 8038-G and, in the case of a qualified private activity bond, the Issuer is required to file Form 8038. Similar to tax compliance check questionnaires, information reporting forms have been revised in recent years to focus on the level and scope of the Issuer's post-issuance compliance program.

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

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

Given that these forms are frequently revised, it is expected that the range of questions addressing post-issuance tax compliance matters will grow and become more detailed. Moreover, 8038 Forms are closely reviewed by IRS staff and serve as a tool in the IRS audit program.

CHAPTER FOUR

Federal Tax Rules Applicable to Tax-Exempt Bonds

The federal tax rules applicable to tax-exempt bonds are technical and complex. Tax-exempt bonds are generally divided into two broad categories – governmental bonds and qualified private activity bonds. Qualified private activity bonds can be further divided into three sub-categories: (i) qualified section 501(c)(3) bonds (bonds issued for the benefit of section 501(c)(3) organizations), (ii) exempt facility bonds (bonds issued for specific purposes for the benefit of for-profit entities), and (iii) bonds to finance loans to certain eligible borrowers, such as single-family mortgage bonds and student loan bonds.

Governmental Bonds

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

Generally, the federal tax rules for governmental bonds are intended to limit “private business use.” Private business use generally occurs when a nongovernmental entity (such as a private trade or business), has a special legal entitlement to use bond-financed property (“Private Business Use”). Examples of a special legal entitlement include leases, licenses, certain management and sponsored research contracts and similar use agreements. Aside from limits on making loans to nongovernmental entities, a bond will be a governmental bond if either: (a) ten percent or less of the proceeds of the bond issue are used directly or indirectly in a Private Business Use (the “Private Business Use Test”), or (b) the amount of revenues derived (directly or indirectly) from a Private Business Use and payments or property used in a Private Business Use that secures the bond issue is ten percent or less of the present value of debt service on the bond issue (the “Private Payment/Security Test”).

Importantly, the use of bond-financed property pursuant to management or sponsored research contracts with nongovernmental entities will not violate the Private Business Use Test if the agreement meets the IRS safe harbor rules set forth in Revenue Procedure 97-13 and Revenue Procedure 2007-47, respectively, set forth in the Appendix hereto (collectively, the “IRS Safe Harbor Contract Rules”).

501(c)(3) Bonds

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

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

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

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

Other Private Activity Bonds

Qualified private activity bonds (other than qualified 501(c)(3) bonds) are tax-exempt bonds issued by state and local governments, the proceeds of which are used for defined purposes by other than the governmental entity issuing the bonds. For such private activity bonds, at least 95% or more of the net proceeds must be used for one or more qualified purposes which include: (i) facilities such as airports, solid waste disposal facilities, and multi-family housing facilities; (ii) qualified single-family mortgages; (iii) qualified small issue bonds; (iv) student loans; and (v) qualified enterprise and empowerment zone facilities among other purposes.

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

RESTRICTIONS	GOVERNMENTAL BONDS	QUALIFIED 501(C)3 BONDS	OTHER PRIVATE ACTIVITY BONDS
Private Business Use Test	Generally, no more than 10% of the proceeds of the bonds may be used for a Private Business Use	Generally, no more than 5% of the net proceeds of the bonds may be used for a Private Business Use	Not Applicable
Private Payment/ Security Test	Generally, no more than 10% of the present value of debt service on the bonds may be privately paid or secured	Generally, no more than 5% of the present value of debt service on the bonds may be privately paid or secured	Not Applicable
Private Loan Test	No more than the lesser of 5% of bond proceeds or \$5 million may be loaned to nongovernmental entities	Not Applicable	Not Applicable
Ownership	Not Applicable	All property must be owned by 501(c)(3) organization or governmental entity	For certain facilities, governmental ownership is required
Management Contracts/Sponsored Research Contracts	Permitted only if IRS Safe Harbor Contract Rules are satisfied	Permitted only if IRS Safe Harbor Contract Rules are satisfied	Not Applicable

Arbitrage Rebate	Generally, earnings on the investment of bond proceeds above the cost of funds need to be rebated to U.S. Treasury every 5 years	Generally, earnings on the investment of bond proceeds above the cost of funds need to be rebated to U.S. Treasury every 5 years	Generally, earnings on the investment of bond proceeds above the cost of funds need to be rebated to U.S. Treasury every 5 years
Yield Restriction	Certain funds, such as pledge funds and project proceeds more than 3 years old are subject to yield restriction	Certain funds, such as pledge funds and project proceeds more than 3 years old are subject to yield restriction	Certain funds, such as pledge funds and project proceeds more than 3 years old are subject to yield restriction
Final Allocation of Bond Proceeds	Generally, allocation is required no later than 18 months after the later of the date of expenditure or the placed in service date of the project	Generally, allocation is required no later than 18 months after the later of the date of expenditure or the placed in service date of the project	Generally, allocation is required no later than 18 months after the later of the date of expenditure or the placed in service date of the project
Costs of Issuance	Not Applicable	No more than 2% of the proceeds of the bonds may be used to finance costs of issuance	No more than 2% of the proceeds of the bonds may be used to finance costs of issuance
Limits on Acquisition of Existing Property	Not Applicable	Not Applicable	No portion of the bond proceeds may be spent on the acquisition of existing property absent rehabilitation

CHAPTER FIVE

The Essentials of a Post-Issuance Tax Compliance Program

Every Issuer and Borrower needs a post-issuance tax compliance program. The consequence of noncompliance with federal tax law requirements could result in the loss of the tax-exempt status of the bonds.

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

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

Elements of a Post-Issuance Tax Compliance Program

The elements of a post-issuance tax compliance program are as follows:

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

Designation of Tax Compliance Point Person

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

Ongoing Communication with a Tax Specialist and Continuing Education

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

In addition, Issuers and Borrowers should actively seek out education opportunities (appropriate to their circumstance), to keep abreast of changes and developments in federal tax law. Note, whether an organization provides training or educational resources to personnel that are responsible for post-issuance tax

compliance has been a question in IRS tax compliance check questionnaires.

Tracking and Allocating Bond Proceeds

The process of allocating bond proceeds and developing an accurate summary of bond-financed property on an issue-by-issue basis is an essential element of a tax compliance program. Such process should include the following:

- Identify at issuance the funds and accounts into which bond proceeds are to be deposited;
- Document the reimbursement of any pre-issuance expenditures;
- Monitor the expenditure of bond proceeds to ensure that bond proceeds are spent within applicable time frames; and
- Upon project completion, make a final allocation of bond proceeds and other funds to bond-financed property. Such other funds could include fund-raising dollars, gifts and proceeds of a taxable issue. Such allocation should clearly reflect what portions of the project are treated as bond-financed property and, conversely, what portions are not bond-financed.

Monitoring the Use of Bond-Financed Property

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

- On no less than an annual basis, identify and review any bond-financed property subject to a lease, license, management contract, sponsored research contract or similar use agreement, in order to analyze and measure any Private Business Use or unrelated trade or business use impact;
- Establish protocol for external tax review by outside tax professionals of management and sponsored research contracts involving bond-financed property on no less than an annual basis for compliance with IRS Safe Harbor Contract Rules;
- Where appropriate, develop uniform management and sponsored research contracts for use in bond-financed property, which satisfy the IRS Safe Harbor Contract Rules; and
- In the case of section 501(c)(3) organizations, establish a protocol for the calculation of Private Business Use and unrelated trade or business use as required by Part III of Schedule K, as more fully discussed in Chapter 6.

With increasing frequency, this calculation is undertaken with the assistance of an outside service provider.

Monitoring Investment Income and Arbitrage Compliance

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

- Monitor compliance with “temporary period” expectations for expenditure of project bond proceeds (typically three years for new money bonds), and provide for yield restriction of bond proceeds as necessary;
- Monitor compliance with the 24-month, 18-month and 6-month rebate exceptions;
- Establish procedures to ensure investments acquired with bond proceeds are purchased at fair market value;
- Consult with outside tax counsel before engaging in post-issuance credit enhancement transactions (e.g., bond insurance, letter of credit) or hedging transactions (e.g., interest rate swap, cap);
- Identify situations and establish procedures in which compliance with applicable yield restrictions depends upon later investments, e.g., purchase of 0% SLGS from U.S. Treasury, and monitor implementation;
- Arrange for timely computation of rebate liability and, if rebate is payable, for timely filing of Form 8038-T and payment of rebate. Rebate is ordinarily due at 5-year intervals; and
- Arrange for timely computation and payment of “yield reduction payments,” if applicable.

Recordkeeping and Retention

The following documents should be retained for the life of the bonds and any refunding bonds (plus 3 years).

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

and sponsored research agreements;

- Documentation evidencing all sources of payment or security of the bonds;
- Documentation pertaining to any investment of bond proceeds, including the purchase and sale of securities, SLG subscriptions, yield calculations for each class of investments, investment income received from the investment of proceeds, guaranteed investment contracts and rebate calculations and reports;
- Documentation regarding the allocation of bond proceeds to expenditures (e.g., allocation of bond proceeds to expenditures for the construction, renovation, or purchase of facilities);
- Documentation regarding allocations of bond proceeds to bond issuance costs;
- Copies of requisitions, draw schedules, draw requests, invoices, bills and cancelled checks related to bond proceeds spent during the construction period;
- Copies of all contracts entered into for the construction, renovation or purchase of bond-financed facilities;
- Records of expenditure reimbursements incurred prior to issuing bonds for facilities financed with bond proceeds;
- Asset list or schedule of all bond-financed facilities or equipment; and
- Records regarding the purchases and sales of bond-financed assets.

Addressing Change in Use of Bond-Financed Property Through Self-Help Remediation and the IRS VCAP Program

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

- If an Issuer or Borrower engages in an activity causing bond-financed property to be used in a manner that violates the applicable use limitations, an Issuer may take one or more “self-help” remedial actions. Possible remedial actions include defeasing the non-qualified portion of the outstanding bonds or using the amounts realized from the sale of the bond-financed property for another qualifying use; and
- Issuers and Borrowers that fail to timely identify noncompliance early enough to qualify for self-help remedial actions or for matters in which self-help is not

available, can approach the IRS under its VCAP program which is described in more detail in IRS Notice 2008-31 and Internal Revenue Manual Sections 7.2.3.

Written Post-Issuance Tax Compliance Procedures

Although not specifically required by the Code, written post-issuance tax compliance procedures have become a focus of the IRS in recent years. Recent updates of IRS bond information returns, Forms 8038, 8038-G, 8038-B, 8038TC and Schedule K (for section 501(c)(3) organizations, discussed in Chapter 6), each contain at least one question regarding whether the Issuer or Borrower has adopted written post-issuance procedures. Similar questions have appeared in a range of IRS tax compliance questionnaires sent to Issuers and Borrowers over the past couple of years and in IRS Information Document Requests sent to Issuers in connection with tax-exempt bond audits. In addition, the IRS recently amended their VCAP procedures to give more favorable treatment in settlements involving tax violations with Issuers who have adopted written procedures.

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

- Identification of the individual(s) with responsibility for monitoring post-issuance tax compliance;
- A description of the training provided to such responsible individual(s) with regard to monitoring compliance;
- The frequency of compliance checks (most being at least annually);
- The nature of the compliance activities required to be undertaken;
- The procedures used to timely identify and elevate the resolution of a violation when it occurs or is expected to occur;
- Procedures for the retention of all records material to substantiate compliance with the federal tax law requirements; and

- The acknowledgement of the availability of the IRS VCAP program and other self-help remedial actions.

Addressing Conduit Borrower Tax Compliance

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

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

CHAPTER SIX

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

In 2008, the IRS introduced Schedule K (Supplemental Information On Tax-Exempt Bonds) as a means of gathering comprehensive bond-related information on 501(c)(3) organizations that have borrowed on a tax-exempt basis. Schedule K is filed annually by section 501(c)(3) organizations as part of their annual IRS Form 990 (Return of Organizations Exempt From Income Tax) information return. Schedule K requires section 501(c)(3) organizations to report activities with respect to bond-financed property and related information which have occurred within the 12-month reporting period.

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

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

PART I — IDENTIFICATION

(a) Issuer name	(b) Issuer EIN	(c) CUSIP #	(d) Date issued	(e) Issue price	(f) Description of purpose	(g) Defeased		(h) On behalf of issuer		(i) Pooled financing	
						Yes	No	Yes	No	Yes	No

Part I requires the Borrower to report basic information with respect to its outstanding bond issues. The primary purpose of Part I is to permit the IRS to cross-reference this basic information relating to the bonds with the IRS

information return filed at issuance (i.e., Form 8038). Accordingly, it is important for Borrowers to carefully review the Form 8038 information with respect to each outstanding bond issue regarding the Issuer name, issue date, Issuer employer identification number, CUSIP number etc., and complete Part I of Schedule K in a consistent manner.

PART II — BOND PROCEEDS AND SPENDING

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

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

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

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

PART III—PRIVATE USE

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

Part III is the most difficult part of Schedule K to complete and the portion of the Schedule for which most organizations need outside assistance. The focus of Part III is on whether any portion of the bond-financed property is being used for a Private Business Use and/or an unrelated trade or business use and, if so, to what degree.

Leases

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

Management and Sponsored Research Agreements

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

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

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

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

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

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

Math Questions – Measuring Private Use

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

Accurately quantifying the level of Private Business Use is a difficult task. For most organizations, outside tax expertise is required to properly address this question. Importantly, Borrowers should not rely on any Private Business Use calculations completed at the time the bonds were issued. Often, events and facts change after the date of issuance which will influence such calculations and, moreover, such calculations are often not as precise as Schedule K requires.

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

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

- The Borrower must accurately trace the bond proceeds of the issue to the financed property, taking into account whether the bond proceeds were directly allocable to specific space within the bond-financed property or whether the bond proceeds and other funds (if any) were used proportionally to finance the same space.
- The Borrower must examine all use of bond-financed property and determine whether there are any contracts with outside parties such as leases, management or sponsored research contracts or similar agreements with rights to use such space.
- To the extent that management or sponsored research contracts are found, the Borrower must determine whether such use should be treated as Private Business Use or whether such agreements satisfy the IRS Safe Harbor Contract Rules.
- If Private Business Use of bond-financed property is identified, a proper and reasonable method must be applied to measure the amount of Private Business Use. Common methods of measuring Private Business Use include:
 - o Determining the square footage of the space used for a Private Business Use over the total bond-financed square footage;
 - o Determining the amount of time of the Private Business Use with respect to the financed property over the total amount of time that the bond-financed property is otherwise used; and
 - o Determining the amount of revenue derived from the Private Business Use over the total amount of revenue derived from the bond-financed property.

- Once a Private Business Use percentage is determined, that percentage will be multiplied by the amount of bonds applied to finance the property used for such purpose.
- The above process is repeated for each Private Business Use and such amounts are aggregated and reflected on Line 4.

Math Questions- Measuring Unrelated Trade or Business Use

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

Other Important Matters to Consider in Completing Part III

- Under applicable tax law, costs of issuance paid out of bond proceeds are treated as Private Business Use. For this purpose, no more than 2 percent of the bond proceeds may be used to finance costs of issuance.
- The fact that Part III of Schedule K does not take into account any pre-2003 bond-financed use of property means that bond issues that include property financed prior to and after 2003 will reflect only the use of the post-2003 property. In an integrated facility, it can be difficult to differentiate “use” financed with bonds issued prior to 2003 and subsequent to 2003.
- Lines 8a, b and c, inquire whether there has been a sale or disposition of any bond-financed property (i.e., a change in use), the amount of property sold and whether any “self-help” remedial action was taken under applicable law.
- Finally, Line 9 asks whether the organization has adopted written procedures to ensure that all nonqualified bonds of the issue are remediated in accordance with applicable remedial action provisions.

PART IV — ARBITRAGE

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

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

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

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

CHAPTER SEVEN

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

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

Experience has shown that infrequent Issuers and Borrowers of tax-exempt bonds often find it difficult to become proficient in post-issuance tax compliance matters given limited exposure to the market place. On the other hand, frequent Issuers and Borrowers of tax-exempt bonds may find the volume of debt, the associated tracking of expenditures and use of facilities to be unmanageable.

Getting Started

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

Bond Allocations and Tracking Private Business Use

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

If the organization enters into management or sponsored research contracts regarding bond-financed property, an outside service provider can review such contracts and provide a written report summarizing the material provisions of the agreements as well as a determination regarding whether such contracts fall within the applicable IRS Safe Harbor Rules. Recent statements by the IRS officials in various forums have indicated that such reports may be relied upon by IRS agents and organizations in the context of an audit examination. For Issuers and Borrowers that enter into a high number of management and sponsored research contracts, an outside service provider can develop checklists and train employees of the Issuer or Borrower to review contracts for compliance with IRS Safe Harbor Contract Rules.

Preparing Schedule K

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

BLX Can Help

The consequences of noncompliance with federal tax law requirements could result in the loss of the tax-exempt status of the bonds. To assist Issuers and Borrowers in meeting ongoing post-issuance tax compliance responsibilities, BLX Group LLC (“BLX”), a wholly owned subsidiary of Orrick, offers a wide range of post-issuance services. With 69 financial professionals in seven offices nationwide, BLX is the industry leader in providing post-issuance compliance services to a growing number of Issuers and Borrowers. BLX offers the following post-issuance tax compliance services, among others:

- Private Business Use review, analysis and tabulation;
- Seminars and in-house training regarding post-issuance compliance matters;
- Completion of IRS Schedule K;
- Assistance in developing or analysis of post-issuance tax compliance policies and procedures; and
- Review of tax documentation and recordkeeping procedures.

CHAPTER EIGHT

Continuing Disclosure – Another Post-Issuance Requirement

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

Rule 15c2-12² requires two types of ongoing disclosure: (1) an annual report (which contains the latest annual audited financial statements and certain other operating and financial data); and (2) notices of certain disclosure events, if and when any occur. The Continuing Disclosure Agreement obligates the Issuer and/or the Borrower to make the ongoing disclosures for the life of the bond issue. Such disclosures are to be filed with the Municipal Securities Rulemaking Board (the “MSRB”) on its EMMA website.

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

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

The Annual Report

As stated above, the annual report is required to contain (1) the Issuer's or Borrower's annual audited financial statements; and (2) certain annual financial information and operating data for the Issuer or Borrower of the type contained in the final official statement—all of which should be specified in the Continuing Disclosure Agreement. Most Issuers and Borrowers agree to provide the annual report for a given fiscal year within a certain period of time, often ranging from 180 days to as long as 270 days after the fiscal year end.

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

Disclosure Event Notices

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

DISCLOSURE EVENTS

EVENTS THAT ALWAYS REQUIRE NOTIFICATION	EVENTS THAT REQUIRE NOTIFICATION IF MATERIAL
<ul style="list-style-type: none"> • Principal and interest payment delinquencies; • Unscheduled draws on debt service reserves reflecting financial difficulties; • Unscheduled draws on credit enhancements reflecting financial difficulties; • Substitution of credit or liquidity providers, or their failure to perform; • Issuance by the Internal Revenue Service of proposed or final determination of taxability or of a Notice of Proposed Issue (IRS Form 5701 TEB); • Tender offers; • Defeasances; • Rating changes; or • Bankruptcy, insolvency, receivership or similar event of the obligated person. 	<ul style="list-style-type: none"> • Unless described in the left-hand column, adverse tax opinions or other material notices or determinations by the Internal Revenue Service with respect to the tax status of the securities or other material events affecting the tax status of the securities; • Modifications to rights of holders of the securities; • Optional, unscheduled or contingent Bond calls; • Release, substitution or sale of property securing repayment of the securities; • Non-payment related defaults; • The consummation of a merger, consolidation or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business, the entry into a definitive agreement to undertake such an action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms; or • Appointment of a successor or additional trustee or the change of name of trustee.

Compliance

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

BLX Can Help

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

With 69 professionals dedicated to financial and consultative services in seven offices nationwide, BLX is well-qualified to assist and guide Issuers and Borrowers with all elements of continuing disclosure compliance in a cost-effective manner. BLX's services can include: setting up tickler systems; assigning a point person for the continuing disclosure; determining when annual reports are due; assisting Issuers and/or Borrowers in assembling the required disclosure information; comparing the annual report to the Continuing Disclosure Agreements to make sure all required information is included; formatting the annual report; assisting in the preparation of disclosure event notices; and disseminating annual reports and disclosure event notices via EMMA.

Consequences for Noncompliance

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

- (1) Failure to file the annual report by the date agreed to, failure to include all of the information in the annual report that is required by the Continuing Disclosure Agreement or failure to file an event notice is an event of default under the Continuing Disclosure Agreement. The only remedy is by specific performance (that is, an injunction or other order to perform). However, it may also subject the Issuer or the Borrower that defaulted to liability to bondholders claiming they would not have bought, sold or held the tax-exempt bonds had the required information been provided in a timely manner. In addition, these failures must be disclosed in all official statements of the Issuer and/or the Borrower for a period of five years following such failure. Such disclosure may adversely affect the price and marketability of the Issuer's or Borrower's future debt. Persistent or material failure could also render the underwriters unable to rely on the Issuer's or Borrower's future Continuing Disclosure Agreements and, as a result, unable to underwrite or bid on their bonds.

(2) Including only the information required by the Continuing Disclosure Agreement in the annual report may not be sufficient, and could result in securities fraud liability under Rule 10b-5 promulgated by the U.S. Securities Exchange Act of 1934, if the information included is materially inaccurate or omits information necessary to make the information included not misleading to investors purchasing, selling or holding the bonds. Furthermore, although Rule 15c2-12 appears to contemplate that the annual report will cover only the preceding year, if an event has occurred since the end of the fiscal year that would make the fiscal year information in the annual report misleading, it could result in securities liability if not included in the annual report.

Market Developments

In recent years, there has been increased attention to continuing disclosure compliance by the municipal marketplace. Investors, now more than ever, are concerned with an Issuer's or Borrower's ongoing disclosure and in certain sectors require quarterly information in order to make an investment in the bonds. In addition, the SEC has created a specific municipal securities enforcement division which has launched a number of investigations with respect to disclosure. Furthermore, the SEC has been vocal regarding the need to address the inadequacies it perceives with respect to municipal disclosure practices.

As previously stated, the SEC cannot directly regulate the Issuer or Borrower.³ However, the SEC can regulate the underwriters regarding their responsibilities under Rule 15c2-12. In its August 2010 Release No. 34-62184A entitled, "Interpretive Guidance with Respect to Obligations of Participating Underwriters," the SEC clarified and reinforced its view of the obligation of an underwriter to consider the record of compliance by an Issuer or Borrower with its Continuing Disclosure Agreements on prior bond issues in determining whether that Issuer or Borrower can be relied upon to comply with its continuing disclosure undertaking on the new bond issue. The SEC went on to say that the underwriters must establish that each annual report and event notice complied with the requirements of the applicable Continuing Disclosure Agreement and was filed in a timely manner with each NRMSIR (prior to July 1, 2009) or on EMMA. The release went on further to state that the underwriter may no longer rely on representations

³ SEC may seek regulatory authority to do so.

from the Issuer or Borrower regarding its compliance. Rather, the underwriter must conduct its own investigation and make an independent judgment concerning the Issuer's or Borrower's compliance.

As a result of this increased scrutiny, Issuers and Borrowers are likely to be asked by the underwriter about their internal policies and procedures for compliance. Issuers and Borrowers may also be asked to provide proof of filing the annual reports or event notices and, in some instances, may be asked to engage or pay for an outside consultant to review and provide a report of such compliance or lack thereof for the underwriter. In addition, if there has been noncompliance, the underwriter will require the Issuer or Borrower to implement procedures so that the underwriter has a reasonable basis to rely on the Issuer's or Borrower's representation that the noncompliance will not reoccur and that they will comply with the continuing disclosure obligation for the new bond deal. It is important for the underwriter to address the noncompliance and the procedures that will be put in place to assure future compliance by the Issuer or Borrower, as applicable, so that the underwriter has a reasonable basis for recommending the bonds to investors. Such procedures may include a written policy assigning a responsible person at the Issuer or Borrower, or hiring an outside consultant, to assist in the preparation and filing of the annual report and event notices.

CHAPTER NINE

Other Bond Document Post-Issuance Compliance

In addition to the post-issuance tax compliance and continuing disclosure compliance, the Issuer and the Borrower are also typically subject to ongoing reporting and notice covenants that are contained in the bond documents⁴ to which they are a party. Compliance with these requirements is necessary in order to avoid an event of default on the bonds. The particular required post-issuance activities vary widely from transaction to transaction, especially depending on type, complexity and number of parties. Common examples include:

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

⁴ The bond documents may include the Indenture, Resolution, Loan Agreement, Lease Agreement, Installment Sale Agreement, Security Agreement (Pledge Agreement, Mortgage, etc.) and Credit Facility Reimbursement Agreement.

BLX Can Help

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

APPENDIX

Rev. Proc. 1997-13

Rev. Proc. 97-13, 1997-5 I.R.B. 18, 1997-1 C.B. 632, 1997 WL 8805 (IRS RPR)

Internal Revenue Service (I.R.S.)

Revenue Procedure

TAX-EXEMPT BONDS; PRIVATE ACTIVITY BONDS

Released: January 10, 1997

Published: February 3, 1997

26 CFR 601.601: Rules and regulations.

Section 103.-Interest on State and Local Bonds

Section 141.-Private Activity Bond; Qualified Bond

26 CFR 1.141-3: Definition of private business use.

Section 145.-Qualified 501(c)(3) Bonds

26 CFR 1.145-2: Application of private activity bond regulations.

Tax-exempt bonds; private activity bonds. This procedure sets forth conditions under which a management contract does not result in private business use under section 141(b) of the Code. This procedure also applies to determinations of whether a management contract causes the test in section 145(a)(2)(B) to be met for qualified 501(c)(3) bonds.

Section 1. Purpose

The purpose of this revenue procedure is to set forth conditions under which a management contract does not result in private business use under § 141(b) of the Internal Revenue Code of 1986. This revenue procedure also applies to

determinations of whether a management contract causes the test in § 145(a)(2)(B) of the 1986 Code to be met for qualified 501(c)(3) bonds.

Section 2. Background

.01 Private Business Use.

(1) Under § 103(a) of the 1986 Code, gross income does not include interest on any state or local bond. Under § 103(b)(1) of the 1986 Code, however, § 103(a) of the 1986 Code does not apply to a private activity bond, unless it is a qualified bond under § 141(e) of the 1986 Code. Section 141(a)(1) of the 1986 Code defines “private activity bond” as any bond issued as part of an issue that meets both the private business use and the private security or payment tests. Under § 141(b)(1) of the 1986 Code, an issue generally meets the private business use test if more than 10 percent of the proceeds of the issue are to be used for any private business use. Under § 141(b)(6)(A) of the 1986 Code, private business use means direct or indirect use in a trade or business carried on by any person other than a government unit. Section 145(a) of the 1986 Code also applies the private business use test of § 141(b)(1) of the 1986 Code, with certain modifications.

(2) Corresponding provisions of the Internal Revenue Code of 1954 set forth the requirements for the exclusion from gross income of the interest on state or local bonds. For purposes of this revenue procedure, any reference to a 1986 Code provision includes a reference to the corresponding provision, if any, under the 1954 Code.

(3) Private business use can arise by ownership, actual or beneficial use of property pursuant to a lease, a management or incentive payment contract, or certain other arrangements. The Conference Report for the Tax Reform Act of 1986, provides as follows:

The conference agreement generally retains the present-law rules under which use by persons other than governmental units is determined for purposes of the trade or business use test. Thus, as under present law, the use of bond-financed property is treated as a use of bond proceeds. As under present law, a person may be a user of bond proceeds and bond-financed property as a result of (1) ownership or (2) actual or beneficial use of property pursuant to a lease, a management or incentive payment contract, or (3) any other arrangement such as a take-or-pay or other output-type contract.

2 H.R.Conf.Rep. No. 841, 99th Cong., 2d Sess. II-687-688, (1986) 1986-3 (Vol. 4) C.B. 687-688 (footnote omitted).

(4) A management contract that gives a nongovernmental service provider an ownership or leasehold interest in financed property is not the only situation in which a contract may result in private business use.

(5) Section 1.141-3(b)(4)(i) of the Income Tax Regulations provides, in general, that a management contract (within the meaning of § 1.141-3(b)(4)(ii)) with respect to financed property may result in private business use of that property, based on all the facts and circumstances.

(6) Section 1.141-3(b)(4)(i) provides that a management contract with respect to financed property generally results in private business use of that property if the contract provides for compensation for services rendered with compensation based, in whole or in part, on a share of net profits from the operation of the facility.

(7) Section 1.141-3(b)(4)(iii), in general, provides that certain arrangements generally are not treated as management contracts that may give rise to private business use. These are-

- (a) Contracts for services that are solely incidental to the primary governmental function or functions of a financed facility (for example, contracts for janitorial, office equipment repair, hospital billing or similar services);
- (b) The mere granting of admitting privileges by a hospital to a doctor, even if those privileges are conditioned on the provision of de minimis services, if those privileges are available to all qualified physicians in the area, consistent with the size and nature of its facilities;
- (c) A contract to provide for the operation of a facility or system of facilities that consists predominantly of public utility property (as defined in § 168(i)(10) of the 1986 Code), if the only compensation is the reimbursement of actual and direct expenses of the service provider and reasonable administrative overhead expenses of the service provider; and
- (d) A contract to provide for services, if the only compensation is the reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties.

(8) Section 1.145-2(a) provides generally that §§ 1.141-0 through 1.141-15 apply to § 145(a) of the 1986 Code.

(9) Section 1.145-2(b)(1) provides that in applying §§ 1.141-0 through 1.141-15 to § 145(a) of the 1986 Code, references to governmental persons include section 501(c)(3) organizations with respect to their activities that do not constitute unrelated trades or business under § 513(a) of the 1986 Code.

.02 *Existing Advance Ruling Guidelines*. Rev. Proc. 93-19, 1993-1 C.B. 526, contains advance ruling guidelines for determining whether a management contract results in private business use under § 141(b) of the 1986 Code.

Section 3. Definitions

.01 *Adjusted gross revenues* means gross revenues of all or a portion of a facility, less allowances for bad debts and contractual and similar allowances.

.02 *Capitation fee* means a fixed periodic amount for each person for whom the service provider or the qualified user assumes the responsibility to provide all needed services for a specified period so long as the quantity and type of services actually provided to covered persons varies substantially. For example, a capitation fee includes a fixed dollar amount payable per month to a medical service provider for each member of a health maintenance organization plan for whom the provider agrees to provide all needed medical services for a specified period. A capitation fee may include a variable component of up to 20 percent of the total capitation fee designed to protect the service provider against risks such as catastrophic loss.

.03 *Management contract* means a management, service, or incentive payment contract between a qualified user and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility. For example, a contract for the provision of management services for an entire hospital, a contract for management services for a specific department of a hospital, and an incentive payment contract for physician services to patients of a hospital are each treated as a management contract. See §§ 1.141-3(b)(4)(ii) and 1.145-2.

.04 *Penalties* for terminating a contract include a limitation on the qualified user's right to compete with the service provider; a requirement that the qualified user purchase equipment, goods, or services from the service provider; and a requirement that the qualified user pay liquidated damages for cancellation of the contract. In contrast, a requirement effective on cancellation that the qualified user

reimburse the service provider for ordinary and necessary expenses or a restriction on the qualified user against hiring key personnel of the service provider is generally not a contract termination penalty. Another contract between the service provider and the qualified user, such as a loan or guarantee by the service provider, is treated as creating a contract termination penalty if that contract contains terms that are not customary or arm's-length that could operate to prevent the qualified user from terminating the contract (for example, provisions under which the contract terminates if the management contract is terminated or that place substantial restrictions on the selection of a substitute service provider).

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

.06 *Per-unit fee* means a fee based on a unit of service provided specified in the contract or otherwise specifically determined by an independent third party, such as the administrator of the Medicare program, or the qualified user. For example, a stated dollar amount for each specified medical procedure performed, car parked, or passenger mile is a per-unit fee. Separate billing arrangements between physicians and hospitals generally are treated as per-unit fee arrangements.

.07 *Qualified user* means any state or local governmental unit as defined in § 1.103-1 or any instrumentality thereof. The term also includes a section 501(c)(3) organization if the financed property is not used in an unrelated trade or business under § 513(a) of the 1986 Code. The term does not include the United States or any agency or instrumentality thereof.

.08 *Renewal option* means a provision under which the service provider has a legally enforceable right to renew the contract. Thus, for example, a provision under which a contract is automatically renewed for one-year periods absent cancellation by either party is not a renewal option (even if it is expected to be renewed).

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

Section 4. Scope

This revenue procedure applies when, under a management contract, a service provider provides management or other services involving property financed with proceeds of an issue of state or local bonds subject to § 141 or § 145(a)(2)(B) of the 1986 Code.

Section 5. Operating Guidelines For Management Contracts

.01 *In general.* If the requirements of section 5 of this revenue procedure are satisfied, the management contract does not itself result in private business use. In addition, the use of financed property, pursuant to a management contract meeting the requirements of section 5 of this revenue procedure, is not private business use if that use is functionally related and subordinate to that management contract and that use is not, in substance, a separate contractual agreement (for example, a separate lease of a portion of the financed property). Thus, for example, exclusive use of storage areas by the manager for equipment that is necessary for it to perform activities required under a management contract that meets the requirements of section 5 of this revenue procedure, is not private business use.

.02 *General compensation requirements.*

(1) *In general.* The contract must provide for reasonable compensation for services rendered with no compensation based, in whole or in part, on a share of net profits from the operation of the facility. Reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties is not by itself treated as compensation.

(2) *Arrangements that generally are not treated as net profits arrangements.*

For purposes of § 1.141-3(b)(4)(i) and this revenue procedure, compensation based on-

- (a) A percentage of gross revenues (or adjusted gross revenues) of a facility or a percentage of expenses from a facility, but not both;
- (b) A capitation fee; or
- (c) A per-unit fee is generally not considered to be based on a share of net profits.

(3) *Productivity reward.* For purposes of § 1.141-3(b)(4)(i) and this revenue

procedure, a productivity reward equal to a stated dollar amount based on increases or decreases in gross revenues (or adjusted gross revenues), or reductions in total expenses (but not both increases in gross revenues (or adjusted gross revenues) and reductions in total expenses) in any annual period during the term of the contract, generally does not cause the compensation to be based on a share of net profits.

(4) *Revision of compensation arrangements.* In general, if the compensation arrangements of a management contract are materially revised, the requirements for compensation arrangements under section 5 of this revenue procedure are retested as of the date of the material revision, and the management contract is treated as one that was newly entered into as of the date of the material revision.

.03 *Permissible Arrangements.* The management contract must be described in section 5.03(1), (2), (3), (4), (5), or (6) of this revenue procedure.

(1) *95 percent periodic fixed fee arrangements.* At least 95 percent of the compensation for services for each annual period during the term of the contract is based on a periodic fixed fee. The term of the contract, including all renewal options, must not exceed the lesser of 80 percent of the reasonably expected useful life of the financed property and 15 years. For purposes of this section 5.03(1), a fee does not fail to qualify as a periodic fixed fee as a result of a one-time incentive award during the term of the contract under which compensation automatically increases when a gross revenue or expense target ;(but not both) is reached if that award is equal to a single, stated dollar amount.

(2) *80 percent periodic fixed fee arrangements.* At least 80 percent of the compensation for services for each annual period during the term of the contract is based on a periodic fixed fee. The term of the contract, including all renewal options, must not exceed the lesser of 80 percent of the reasonably expected useful life of the financed property and 10 years. For purposes of this section 5.03(2), a fee does not fail to qualify as a periodic fixed fee as a result of a one-time incentive award during the term of the contract under which compensation automatically increases when a gross revenue or expense target (but not both) is reached if that award is equal to a single, stated dollar amount.

(3) *Special rule for public utility property.* If all of the financed property subject to the contract is a facility or system of facilities consisting of predominantly public

utility property (as defined in § 168(i)(10) of the 1986 Code), then “20 years” is substituted-

(a) For “15 years” in applying section 5.03(1) of this revenue procedure; and

(b) For “10 years” in applying section 5.03(2) of this revenue procedure.

(4) *50 percent periodic fixed fee arrangements.* Either at least 50 percent of the compensation for services for each annual period during the term of the contract is based on a periodic fixed fee or all of the compensation for services is based on a capitation fee or a combination of a capitation fee and a periodic fixed fee. The term of the contract, including all renewal options, must not exceed 5 years. The contract must be terminable by the qualified user on reasonable notice, without penalty or cause, at the end of the third year of the contract term.

(5) *Per-unit fee arrangements in certain 3-year contracts.* All of the compensation for services is based on a perunit fee or a combination of a per-unit fee and a periodic fixed fee. The term of the contract, including all renewal options, must not exceed 3 years. The contract must be terminable by the qualified user on reasonable notice, without penalty or cause, at the end of the second year of the contract term.

(6) *Percentage of revenue or expense fee arrangements in certain 2-year contracts.* All the compensation for services is based on a percentage of fees charged or a combination of a per-unit fee and a percentage of revenue or expense fee. During the start-up period, however, compensation may be based on a percentage of either gross revenues, adjusted gross revenues, or expenses of a facility. The term of the contract, including renewal options, must not exceed 2 years. The contract must be terminable by the qualified user on reasonable notice, without penalty or cause, at the end of the first year of the contract term. This section 5.03(6) applies only to-

(a) Contracts under which the service provider primarily provides services to third parties (for example, radiology services to patients); and

(b) Management contracts involving a facility during an initial start-up period for which there have been insufficient operations to establish a reasonable estimate of the amount of the annual gross revenues and expenses (for example, a contract for general management services for the first year of operations).

.04 No Circumstances Substantially Limiting Exercise of Rights.

(1) *In general.* The service provider must not have any role or relationship with the qualified user that, in effect, substantially limits the qualified user's ability to exercise its rights, including cancellation rights, under the contract, based on all the facts and circumstances.

(2) *Safe harbor.* This requirement is satisfied if-

- (a) Not more than 20 percent of the voting power of the governing body of the qualified user in the aggregate is vested in the service provider and its directors, officers, shareholders, and employees;
- (b) Overlapping board members do not include the chief executive officers of the service provider or its governing body or the qualified user or its governing body; and
- (c) The qualified user and the service provider under the contract are not related parties, as defined in § 1.150-1(b).

Section 6. Effect On Other Documents

Rev. Proc. 93-19, 1993-1 C.B. 526, is made obsolete on the effective date of this revenue procedure.

Section 7. Effective Date

This revenue procedure is effective for any management contract entered into, materially modified, or extended (other than pursuant to a renewal option) on or after May 16, 1997. In addition, an issuer may apply this revenue procedure to any management contract entered into prior to May 16, 1997.

DRAFTING INFORMATION

The principal author of this revenue procedure is Loretta J. Finger of the Office of Assistant Chief Counsel (Financial Institutions and Products). For further information regarding this revenue procedure contact Loretta J. Finger on (202) 622-3980 (not a toll-free call).

Rev. Proc. 97-13, 1997-5 I.R.B. 18, 1997-1 C.B. 632, 1997 WL 8805 (IRS RPR)

END OF DOCUMENT

Rev. Proc. 2007-47

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 1.141-3: Definition of Private Business Use

(Also: §§ 103, 141,145; 1.141-3, 1.145-2)

Rev. Proc. 2007-47

Section 1. Purpose

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

Section 2. Background

.01 Private Business Use.

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

145(a) also applies the private business use test of § 141(b)(1) to qualified 501(c)(3) bonds, with certain modifications.

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

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

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

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

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

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

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

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

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

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

Section 3. Definitions

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

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

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

Section 4. Changes

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

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

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

Section 5. Scope

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

Section 6. Operating Guidelines For Research Agreements

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

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

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

- (1) A single sponsor agrees, or multiple sponsors agree, to fund governmentally performed basic research;
- (2) The qualified user determines the research to be performed and the manner in which it is to be performed (for example, selection of the personnel to perform the research);
- (3) Title to any patent or other product incidentally resulting from the basic research lies exclusively with the qualified user; and

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

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

Section 7. Effect On Other Documents

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

Section 8. Effective Date

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

Section 9. Drafting Information

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

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