

# The Party Never Ends

## Hot Topics in Post-Issuance Bond Compliance

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# Immediate Post-Issuance



# Two Basic Areas

## Federal Tax Compliance for Tax-Exempt Bonds

- Private Use Restrictions
- Arbitrage/Rebate Restrictions

## Continuing Disclosure Obligations

- Annual Reports
- Material Event Notices

# New Scrutiny in Both Areas

## Tax

- Lines 43 and 44 of Form 8038-G
- Implied (and express) expectation of formal compliance policies and procedures

## Disclosure

- MCDC initiative of SEC
- Current Issuer “Participation” deadline of December 1, 2014

# Basics: Tax Compliance

- Private Use Restrictions
  - TEB becomes Private Activity Bond if:
    - More than 10% of proceeds used in private trade or business; and
    - More than 10% of Bond Proceeds secured by an interest in property used in a private trade or business
    - “Private use and Private Payment.”
    - “Reasonable Expectation at Issue Date” but “deliberate action” subsequent to issue date relevant.

# Tax Compliance: Private Use

- “A deliberate action is any action taken by the issuer that is within its control. Intent to violate the requirements of section 141 of the Code is not necessary for an action to be deliberate.”
- Most often issue with management, service, and research contracts.
- Critical to consult tax counsel before entering into such arrangements with regard to facilities financed with tax-exempt bonds.

# Tax Compliance: Arbitrage

- Bonds lose TEB status if they become “Arbitrage Bonds.”
- Unless exception applies, proceeds cannot be invested at “materially higher” yield than TEB.
- Again, “Reasonable Expectation at Issue Date” but “Intentional Acts” can change.
- Exceptions: (1) temporary periods (generally, 3 years for capital projects); (2) “Reasonably required reserve or replacement fund”; and (3) “Minor Portion” (Lesser of 5% of proceeds or \$100,000).
- Remedial action in form of Yield Reduction Payments.

# Tax Compliance: Rebate

- Even if an arbitrage exception applies, a bond will be deemed an “arbitrage bond” if rebate payments are not made.
- Rebate generally is the arbitrage yield plus earnings.
- Two general exceptions: Spending Exception and Small Issuer Exception.
- Spending Exception
  - 6 Month, 18 Month, 2 Year
  - 18 Month (15% in 6; 60% in 12; 100% in 18)
  - 2 Year (10% in 6; 45% in 12; 75% in 18; 100% in 24)
- Small Issuer Exception
  - Governmental Issuer issuing \$5M or less in calendar year
  - \$10M for school capital expenditures

## “Traditional” Tax Compliance

- Track Expenditure and Investment of Bond Proceeds.
- Run Rebate every 5 years.
- Monitor use of bond financed facilities for private use.
- Maintain good records of all post-issuance compliance.

# Continuing Disclosure: Basics

- Very little direct regulation of issuers of governmental bonds by SEC.
- Primary regulations affecting issuers is SEC Rule 15c2-12 and anti-fraud provisions in 1933 and 1934 Securities Acts.
- Before selling municipal securities, underwriter must obtain and review an official statement and determine that the issuer has “undertaken...in a written agreement or contract for the benefit of holders of such securities” to provide: (1) annual financial information (including audit); and (2) “material event” information.
- Repositories for this information and access to it a problem for a number of years.
- Electronic Municipal Market Access System (EMMA) established in 2009.

# “Traditional” Continuing Disclosure

- File annual reports
  - Most “written agreements” provide for filing by February 1 following the end of the fiscal year in question.
- File material event notices “in a timely manner.”
  - What is “material”?
  - What is “timely”?

# New Initiatives by IRS and SEC

- IRS
  - Focusing on internal policies and procedures of issuers with regard to tax compliance.
- SEC
  - Seeking to document “material misstatements” by issuers regarding compliance with Rule 15c2-12 continuing disclosure

# IRS: Lines 43 and 44 of 8038-G

## Part VII Miscellaneous

- 37 Name of governmental unit(s) approving issue (see the instructions) ▶ \_\_\_\_\_
- 38 Check the box if you have designated any issue under section 265(b)(3)(B)(i)(III) . . . . . ▶
- 39 Check the box if you have elected to pay a penalty in lieu of arbitrage rebate . . . . . ▶
- 40a Check the box if you have identified a hedge and enter the following information . . . . . ▶
- b Name of hedge provider \_\_\_\_\_
- c Type of hedge ▶ \_\_\_\_\_
- d Term of hedge ▶ \_\_\_\_\_
- 41 Check the box if the hedge is superintegrated . . . . . ▶
- 42a Enter the amount of gross proceeds invested or to be invested in a guaranteed investment contract (GIC) ▶ \_\_\_\_\_
- b Enter the final maturity date of the GIC . . . . . ▶
- c Enter the name of the GIC provider ▶ \_\_\_\_\_
- 43 Check the box if the issuer has established written procedures to ensure that all nonqualified bonds of this issue are remediated in accordance with the requirements under the Code and Regulations (see instructions) . . . . . ▶
- 44 Check the box if the issuer has established written procedures to monitor the requirements of section 148 . . . . . ▶
- 45a Enter the amount of reimbursement if some portion of the proceeds was used to reimburse expenditures . ▶ \_\_\_\_\_
- b Enter the date the official intent was adopted . . . . . ▶
- 46 Check the box if the issue is comprised of qualified redevelopment, qualified small issue, or exempt facilities bonds and provide name and EIN of the primary private user . . . . . ▶
- Name ▶ \_\_\_\_\_ EIN \_\_\_\_\_

## IRS: Lines 43 and 44 of 8038-G

- No legal requirement that you have such policies and procedures.
- But IRS has long made clear its expectation that issuers have well-developed compliance policies and procedures.
- IRS has independently sent over 1,000 issuers compliance check questionnaires since 2007.
- IRS Manual provides favorable VCAP settlement for issuer if it “adopted written procedures to ensure that its tax-advantaged bonds remain in compliance with all post-issuance related federal tax requirements that are conditions to the tax-advantaged status of the bonds.”
- What if you don’t check the box(es)?

# IRS Position on Tax Compliance

- The IRS Web site currently contains a page titled “TEB Post-Issuance Compliance: Some Basic Concepts” that promotes the adoption of post-issuance compliance procedures. See <http://www.irs.gov/taxexemptbond>. The page states that the “on-going nature of post-issuance compliance requirements applicable to tax-advantaged bonds requires issuers to actively monitor compliance throughout the entire period their bonds remain outstanding.”
- Site gives detailed guidance as to what issuers should include in compliance policies and procedures.

# IRS Recommendation on Written Procedures

“Written procedures should contain certain key characteristics, including making provision for:

- Due diligence review at regular intervals;
- Identifying the official or employee responsible for review;
- Training of the responsible official/employee;
- Retention of adequate records to substantiate compliance (e.g., records relating to expenditure of proceeds);
- Procedures reasonably expected to timely identify noncompliance; and
- Procedures ensuring that the issuer will take steps to timely correct noncompliance.”

# Tax Compliance Procedures; Points to Consider

- You may already have elements of all of these in different policies, procedures, and practices.
- Nevertheless best to have them in one document you can hand to IRS in an audit– less explaining you have to do.
- Having procedures means you have got to follow them. Can't just adopt and put on a shelf. Better to not have than to have and not follow.
- Level of approval required dependent on internal governance, best practice is to have governing board approve, but some issuers choose to implement administratively, or have board approve general concept and mandate consistent policies and procedures.

# Tax Compliance Procedures; Points to Consider

- Line 43 refers only to remediation of nonqualified bonds.
- Line 44 references only written procedures “to monitor the requirements of Section 148.”
- “Bare Bones” approach deals only with remediation for deliberate action and arbitrage/rebate compliance.
- “Intermediate” approach allows for favorable VCAP treatment under IRS manual.
- “Best Practice” approach— comprehensive policies and procedures for tax compliance.
- Most bond counsel recommending “Best Practice” approach.
- Cost of implementation and maintenance main consideration.

## IRS Manual 7.2.3.4.4

- “Such procedures must, at a minimum, specify the official(s) with responsibility for monitoring compliance, a description of the training provided to such responsible official(s) with regard to monitoring compliance, the frequency of compliance checks (must be 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 applicable federal tax requirements, and an awareness of the availability of TEB VCAP and other remedial actions to resolve violations.”

## SEC Municipal Continuing Disclosure Cooperation Initiative

- Again, municipal bond issuers not subject to direct SEC regulation.
- Underwriters are subject to direct SEC regulation through 15c2-12 but issuers only subject to anti-fraud provisions of federal securities laws which prevent issuers from making “materially misleading.”

## Rule 10b-5

- **Rule 10b-5 Employment of Manipulative & Deceptive Devices**

“It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange... [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading...in connection with the purchase or sale of any security.”

# SEC Action

- SEC has instituted enforcement actions against underwriters and issuers for “materially misleading” statements in official statements regarding compliance with Rule 15c2-12 continuing disclosure obligations.
- West Clark School District (Indiana) enforcement action in 2013.

# MCDC

- SEC announced MCDC in March 2014.
- Underwriters and issuers allowed to participate by “self reporting” material misstatements in offering documents during the prior 5 years of compliance with continuing disclosure obligations.
- September 10 deadline for underwriters; revised December 1 deadline for issuers.

## MCDC (continued)

- Participation means willingness to enter into a “cease and desist” order with SEC.
- For underwriters \$20,000 to \$60,000 per issue penalties, with caps of \$100,000 to \$500,000 based on underwriter’s total annual revenue.
- For issuers, no liability admitted but agreement to cease and desist order: implementation of policies and procedures, cooperation with SEC, future reporting and certifications to SEC with regard to compliance, disclosure in future offering documents.

## MCDC: Report or No?

- Review your offering documents for last 5 years.
- Are statements on compliance with continuing disclosure correct?
- If incorrect, is the misstatement material?
- Have you been informed by an underwriter that they are self-reporting on an issue?
- Board approval to report?
- While participation is billed by SEC as means to avoid issuer liability, no assurances are given for possible SEC actions against individuals.
- SEC likely to issue press release on settlement with issuer.