

***The Board of Regents for the Oklahoma  
Agricultural and Mechanical Colleges***

***Debt Issuance and Management Guidelines***

***November 2011***

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# **The Board of Regents for the Oklahoma Agricultural and Mechanical Colleges**

## **Debt Issuance and Management Guidelines**

It is the stated policy of The Board of Regents for the Oklahoma Agricultural and Mechanical Colleges (the “Board”) that all institutions or agencies (“Institutions”) under its governance will commit to the efficient structuring, sale, and management of debt issued to finance capital facilities and equipment.

Components of a successful debt program will include:

- Project Planning / Identification of Potential Funding Sources;
- Evaluation of Borrowing Alternatives;
- Securing Financing Approval;
- Determining the Tax Status of Proposed Debt;
- Structuring of a Planned Offering;
- Marketing, Sale and Delivery of an Issue; and
- Post-issuance Compliance.

This guidelines manual is offered to help Institutions identify the requirements of an effective borrowing program and provide guidance in the development of their internal practices. However, this document is not intended to be a comprehensive listing of an issuer’s responsibilities and each Institution is advised to consult with its internal counsel and bond counsel to ensure compliance with applicable statutes, rules and regulations.

### **Project Planning / Identification of Funding Sources**

Generally, debt financing should be considered only for those projects that are both critical to the mission of the Institution and too expensive to reasonably acquire with current funds. A careful analysis of capital funding priorities will help ensure that an Institution’s borrowing capacity is optimally utilized. Among the issues to be considered in the planning process are:

- Non-borrowed sources of funding, including matching funds;
- Useful life of the capital asset;
- Impact of a proposed project on operating costs;
- Importance of a project in the overall capital plan; and
- Low-cost loan programs offered by the State or federal government.

Revenue generating projects with identified cash-flows available for the payment of debt service and incremental operating costs should be given priority consideration.

Compliance with the federal tax code and related rules and regulations begins in the early stages of planning for debt issuance. Most issues by Institutions are likely to comply with the tests used to determine eligibility for tax-exemption. However, awareness of applicable laws and rules early in the planning process will make compliance much easier. As noted below, particular attention must be given to those

financings where the facility or equipment may benefit or be used by a private or for-profit entity or for sponsored research.

## **Evaluation of Borrowing Alternatives**

A number of borrowing options may be available to Institutions to fund their capital needs. Institutions should evaluate each available option and consider which offers the lowest cost of funding and the best match with its capital program objectives. All potential funding sources should be reviewed by Institutions within the context of the Board's Debt Policy. A few of these funding options are described below:

### General Revenue Bonds

The Oklahoma Promise of Excellence Act (70 O.S. 3980.4C) authorized the Board of Regents for the Oklahoma Agricultural and Mechanical Colleges to issue indebtedness for capital projects (subject to review by the Oklahoma Legislature), to benefit Oklahoma State University, that are secured by any lawfully available source of revenue, other than revenues appropriated by the Legislature from tax receipts and certain restricted moneys. In 2009, the Board created an OSU Financing System under the Promise of Excellence Act that includes OSU-Stillwater and OSU-Tulsa. The broad security pledge permitted under this statutory authorization offers excellent market access and favorable financing terms.

### Revenue Bonds

Under the authority granted by 70 O.S. 4002 et seq., Institutions may issue bonds (with legislative approval) secured by a specific source of funds (e.g., Student Facility Fees, Athletic Revenues, Student Union Fees, etc.). For revenue bond issues, investors will typically require funding of a debt service reserve and expect the pledged flow of funds to provide strong coverage of annual debt service requirements. Without a strong security pledge, the Institution could end up having to pay high interest rates to attract investors.

### Master Lease Programs

The Oklahoma Development Finance Authority operates two Master Lease programs for public institutions of higher education in Oklahoma (see 70 OS 3206.6 and 3206.6a). These are (i) the Master Equipment Lease Program; and (ii) the Master Real Property Lease Program. The Master Lease programs offer Institutions more attractive interest rates and lower issuance costs than most stand-alone financings.

Institutions should take into consideration the comparative funding costs, flexibility in market timing, and bond ratings of each alternative. In evaluating the advantages and disadvantages of each financing option, Institutions should also consider the obligation's impact on overall debt affordability and debt capacity. In this process, assistance is available from the Institution's bond counsel, financial advisor, and the Oklahoma State Bond Advisor.

*Note: Generally, the use of the Master Equipment Lease Program should be limited to the acquisition of capital items. To ensure compliance with the post-issuance provisions of IRS Code, Institutions must monitor the use of all items acquired with tax-exempt proceeds until all of the bonds have been paid. Small, non-capital items are often not included in property inventories and, as a result, are difficult to track. Unless special provision is made, Institutions should not use the Master Equipment Lease Program to acquire such items.*

### Direct Lease-Purchase

For certain capital items, a lease purchase financing may offer an alternative to revenue bonds. Direct lease purchases by Institutions, under the authority granted by 70 O.S. 4018, offer investors security based on an Institution's promise to make lease payments, subject to availability of funds. The capital item being financed must be considered "essential" to the operation of the Institution. In most cases, the Master Lease programs described above will result in a lower borrowing cost than these direct leases (especially when reasonably priced bond insurance is not readily available).

### **Securing Approval of a Financing**

Any original or refunding debt issue or a contract for a derivative product requires Board approval and must satisfy all Board policies and procedures. Institutions must ensure compliance with State of Oklahoma and federal law, as well as all applicable regulatory requirements.

Institutions must obtain approval from the Oklahoma Legislature to issue direct revenue bonds, unless the bonds are being sold to refund outstanding obligations. Statutes governing the issuance of general revenue debt under the OSU Financing System provide for a legislative review of requests, but also allow an exception from this review process for refunding or defeasance obligations. A similar statutory review period is required for participation in the Master Real Property Lease Program. Institutions proposing to take part in either General Revenue Bond or Master Real Property Lease financings must submit their project lists to the Board for consideration, preferably at its December Board meeting each year.

Generally, Institutions seeking Board approval of debt issuance should submit their requests at least three weeks prior to the Board meeting at which action is requested. If the Board approves the request, it will grant authority to seek the required approvals of the Council of Bond Oversight, the Oklahoma State Regents for Higher Education, and the Oklahoma Attorney General. Institutions should provide adequate time for these approvals in their financing schedules to ensure that funding for projects is available when needed. The Board will help ensure that all legal opinions necessary to comply with applicable Oklahoma and federal laws, as well as any other opinions appropriate for the proposed financing, are obtained.

### **Determining the Tax Status of Proposed Debt**

Generally, Section 141 of the IRS Code defines a private activity bond as any bond issued as part of an issue that meets both the private business use test and the private security payment test or is part of an issue that meets the private loan financing test.

Depending on the type of facility or equipment and how it is used to further the mission of the Institution, the determination of private use can be very complex. The method used by an Institution to determine any private use must be reasonable and consistently applied. Institutions are encouraged to work with their bond attorneys and/or special tax counsel to make a determination of an issue's tax status.

Brief summaries of the private activity tests are provided below.

### Private Business Use

Generally, under Section 141(b)(1) and 141(b)(6)(A), private business use occurs if more than 10 percent of the proceeds of the bonds are to be used (directly or indirectly) in a trade or business carried on by a person other than a governmental unit. Any activity carried on by a person other than a natural person is treated as trade or business use.

- Under Section 1.141-3(b)(1), private business use can arise 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 output-type contract.
- Section 1.141-3(b)(4)(i) provides that a management contract with respect to financed property may result in private business use of that property based on all of the facts and circumstances. 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.

### Private Security or Payment Test

The private security or payment test is met if the payment of the principal of, or the interest on, more than ten percent of the proceeds of an issue is directly or indirectly (1) secured by an interest in property used or to be used for a private business use, (2) secured by an interest in payments in respect of such property, or (3) to be derived from payments, whether or not to the issuer, in respect of property, or borrowed money, used or to be used for a private business use.

### Private Loan Financing

The private loan financing test is satisfied if more than the lesser of \$5 million or 5 percent of the proceeds of an issue are to be used to make or finance loans to persons other than governmental units. Exceptions to this test exist for certain student loan and low-income housing bonds.

These provisions of the Code are very complicated and are subject to interpretation. This is especially true for facilities or equipment that an institution of higher education might use to conduct research. While certain safe harbors exist in this area, Institutions need to be very careful when using assets funded with tax-exempt debt to conduct research that might be viewed as benefiting a for-profit enterprise. Bond counsel and special tax counsel should be consulted if there is ever a question about how a transaction might be treated under the Code.

Also important is the need to monitor the use of debt-funded assets over the life of the bond issue to ensure that there has not been a change in use that would affect the original tax-exempt determination. Institutions should establish a procedure for annual review of facility or equipment use and document their results.

### **Structuring of a Planned Offering**

In the structuring of an issue, care should be taken to preserve maximum administrative flexibility over the life of the debt. The term of the obligation should not exceed the useful life of the facility or equipment being financed and, to the extent that it can be done without an interest rate penalty, optional redemption provisions should be included to allow a refunding if the opportunity (or need) arises. Depending on the source of funds for repayment of the obligation, it may also be important to consider the dates on which principal and interest payments are due.

Typically, issues are structured to result in level annual debt service requirements. However, if the revenues securing the debt are to be derived from the facility being constructed (or renovated), an Institution may want to consider an issue structure that incorporates a combination of capitalized interest and/or deferred principal. This will allow completion of the project (and collection of the generated revenues) before the full annual debt service requirement impacts the budget.

Institutions are encouraged to work with their financial advisors early in the planning process to determine the most cost-effective structure for their transactions.

### **Ratings and Credit Enhancement**

Most issues offered for sale in the municipal market are rated by one or more of the three national bond rating agencies: Fitch Ratings, Standard & Poor's, and Moody's Investor's Service. Investors frequently expect issuers to have ratings from at least two of these firms. While securing ratings is a relatively simple process, it is an important part of not only the individual transaction, but the on-going capital program of an Institution. For that reason, care should be taken to ensure that the initial rating accurately reflects the credit quality of the offering and the Institution. Generally, a financial advisor will provide assistance with the rating request, but the Institution should be an active participant in this process.

Additional information about each of the rating agencies' criteria is available on their internet sites.

[www.fitchratings.com](http://www.fitchratings.com)  
[www.moodys.com](http://www.moodys.com)

In some cases, an Institution may need additional security to attract investors and efficiently market its obligations. The most common forms of credit enhancement in recent years have been bond insurance, surety policies, liquidity facilities, and lines and letters of credit. However, recent events in the financial markets have resulted in a significant decline in the availability of these instruments at rates that are attractive to issuers. Institutions should consider both the Master Equipment Lease Program and Master Real Property Lease Program as financing options that offer strong credit quality and good market access.

## **Marketing, Sale and Delivery of an Issue**

The primary options for marketing an Institution's debt obligation are: (i) competitive sale; (ii) negotiated sale; and (iii) private placement. The size, security pledge, issue structure and other factors will contribute to the determination of which marketing approach is likely to result in the best sale results. Institutions should consult with their financial advisors and the Oklahoma State Bond Advisor before making a final determination on method of sale. A brief overview of each type of sale is provided below.

### Competitive Sale

A competitive sale is effective when the issue structure is simple, the obligation is well-secured, and market conditions are stable. Many issuers prefer this approach because they feel it offers a true indication of market conditions on the date of sale. However, if an Institution chooses a competitive sale, it must assume more of the responsibility for marketing the issue. As a regular participant in the market, the financial advisor can be helpful in this process. The type, size and structure of the issue will determine which underwriting firms will be interested and the financial advisor can help the Institution identify these firms. The financial advisor will also assist with the review of bids and advise the Institution on the award, consistent with the bid specifications.

### Negotiated Sale

An increasingly popular method of marketing bonds and other debt instruments is the negotiated sale. This approach involves the competitive selection of an underwriter or underwriting team that will work with the Institution and its financial advisor to negotiate the price at which the bonds will be sold. This approach is most common when the issue is complex, very large, or during unstable market conditions. The underwriter can help the Institution and its financial advisor with the marketing of the obligations and provide input on structuring to help ensure good investor demand.

### Private Placement

The least common of the three methods of sale, the private placement is normally used to negotiate the sale with a single institutional investor. This may be done for a variety of reasons, but the most common are: (i) small issue size; (ii) special security

provisions; and (iii) weak credit quality. For these reasons, private placements often result in higher costs to the issuer than either competitive or negotiated sales.

### Documentation

Once an issue has been priced, a number of documents must be completed to permit the delivery and closing of the securities. Bond counsel will provide a list of the required documentation and work with the Institution and its financial advisor to complete the transaction. If underwriter's counsel and/or a trustee bank are involved, representatives of those firms will also participate in this process.

Normally, the preliminary official statement (POS) that was prepared as a part of the marketing effort, will be updated with the coupon rates, re-offering yields and other sale information and be published as the final official statement (OS). Another key document the issuer will execute prior to closing is the Continuing Disclosure Agreement. This document identifies the information that the issuer agrees to provide to the market for as long as the debt is outstanding (see below). A typical period between sale and delivery of the bonds (closing) is about two weeks.

#### **Rule 15c2-12**

*Institutions should be aware of the disclosure requirements of SEC Rule 15c-2-12. This rule sets forth certain obligations of (i) underwriters to receive, review and disseminate official statements prepared by issuers of most primary offerings of municipal securities, (ii) underwriters to obtain continuing disclosure agreements from issuers and other obligated persons to provide timely event notices and annual financial information on a continuing basis, and (iii) broker-dealers to have access to such continuing disclosure in order to make recommendations of municipal securities in the secondary market. While Rule 15c-2-12 governs actions by underwriters, Institutions selling municipal debt will need to assume some of the responsibility for data collection and filing to ensure that their issues are in compliance.*

### **Post-issuance Compliance**

Once the debt has been sold and delivered, an Institution moves into the compliance phase of the transaction. There are a number of rules and regulations that govern post-issuance responsibilities. In all matters relating to compliance, Institutions should work closely with their financial advisor and bond counsel to ensure preparation and filing of complete and timely information. Provided below is a summary of the key elements of a post-issuance compliance program.

### Required Filings

Issuers of tax-exempt debt are required by the IRS to file a version of Form 8038 "on or before the 15th day of the 2nd calendar month after the close of the calendar quarter in which the issue is issued". Filers are instructed to complete IRS Form 8038 based on

the facts as of the issue date. If the issue price is \$100,000 or more, Form 8038-G should be used. If the bond issue price is under \$100,000, or if it is a lease or installment sale, issuers are directed to use IRS Form 8038-GC. This filing is required to provide information required by Section 149(e) of the Internal Revenue Code and to allow the IRS to monitor compliance with Sections 141 to 150 of the Code. Bond counsel generally prepares the appropriate 8038 on the issuer's behalf.

### Compliance with Security Covenants

At the time of sale, Institutions will normally execute a document that describes the actions it will take to ensure that investors' interests are protected. This may take the form of a Resolution, Indenture, or Private Placement Memorandum. Whatever the form, it is important that Institutions monitor their compliance with these security provisions. Failure to do so could trigger a requirement to disclose negative developments, such as rating reductions, and/or draws on reserves or credit enhancements. Any of these developments will have an adverse impact on the market's perception of an Institution's credit quality. These could also make it more difficult for the Institution to access the capital markets in the future.

### Regular Monitoring of Private Use

As noted above, there are a number of tests that must be satisfied before an obligation can be sold as tax-exempt debt. The rules governing tax-exempt status are applicable until an issuer has provided for final payment of the obligations. If an issuer violates these rules, the tax-exempt status of an issue may be lost. For that reason, Institutions have an obligation to monitor the use of all equipment and/or facilities acquired with tax-exempt proceeds to ensure that there has been no change in use.

### Continuing Disclosure Agreement Requirements

As noted above, Rule 15c2-12 (the "Rule") requires that an underwriter, prior to purchasing or selling Bonds in connection with a covered bond offering, determine that the Governmental Issuer, and/or one or more Obligated Persons for whom financial or operating data is presented in the official statement, has undertaken in writing to provide the following information to the Electronic Municipal Market Access system ("EMMA") and to the appropriate state information depository ("SID"), if any:

- By a specified date, annual financial and operating information for the Governmental Issuer and each other Obligated Person for whom financial information or operating data is presented in the official statement (an "Annual Information Filing");
- When and if available, audited annual financial statements for Obligated Persons ("Audits");
- In a timely manner, notice of the occurrence of one of the events described below (a "Rule 15c2-12 Event Notice")<sup>1</sup>; and

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<sup>1</sup> Rule 15c2-12 was amended in 2010 to (i) remove the exemption from continuing disclosure provisions for demand securities, (ii) establish a timeliness standard for submission of 15c2-12 Event Notices of ten business days after the occurrence of the event, (iii) delete the general materiality condition for certain Event Notices; (iv) modify the Event Notice regarding adverse tax events; and (v) add new Rule 15c2-12 Event Notices.

- In a timely manner, notice of a failure of any person required to provide the Annual Information Filing referred to above, on or before the date specified in the Continuing Disclosure Agreement (“Notice of Failure”).

**Rule 15c2-12 Event Notices**

Effective December 1, 2010, the continuing disclosure service of EMMA will accept submission of and make publicly available through EMMA, the following categories of event-based continuing disclosure documents. Issuers are required to provide notice of the following events to the EMMA system, within ten (10) business days of occurrence. The events are described as follows:

- 1) Principal and interest payment delinquencies;
- 2) Non-payment related defaults, if material;
- 3) Unscheduled draws on debt service reserves, reflecting financial difficulties;
- 4) Unscheduled draws on credit enhancements, reflecting financial difficulties;
- 5) Substitution of credit or liquidity providers, or their failure to perform;
- 6) Adverse tax opinions, IRS notices, or events affecting the tax-exempt status of the security;
- 7) Modifications to rights of security holders, if material;
- 8) Bond calls, if material;
- 9) Defeasances;
- 10) Release, substitution, or sale of property securing repayment of the securities, if material;
- 11) Rating changes;
- 12) Tender offers;
- 13) Bankruptcy, insolvency, receivership, or similar event of the obligated person;
- 14) Merger, consolidation, or acquisition of the obligated person, if material; and
- 15) Appointment of a successor or additional trustee, or the change of name of a trustee, if material

The 2010 amendments to the Rule also modified the list of voluntary event-based disclosures that may be submitted to the EMMA continuing disclosure service. A list of these voluntary event-based disclosures is provided below.

**Voluntary Event-Based Disclosures**

- Amendment to continuing disclosure undertaking
- Change in obligated person
- Notice to investors pursuant to bond documents
- Certain communications from the Internal Revenue Service
- Secondary market purchases
- Bid for auction rate or other securities
- Capital or other financing plan
- Litigation/enforcement action
- Change of tender agent, remarketing agent, or other on-going party

- Derivative or similar transaction
- Other, event-based disclosures

Although the Rule originally stated that a filing needed to be made with each Nationally Recognized Municipal Securities Information Repository (“NRMSIR”), procedures have been established for electronic filing with the new, centralized EMMA system.

The specific continuing disclosure obligations taken on by an issuer will be set out in the Continuing Disclosure Agreement. The form of a Continuing Disclosure Agreement is not prescribed by Rule 15c2-12, other than the requirement that it shall contain undertakings addressing the matters described above.

The Continuing Disclosure Agreement usually takes the form of a “Continuing Disclosure Certificate” signed by the Governmental Issuer or other Obligated Person, or a Continuing Disclosure Agreement between the Governmental Issuer or other Obligated Person and the Bond trustee or some other disclosure agent. The Continuing Disclosure Agreement is executed in connection with the preparation for or closing of the Bond issue, and is enforceable against the signing party by the holders of the Bonds. The Continuing Disclosure Agreement will be included in the closing transcript for the issue and typically is made an appendix to or set forth substantially in full in the text of the official statement.

### Arbitrage Compliance

Tax-exempt bonds, including governmental bonds, lose their tax-exempt status if they are determined to be arbitrage bonds under Section 148 of the IRS Code. In general, arbitrage is earned when the gross proceeds of an issue are used to acquire investments that earn a yield materially higher than the yield on the bonds of the issue. For these purposes, “materially higher yield” means a yield which is at or above one-eighth of one percent above the bond yield (see Treasury Regulation § 1.148-2(d)(2) for exceptions to this general rule).

Note that investment yield restrictions apply to both the gross proceeds of the issue and any “replacement proceeds.” Replacement proceeds include moneys held by the issuer or a substantial beneficiary of the bond issue if: (i) these amounts have sufficiently direct nexus to the issue or the governmental purpose of the issue; and (ii) the amounts invested would have been used for the governmental purpose if the bond proceeds were not used for that purpose.

However, the earning of arbitrage does not mean that the bonds are arbitrage bonds in the following three instances: (i) during a temporary period - generally 3 years for capital projects and 13 months for working capital; (ii) a part of a reasonably required reserve or replacement fund; and (iii) as a minor portion – an amount not exceeding the lesser of 5% of the sale proceeds or \$100,000.

In cases where investments exceed permitted amounts, an issuer may be allowed to make “yield reduction payments” to the U.S. Treasury. IRS Form 8038T is used for this purpose. A determination of whether an issue includes arbitrage bonds is also related to an issuer’s “reasonable expectations” at the time of sale. In many cases, violations

are the result of changing circumstances or events that can't be foreseen or controlled by the issuer.

### Rebate Requirements

If an issuer earns more from the investment of issue or replacement proceeds than is allowed under applicable regulations, the excess must be rebated to the U.S. Treasury. Institutions with outstanding tax-exempt debt (or planning to issue such debt) should retain an arbitrage consultant. The arbitrage consultant will calculate the earnings allocable to a bond issue and determine the amount, if any, of arbitrage rebate that is due. Such calculations are required to be made every 5<sup>th</sup> bond year for as long as the bond is outstanding (although some issuers ask their arbitrage consultants for an annual calculation to determine whether they have a "contingent rebate liability").

If it is determined that an issuer owes rebate, 90% of the amount due must be paid to the U.S. Treasury within 60 days of the required calculation date. Upon redemption of the bond issue, 100% of any rebate liability must be paid within 60 days. If the final rebate calculation shows that an issuer is due a refund of excess rebate payments, an issuer can request a refund using IRS Form 8038-R.

Institutions should be aware that there are three spending exceptions to the rebate requirements. A summary of these three exceptions is provided below.

#### **Rebate Spending Exceptions**

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6-month Spending Exception [Section 1.148-7(c)]	If the gross proceeds of the bond issue are allocated to expenditures for governmental or qualified purposes that are incurred within 6 months after the date of issuance.
18-month Spending Exception [Section 1.148-7(d)]	If the gross proceeds of the bond issue are allocated to expenditures for governmental or qualified purposes which are incurred within the following schedule: 1) 15% within 6 months after the date of issuance; 2) 60% within 12 months after the date of issuance; and 3) 100% within 18 months after the date of issuance.
2-year Spending Exception [Section 1.148-7(e)]	With respect to construction issues financing property to be owned by a governmental entity or 501(c)(3) organization when certain available construction proceeds are allocated to construction expenditures within the following schedule: 1) 10% within 6 months after the date of issuance; 2) 45% within 12 months after the date of issuance; 3) 75% within 18 months after the date of issuance; and 4) 100% within 24 months after the date of issuance.

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### Record-Keeping

An Institution should maintain all material records and information necessary to support a municipal bond issue's compliance with Section 103 of the Internal Revenue Code. In a tax-exempt bond transaction, it is the bondholder that files an annual tax return that

represents that his investment earnings are exempt from federal (and, often, state) income taxation. However, to ensure the continued exclusion of interest by the beneficial holders, the issuer, the conduit borrower (if any), and other participants must retain sufficient records of the transaction to support the tax-exempt status of the bonds. If an issue is audited, IRS agents will look to these parties to provide books, records, and other information documents supporting the bonds continued compliance with federal tax requirements.

Although the required records to be retained depend on the transaction and the requirements imposed by the Code and the regulations, records common to most tax-exempt bond transactions include:

- Basic records relating to the bond transaction, including the trust indenture, loan agreements, and bond counsel opinion;
- Documentation evidencing expenditure of bond proceeds;
- Documentation evidencing use of bond-financed property by public and private sources (i.e., copies of management contracts and research agreements);
- Documentation evidencing all sources of payment or security for the bonds; and
- Documentation pertaining to any investment of bond proceeds, including the purchase and sale of securities, State and Local Government Series (SLG) subscriptions, yield calculations for each class of investments, actual investment income received the investment of proceeds, guaranteed investment contracts, and rebate calculations.

The above list is not intended to be inclusive of all materials that an issuer may need to retain. Each transaction is unique and may, accordingly, have other records that are material to the verification and preservation of tax-exempt status. The decision as to whether any particular record is material must be made on a case-by-case basis.

All records should be kept in a manner that ensures their complete access to the IRS for as long as they are material. While this is typically accomplished through the maintenance of hard copies, taxpayers may keep their records in an electronic format if certain requirements are satisfied. Revenue Procedure 97-22, 1997-1 C.B. 652 provides guidance to taxpayers who maintain books and records by using an electronic storage system that either images their hardcopy (paper) books and records, or transfers their computerized books and records, to an electronic storage media.

Section 1.6001-1(e) of the Regulations provides that records should be retained for as long as the contents thereof are material in the administration of any internal revenue law. With respect to a tax-exempt bond transaction, the information contained in certain records supports the exclusion from gross income taken at the bondholder level for both past and future tax years. Therefore, as long as bondholders are excluding from gross income the interest received due to their ownership of the tax-exempt bonds, certain

bond records will be considered material. Similarly, in a conduit financing, the information contained in the bond records is necessary to support the interest deduction taken by the conduit borrower for both past and future tax years for its payment of interest on the bonds.

Generally, these material records should be kept for as long as the bonds are outstanding, plus three years after the final redemption date of the bonds. This rule is consistent with the specific record retention requirements under section 1.148-5(d)(6)(iii)(E) of the arbitrage regulations. Institutions should be aware that other federal, state, or local record retention requirements may also apply.

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## Appendix A

### Sources of Information

There are a number of resources available to Institutions that want additional information on the rules and regulations referenced in this document. Of course, bond counsel and special tax counsel are the best sources for clear interpretations of how these rules and regulations may affect the tax status of a particular bond issue and Institutions are encouraged to seek their professional advice when needed.

However, it is useful for Institutions that issue debt to have a basic understanding of the rationale behind these rules. For applicable Internal Revenue Service Rules and Regulations, the best source is [www.irs.gov/bonds](http://www.irs.gov/bonds). At this site, users can access the “Tax Exempt Bond Community” page, a resource that contains useful articles, summaries, and the latest IRS Releases. Another useful site is the MSRB home page ([www.msrb.org](http://www.msrb.org)), which contains information about regulation of firms that deal in municipal bonds, municipal notes, and other municipal securities. Helpful continuing disclosure information is available on the Electronic Municipal Market Access (EMMA) page ([www.emma.msrb.org](http://www.emma.msrb.org)).

## **Appendix B**

### **Definitions**

#### **Allocation of Proceeds**

The proceeds of a governmental bond issue must be allocated among the various expenditures or other purposes of the issue in a manner demonstrating compliance with the private activity bond tests. These allocations must generally be consistent with the allocations made for determining compliance with the arbitrage yield restriction and rebate requirements discussed in this publication, as well as other federal tax filings.

#### **Arbitrage Rebate/Yield Reduction Filing Requirements—Form 8038-T**

Issuers of tax-exempt bonds must file IRS Form 8038-T (“Arbitrage Rebate and Penalty in Lieu of Arbitrage Rebate”), to make the following types of arbitrage payments: 1) yield reduction payments; 2) arbitrage rebate payments; 3) penalty in lieu of rebate payments; 4) the termination of the election to pay a penalty in lieu of rebate; and 5) penalty for failure to pay arbitrage rebate on time. A yield reduction payment and/or arbitrage rebate installment payment is required to be paid no later than 60 days after the end of every 5th bond year throughout the term of a bond issue. The payment must be equal to at least 90% of the amount due as of the end of that 5th bond year. Upon redemption of a bond issue, a payment of 100% of the amount due must be paid no later than 60 days after the discharge date. A failure to timely pay arbitrage rebate will be treated as not having occurred if the failure is not due to willful neglect and the issuer submits a Form 8038-T with a payment of the rebate amount owed, plus penalty and interest. The penalty may be waived under certain circumstances. For more information, see section 1.148-3(h)(3) of the Treasury regulations.

#### **Deliberate Actions**

A deliberate action is any action taken by the issuer that is within its control. A governmental bond issue can lose its tax-exempt status if the issuer takes a deliberate action, subsequent to the issue date, which causes the issue to become a private activity bond issue. Intent to violate the requirements of section 141 of the Code is not necessary for an action to be deliberate.

#### **Federal Guarantees - Prohibition**

Section 149(b) of the Code provides that a tax-exempt bond, including a governmental bond, will not be treated as tax-exempt if the payment of principal or interest is directly or indirectly guaranteed by the federal government or any instrumentality of the federal government. Exceptions to this general rule include guarantees by certain quasi-governmental entities administering federal insurance programs for home mortgages and student loans. Additional exceptions apply for the investment of bond proceeds in U.S. Treasury securities or investments in a bona fide debt service fund, a reasonably required reserve or replacement fund, or during a permitted initial temporary period.

## **Governmental Bond**

A governmental bond is issued as part of an issue, no portion of which consists of private activity bonds. Section 141 of the IRS Code sets forth private activity bond tests for the purpose of limiting the volume of tax-exempt bonds that finance activities of persons other than state and local governmental entities. These tests serve to identify arrangements that actually or reasonably expect to transfer the benefits of tax-exempt financing to nongovernmental persons (including the federal government).

## **Intentional Acts**

A deliberate, intentional action to earn arbitrage taken by the issuer or person acting on the issuer's behalf, after the issue date, will cause the bonds of an issue to be arbitrage bonds if that action, had it been reasonably expected on the issue date, would have caused the bonds to be arbitrage bonds. Intent to violate the requirements of section 148 is not necessary for an action to be intentional.

## **Management and Service Contracts**

Management contracts between government entities and certain private parties under which private parties receive compensation for services provided with respect to a bond-financed facility may result in a loss of the tax-exempt status of the bonds as a result of satisfying the private business tests. However, the IRS has provided safe harbors regarding management service contracts between a for-profit entity and a government entity when such service is provided in connection with a bond-financed facility. (For more information, see Appendix C – "Revenue Procedure 97-13").

## **Private Activity Bond**

A bond issue is an issue of private activity bonds (and not tax-exempt governmental bonds) if the issuer reasonably expects, on the issue date, that either: 1) the private business use test and the private payment or security test will be met; or 2) the private loan financing test will be met.

## **Private Business Use Test**

This test is met if more than 10% of the proceeds of an issue will be used for any private business use. In applying this test, bond proceeds can be used to finance the working capital expenditures of a government entity.

### Indirect Use

Indirect uses of proceeds must also be considered in determining whether more than 10% of the proceeds of an issue will be used in a private business use. For example, a facility is treated as being used for a private business use if it is leased to a nongovernmental person and then sub-leased to a governmental person, if the nongovernmental person's use is in a trade or business.

## Trade or Business Use

Use of bond proceeds or bond-financed property by a nongovernmental person in furtherance of a trade or business activity is considered nonqualified private business use for tax-exempt bond purposes. Any activity carried on by a person (including a governmental entity or corporation) other than a natural person (individual acting as a member of the general public) is treated as a trade or business.

## **Private Loan Financing Test**

This test is met if the lesser of 5% of proceeds of the issue or \$5 million is to be used (directly or indirectly) to make or finance loans to persons other than governmental entities.

## **Reasonable Expectations**

Typically, the determination of whether an issue consists of arbitrage bonds under Section 148(a) is based on the issuer's reasonable expectations, as of the issue date, regarding the amount and use of the gross proceeds of the issue.

## **Rebate Requirements**

The rebate requirements of Section 148(f) of the Code generally provide that interest earnings from the investment of bond issue proceeds that exceed the bond yield (by more than allowable amounts) must be rebated to the U.S. Treasury. Failure to rebate these earnings may cause the bonds of an issue to be arbitrage bonds. Certain temporary periods exist that allow unrestricted earnings (see "Spending Exceptions" below).

## **Remedial Actions**

An issuer may take a remedial action prescribed in Section 1.141-12 of the Treasury regulations to cure a deliberate action that would otherwise cause a governmental bond issue to become a private activity bond issue. Such remedial actions include redemption or defeasance of bonds, alternative use of disposition proceeds, and alternative use of bond-financed facilities.

## **Research Agreements**

Generally, certain agreements, where private entities sponsor research through government entities that benefit from tax-exempt bond financing, may result in a violation of the private business tests. However, the IRS has provided safe harbors applicable to such research agreements. (For more information, see Appendix D – "Revenue Procedure 2007-47").

## **Small Issuer Exception**

This exception provides that governmental bonds issued by certain small governmental issuers, with general taxing powers, are treated as meeting the arbitrage rebate requirement. A governmental entity has general taxing powers if it has the power to impose taxes of general applicability which, when collected, may be used for its general purposes.

An issue (other than a refunding issue) qualifies for the small issuer exception only if the issuer reasonably expects as of the issue date to issue, or in fact issues, \$5 million or less in tax-exempt governmental bonds during that calendar year. The aggregation rules of Section 148(f)(4)(D) of the Code should be considered when determining whether this exception applies. The \$5 million limit shall be increased when financing public school capital expenditures by the lesser of \$10 million or so much of the aggregate face amount of the bonds attributable to financing the construction.

## **Spending Exceptions**

The three spending exceptions to the rebate requirements are delineated on page 11. Note: Issuers may still owe rebate on amounts earned on non-purpose investments allocable to proceeds not covered by one of the spending exceptions, which may include earnings in a reasonably required reserve or replacement fund.

## **Request for Recovery of Overpayment of Arbitrage Rebate—Form 8038-R**

In general, a request for recovery of overpayment of arbitrage rebate can be made when the issuer can establish that an overpayment occurred. An overpayment is the excess of the amount paid to the U.S. Department of the Treasury for an issue under Section 148 of the Code over the sum of the rebate amount for the issue as of the most recent computation date and all amounts that are otherwise required to be paid under Section 148 as of the date the recovery is requested. The request can be made by completing and filing IRS Form 8038-R, "Request for Recovery of Overpayments Under Arbitrage Rebate Provisions", with the IRS.

## **Yield Restriction Requirements**

The yield restriction rules of Section 148(a) of the Code generally provide that the direct or indirect investment of the gross proceeds of an issue in investments earning a yield materially higher than the yield of the bond issue causes the bonds of that issue to be arbitrage bonds. However, the investment of proceeds in materially higher yielding investments does not cause the bonds of an issue to be arbitrage bonds in the following three instances: 1) during a temporary period (i.e., generally, 3-year temporary period for capital projects and 13 months for restricted working capital expenditures); 2) as part of a reasonably required reserve or replacement fund; and 3) as part of a minor portion (an amount not exceeding the lesser of 5% of the sale proceeds of the issue or \$100,000).

In many instances, issuers are allowed to make “yield reduction payments” to the U.S. Department of the Treasury to reduce the yield on yield-restricted investments when the yield on those earnings is materially higher than the yield of the bond issue (see definition of “Arbitrage Rebate/Yield Reduction Filing Requirements—Form 8038-T” above).

## Appendix C

### SAFE-HARBOR MANAGEMENT CONTRACT GUIDELINES REV. PROC. 97-13

#### General Rule

A contract between a state or local governmental unit or a section 501(c)(3) organization (a "Qualified User") and a non-exempt provider (a "Provider") for the management of, or services rendered at, or incentive payment in respect of, a Tax-Exempt bond-financed facility that meets the safe-harbor guidelines of Rev. Proc. 97-13 as summarized below and does not otherwise give the Provider an ownership or leasehold interest in bond-financed property for federal income tax purposes is treated as not creating any private business use under section 141(b) or 145(a)(2)(B) of the Internal Revenue Code (the "Code"). In addition, if the guidelines are met, the burden to prove that the contract creates impermissible private activity would shift to the Internal Revenue Service ("IRS") in a tax court proceeding. All contracts must be reviewed on a case-by-case basis.

#### General Requirements

1. *Reasonable Compensation and No Net Profits.* The compensation must be reasonable and no portion of the compensation paid to the Provider may in any event be based on net profits derived from the bond-financed facility. However, a compensation that is based on a percentage either of gross revenues or of expenses (but not both) is permitted. Reimbursement for actual and direct expenses paid by the Provider to unrelated persons is not by itself treated as compensation.
2. *No Penalty if Required to be Cancelable.* Whenever a contract is required to be cancelable as described below, it must be possible to cancel it without penalty imposed on the Qualified User. A "penalty" means: (a) any limitation on the Qualified User's right to compete with the Provider; (b) any requirement that the Qualified User purchase equipment, goods or services from the Provider; or (c) any requirement that the Qualified User pay liquidated damages for cancellation of the contract. A requirement that the Qualified User reimburse ordinary and necessary expenses of the Provider or a restriction against hiring key personnel of the Provider is not a penalty. A penalty may exist where provisions of another contract between the Provider and Qualified User (e.g., a loan or guarantee) impair the practical ability of the Qualified User to terminate the service contract for example by automatically terminating when the service contract terminates.
3. *No Role or Relationship between Qualified User and Provider.* There must not be any role or relationship between the Qualified User and the Provider that would substantially limit the Qualified User's ability to exercise its rights under the contract, including cancellation rights. This requirement is considered satisfied if (a) not more than 20% of the voting power of the governing board of the Qualified User is vested in the 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 Provider are not “related persons” within the meaning of §1.150-1(b) of the Regulations.

### Permitted Contract Term and Compensation Arrangements

The contract term (which includes renewal options) and the compensation arrangements must meet one of the following five requirements:

<b><u>Contract Maximum Term Limit</u></b>	<b><u>Permissible Compensation Arrangements</u></b>
1. Lesser of 15 years (20 years for public utility property) or 80% of the reasonably expected useful life of the bond-financed property. No cancellation right required.	1. At least 95% of compensation for each annual period must be based on a periodic fixed fee. A one-time productivity award is permitted.
2. Lesser of 10 years (20 years for public utility property) or 80% of the reasonably expected useful life of the bond-financed property. No cancellation right required.	2. At least 80% of compensation for each annual period must be based on a periodic fixed fee. A one-time productivity award is permitted.
3. 5 years, cancelable by the Qualified User at the end of 3 years without penalty.	3. At least 50% of compensation for each annual period must be based on a periodic fixed fee or, alternatively, 100 percent must be based on a capitation fee or any combination of periodic fixed fees and capitation fees.
4. 3 years, cancelable by the Qualified User at the end of 2 years without penalty.	4. 100% of compensation may be based on a per-unit fee stated in the contract or otherwise specifically limited by the governmental service recipient or an independent third party (e.g., Medicare reimbursement formulas). Alternatively, 100 percent of compensation may be based on any combination of periodic fixed fees and per-unit fees.
5. 2 years, cancelable by the Qualified User at the end of 1 year without penalty.	5. 100% of compensation may be based on a percentage of the fees charged at the bond-financed facility except that, during the start-up period of the facility, it may be based on either gross revenues, gross revenues adjusted for bad debt or similar allowances or the expenses of the facility. This compensation arrangement is available only (i) with respect to facilities providing services to third parties (e.g., radiology, facilities) or (ii) during an initial start-up period during which operations have been insufficient to permit a reasonable estimate of annual gross revenues.

## Definitions of Permissible Compensation Arrangements

1. *Periodic Fixed Fee* is a stated dollar amount for services rendered for a specified period of time. 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 (e.g., 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).
2. *Capitation Fee* is a fixed periodic amount payable for each person for whom services are provided (e.g., an HMO member) as long as the quantity and type of services actually provided vary substantially from person to person. A capitation fee may include a variable component of up to 20% of the total capitation fee designed to protect the Provider against risks such as catastrophic loss.
3. *Per-Unit Fee* is a stated amount for each unit of services provided (e.g., medical procedure performed, car parked, passenger mile traveled, ton of waste incinerated, unit of landfill capacity consumed).
4. *Productivity Award* is a stated dollar amount of additional compensation based on increases or decreases in gross revenues or reductions in total expense target (but not both) in any annual period during the term of a contract.

## Revision and Renewal of Management Contract

If the compensation arrangements of a management contract are materially revised, the requirements for compensation arrangements 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.

A renewal option is a provision under which the 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).

## Certain Exceptions

Certain arrangements generally are not treated as management contracts that are subject to the above rules. These include:

- (a) contracts for services that are solely incidental to the primary governmental function or functions of a bond-financed facility (e.g., 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 Section 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.

## APPENDIX D

### SAFE-HARBOR RESEARCH AGREEMENT GUIDELINES REV. PROC. 2007-47

#### **General Rule.**

An agreement between a State or Local Governmental Unit or a Section 501(c)(3) organization and a private sponsor for the performance of research by such unit or organization at a tax-exempt bond-financed facility that meets the safe-harbor guidelines of Rev. Proc. 2007-47 as summarized below is treated as not creating any private business use under Section 141(b) or 145(a)(2)(B) of the Internal Revenue Code (the "Code"). In addition, if the guidelines are met, the burden to prove that the contract creates impermissible private activity would shift to the Internal Revenue Service ("IRS") in a tax court proceeding. All agreements must be reviewed on a case-by-case basis.

#### **Background - Research Agreements and Tax-Exempt Financing**

Federal tax law imposes certain restrictions on the use of property financed with tax-exempt bonds, as well as, the payment source and security for such bonds. In general, interest on a State or local bond is excluded from the gross income of a bondholder thereby exempting it from federal income taxation. However, if a State or local bond is determined to be a "private activity bond," the bondholder does not have a right to such exclusion and the interest on the bond is subject to taxation. A private activity bond is any bond issued as part of an issue that meets both the private business use test and the private security or payment test.

The restrictions on private use, payments and security are applicable to State or local bonds (i.e., tax-exempt bonds) issued by States and political subdivisions thereof ("governmental units") primarily for their own benefit ("governmental bonds"). Such restrictions, among others, also apply to tax-exempt bonds that primarily benefit organizations exempt from federal income taxation and described in Section 501(c)(3) of the Code ("exempt organizations") and are issued by either governmental units or entities that issue tax-exempt bonds on behalf of governmental units ("501(c)(3) bonds").

With respect to governmental bonds, 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. With respect to 501(c)(3) bonds, an issue generally meets the private business use test if more than 5 percent of the proceeds of the issue are to be used for any private business use. Private business use means direct or indirect use in a trade or business carried on by any person other than a governmental unit. The term "governmental person" means a state or local governmental unit or any instrumentality thereof. Governmental person does not include the United States or any agency or instrumentality thereof.

In general, 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.

For over a decade, IRS Revenue Procedure 97-14 ("Rev. Proc. 97-14") set forth conditions under which a research agreement does not result in private business use. IRS Revenue Procedure 2007-47 ("Rev. Proc. 2007-47"), which was released June 26, 2007, modifies and supersedes Rev. Proc. 97-14 by (1) modifying the operating guidelines on cooperative research agreements to include agreements regarding industry or federally sponsored research with either a single sponsor or multiple sponsors and (2) providing special rules for applying the revised operating guidelines to federally sponsored research.

### **Federal Government Rights under the Bayh-Dole Act**

- The Patent and Trademark Law Amendments Act of 1980, as amended (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.
- 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 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, which include promoting the utilization and public availability of inventions arising from federally supported research and development programs.
- The new rules in Rev. Proc. 2007-47 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 the revised operating guidelines, upon satisfaction of the new rules. 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 new 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-in rights.

## Definitions

- Basic research 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.
- Qualified user means any state or local governmental unit 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. The term does not include the United States or any agency or instrumentality thereof.
- Sponsor means any person, other than a qualified user, that supports or sponsors research under a contract.

## Permitted Sponsored Research Agreement Arrangements.

- *Corporate-sponsored research.* A research agreement relating to property used for basic research supported or sponsored by a sponsor does not result in private business use, if:
  - 1) 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
  - (2) 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.

- *Industry or federally-sponsored research agreements.* A research agreement relating to property used pursuant to an industry or federally-sponsored research arrangement does not result in private business use, if the following requirements are met (taking into account certain “special rules” for 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.
- *Special Rules:* Federal Government rights under the Bayh-Dole Act. In applying the operating guidelines on industry and federally-sponsored research agreements to federally sponsored research, the rights of the Federal Government and its agencies mandated by the Bayh-Dole Act will not result in private business use, provided that (2) and (3) above 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 Rev. Proc. 2007-47, provided that the qualified user determines the subject and manner of the research, the qualified user retains exclusive title to any patent or other product of the research, 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.

#### **Effective Date**

- Rev. Proc. 2007-47 is effective for any research agreement entered into, materially modified, or extended on or after June 26, 2007.