



Post Bond Issuance Compliance

Training For Managers of Bond-Funded Programs





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Overview



Purpose of Training

- Identify agency/capital program manager roles and responsibilities as they relate to:
 - Bond issuance (program descriptions, spending projections, private management contracts)
 - Managing project spending and use of bond proceeds
 - Records retention
- Review federal tax law and state law requirements with respect to tax-exempt bonds
- Demonstrate how your activities can help the State ensure compliance



What is Post-Bond Issuance Compliance?

- Compliance with federal tax law:
 - Use of bond proceeds
 - Use of private management contracts
 - Change of use and disposition of bond-financed property/facilities
 - Arbitrage and investment of bond proceeds and reserve funds
 - Written compliance policies and procedures
 - Records retention
- Compliance with State law:
 - Use of bond proceeds
 - Grant and use agreements
 - Use and disposition of bond-financed property/facilities
- If in conflict, the more stringent law applies



Federal Tax Law

- Federal tax law requirements for tax-exempt bonds summed up in simple everyday terms:
 - Don't issue too much
 - Don't issue too soon
 - Borrow for qualified capital expenditure
 - Borrow for a governmental purpose



Questions Answered by Federal Tax Law

- What is a qualified capital expenditure?
- Can I administer my capital program using tax-exempt bond proceeds?
- Can tax-exempt bond proceeds be used to reimburse prior capital spending (from cash or other non-bond proceeds)?
- What is arbitrage, spend-down, and rebate?



Why Worry About Post-Issuance Compliance?

- Tax-exempt municipal bonds provide a vehicle for the State to finance capital projects at low interest rates
- The federal government estimates that revenues lost due to the municipal bond tax-exemption total \$37 billion. In their view this is a major drain on the U.S. Treasury
- Consequences of non-compliance with federal law can include:
 - Costly penalties to preserve tax-exempt status
 - Loss of tax-exempt status on the bonds
 - Lost income to bondholders who will file lawsuits
 - Reduced market access
 - Negative impact on credit ratings



IRS Actively Audits Tax-Exempt Bonds

- Burden of proof is on the issuer and recordkeeping is critical
- Auditing rigor and frequency, sometimes many years after the issuance date, is increasing
- What to expect if you are involved in an audit
 - Work with issuer, such as the OPFC or Treasurer of State
 - Significant time commitment due to short turnaround
 - Information document requests for detailed records
- Voluntary Closing Agreement Program (VCAP)
 - State identified violations may be remedied through this negotiated process
 - Key is notifying IRS before discovery via an audit



Legal Authority



Legal Authority

Article VIII of the Ohio Constitution prohibits the state from incurring debt except to:

- Finance authorized capital improvements that have been approved through constitutional amendment
 - constitutional amendments authorize the incurrence of debt for specific purposes
 - Examples: Higher Education, Common Schools, Third Frontier R&D, Prisons, Parks and Recreation, and Highway
 - Capital projects must fit within one of these Constitutional purposes
- Defend the state in time of war or rebellion
- Fund casual deficits not to exceed \$750,000



Legal Authority

Statutory Implementation

- The Ohio Revised Code (ORC) implements the authorized programs, such as creating bond funds, debt service funds, and appropriations

Legal Opinion

- Bond counsel must give an opinion that the bonds are legal and valid obligations for each bond sale

Capital Bill

- General Assembly usually passes a two-year capital bill every even-numbered year
- OBM projects the affordable size of future capital bills



State Law Authorization

Constitutional & Statutory Authorization/Purposes

- Elementary and Secondary Public Schools (Art. VIII, Sec. 2n; ORC 151.03) – facilities for a system of common schools throughout the state
- Higher Education (Art. VIII, Sec. 2n; ORC 151.04) – facilities for state-supported and state-assisted institutions of higher education
- Mental Health Facilities (Art. VIII, Sec. 2i; ORC Ch. 154) – capital improvements for mental health and retardation
- State Office Buildings, Correctional Facilities, and Cultural & Sports Facilities (Art. VIII, Sec. 2i; ORC Ch. 154) – capital improvements for housing of branches and agencies of state government
- Parks & Recreation Facilities (Art. VIII, Sec. 2i; ORC Ch. 154) – capital improvements for parks and recreation
- Natural Resources (Art. VIII, Sec. 2i; ORC 151.05) - capital improvements for state and local parks and land and water recreation facilities; soil and water restoration and protection; land management including preservation of natural areas and reforestation; water management including dam safety, stream and lake management, and flood control and flood damage reduction; fish and wildlife resource management; and other projects that enhance the use and enjoyment of natural resources by individuals
- Conservation (Art. VIII, Sec. 2o; ORC 151.09) – conservation and preservation of natural areas, open spaces, and farmlands and other lands devoted to agriculture, including by acquiring land or interests therein; state and local park and recreation facilities, and other actions that permit and enhance the availability, public use, enjoyment of natural areas and open spaces in Ohio; and land, forest, water, and other natural resource management projects
- Coal Development (Art. VIII, Sec. 15; ORC 151.07) – for research and development of coal technology that will encourage the use of Ohio coal, to any individual, association, or corporation doing business in this state, or to any educational or scientific institution located in this state



State Law Authorization

Constitutional & Statutory Authorization/Purposes (continued)

- Research & Development (Art. VIII, Sec. 2p; ORC 151.10) – research and development in support of Ohio industry, commerce, and business, which includes research and product innovation, development, and commercialization through efforts by and collaboration among Ohio business and industry, state and local public entities, public and private education institutions, or research organizations
- Site Development (Art. VIII, Sec. 2p; ORC 151.11) – development of sites and facilities in Ohio for and in support of industry, commerce, distribution, and research and development purposes
- Local Government Infrastructure (Art. VIII, Sec. 2p/2s; ORC 151.08) – roads and bridges, waste water treatment systems, water supply systems, solid waste disposal facilities, and storm water and sanitary collection, storage, and treatment facilities, including real property, interests in real property, facilities, and equipment related to or incidental thereto
- Highway Capital Improvements (Art. VIII, Sec. 2m; ORC 151.06) – highway capital improvements
- Major New State Infrastructure (Art. VIII, Sec 13; ORC 5531.10) – any public or private transportation project, including the replacement of public or private transportation facilities and the acquisition of real or personal property; any highway, public transit, aviation, rail, or other transportation project eligible for financing or aid under any federal or state program; and any project involving any public or private highway, road, street, parkway, public transit, aviation, or rail project
- Veterans Compensation (Art. VIII, Sec. 2r) – to provide compensation to veterans of the Persian Gulf, Afghanistan, and Iraq
- Certificates of Participation (COPs) (Uncodified Law): MARCS, TMS, EDCS, OAKS, STARS, BCIRS



Related Agreements

- Related agreements often extend tax compliance obligations to grantee or other recipients of bond proceeds over the term of the bond issue
- If the user/owner of the facility does not own the facility site, capital bills require either long-term lease of the site or long term agreement with non-profit organization sharing in the benefits of the project
- Examples of related agreements include:
 - DHE joint use agreements
 - DNR and SFC grant agreements
 - CFC cooperative agreements
 - OPWC grant and loan agreements
 - MHA/DDD agreements/mortgages
 - Other grant and loan agreements
- Include requirements/covenants for continuing public use (no private use) through the final maturity of the bonds



Capital Expenditures: Federal and State Law Requirements

Qualified Capital Expenditures under Federal Tax Law



- Qualified capital expenditures defined:
 - Any cost properly chargeable to a capital account (or would be chargeable with a proper election) under general federal income tax principles
- Examples include :
 - Traditional land/real estate
 - Buildings, facilities, and structures
 - Furniture, fixtures, and equipment
 - Certain operational activities if incurred in research and development
- When in doubt, ask the bond issuer (OPFC or TOS)

Non-Qualified Capital Expenditures

What is not a qualified capital expenditure:

- General maintenance
- Repair costs that do not extend the life of the asset
- Working capital, such as administrative or operational expenses





Administrative Spending

- Federal law limits expenditures for program administration (“working capital”) to no more than 5% of the bond proceeds and provided costs are directly related to the bond-funded capital program
- Directly related costs may include:
 - Salaries and related personnel expenses
 - Technical review
 - Processing of disbursements
 - Directly related expenses that cannot be capitalized
- State law also limits administrative charges and may be more restrictive than federal tax law
- Engineering, architectural, and planning costs of capital-related work, including feasibility studies are qualified capital expenditures (not administrative)



Reimbursements

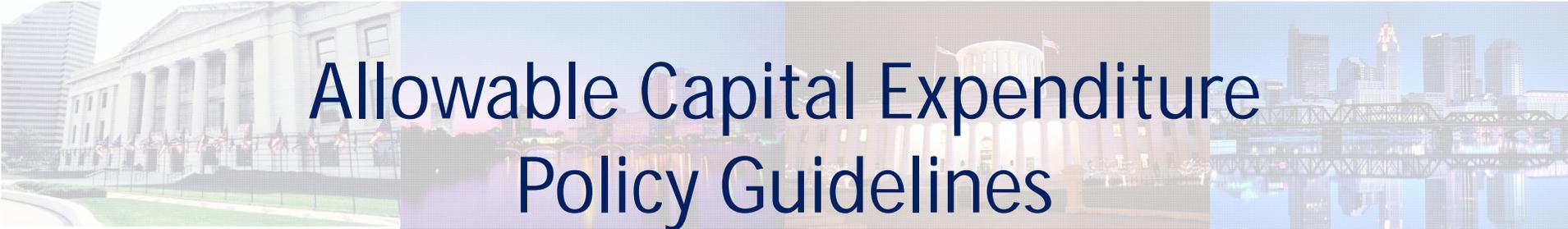
- Federal tax law requirements to use bond proceeds to reimburse a prior capital expenditure include:
 - Within 60 days of the expenditure, demonstrated/documentated official intent to seek reimbursement (typically through the bond issuer)
 - Reimbursement is completed within 18 months of the date of the original spend or within 18 months of a clear placed in service date, (but never more than 3 years from the date of the original spend)
 - Reimbursed amount must be for a qualified capital expenditure
- Project specific capital appropriations may serve as official intent
- State has also developed a form that can be used to document official intent



State Allowable Capital Costs

Each capital bill also sets forth limitations on use of capital appropriations:

- Acquisition of real property or interests in real property;
- Buildings and structures including their internal systems and utilities;
- Directly related architectural, engineering, and professional expenses;
- Machinery that is part of the structure initially;
- New computer systems including integration of new systems with existing system, but excluding costs of ongoing maintenance or support agreements; and
- Furniture, fixtures, or equipment with a useful life of at least five years, a unit cost of about \$100 or more and is directly related to and necessary for the function of the project or essential to bringing it to its intended use



Allowable Capital Expenditure Policy Guidelines

OBM publishes Allowable Capital Expenditure Guidelines to ensure compliance with state law and federal tax law:

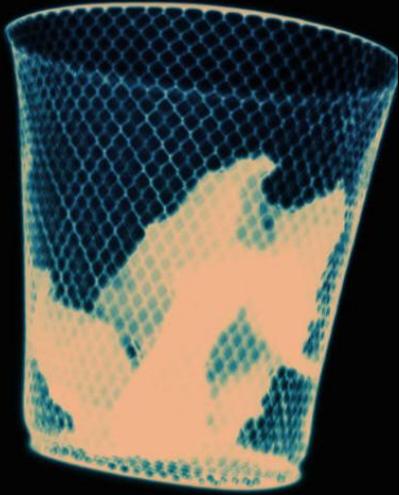
- Allowable/Non-Allowable Equipment and Furnishings
- Maintenance/Repairs versus Renovations
 - Maintenance includes a recurring activity necessary to maintain the operation, functionality, appearance or safety of a piece of equipment, building or structure
 - Repairs fix a known problem and do not qualitatively improve the performance or extend the original useful life of an asset
 - Maintenance and repairs generally includes any project with the objective of retaining or restoring an asset back to its original intended use or state
 - Renovations are more extensive enhancements, upgrades or replacements of buildings, structures or systems
- Lease, Lease-Purchase and Installment Purchases
- Information Technology (IT) System Projects
 - Allowable Hardware, Software, and Personnel Expenses
 - Non-Allowable Training, Maintenance, Software, and Personnel Expenses



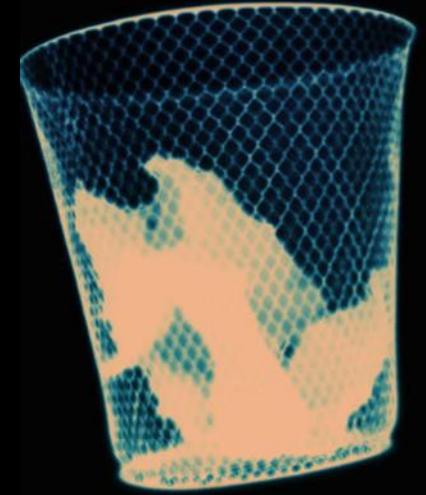
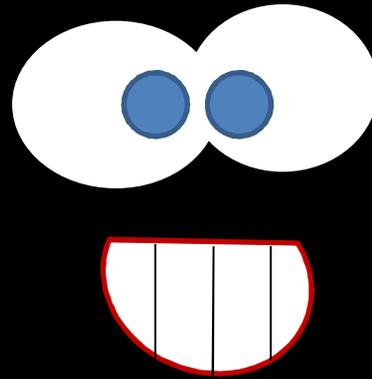
Capital Expenditures for Research and Development Projects

Research and development project expenditures

- Third Frontier, Coal Development, and certain Higher Education projects
- Conducting research and developing products, including business “start-up” expenditures, may qualify as capital expenditures
 - Salaries and rent, generally considered administrative/working capital under federal tax law, are treated as capital expenditures when incurred in conducting research or developing products
- Non-qualified research and development expenditures
 - Projects that fund the commercialization or business development stage of research are not considered “qualified” under federal tax law and must be funded from proceeds of federally *taxable* bonds

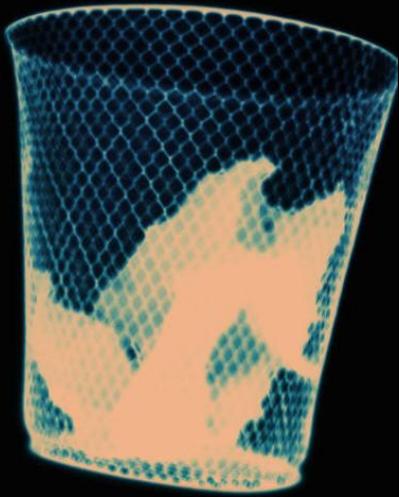


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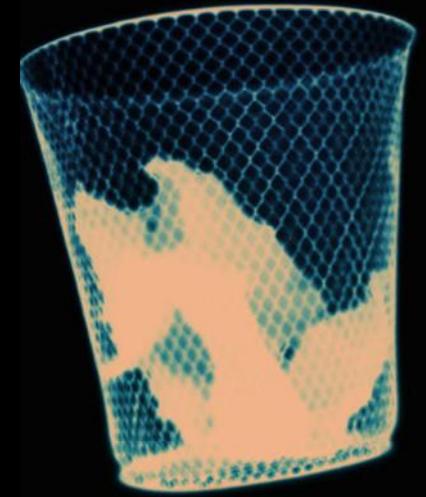
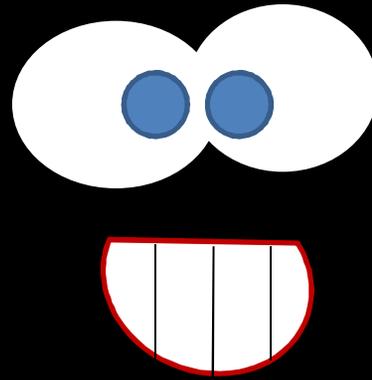


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Heating and air conditioning
system for new building

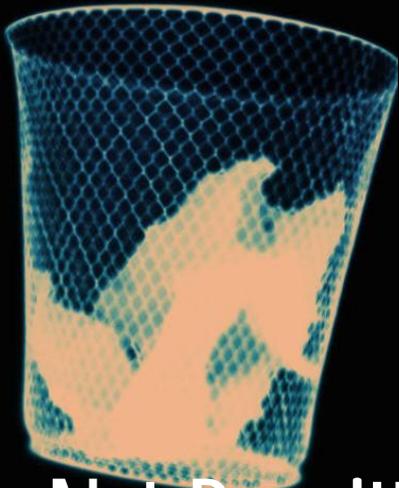


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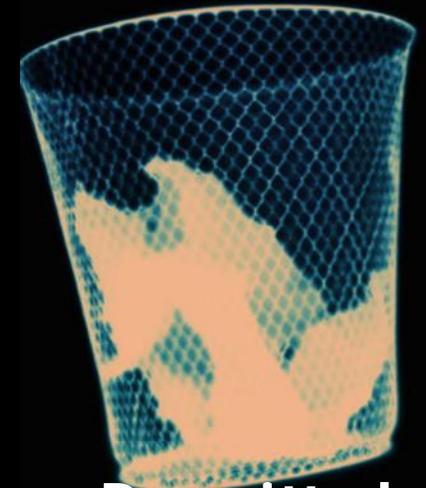
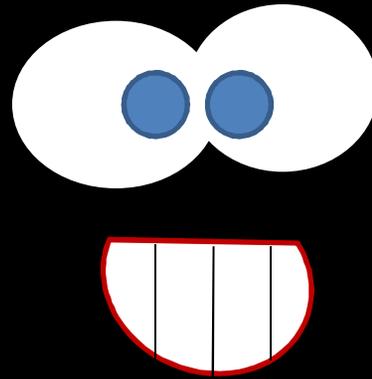


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Replacing a facility's
existing air conditioning system
with a new cooling system

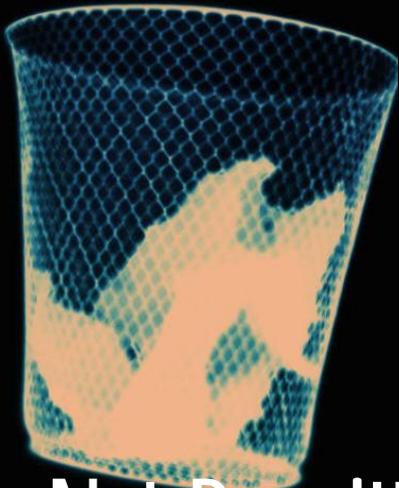


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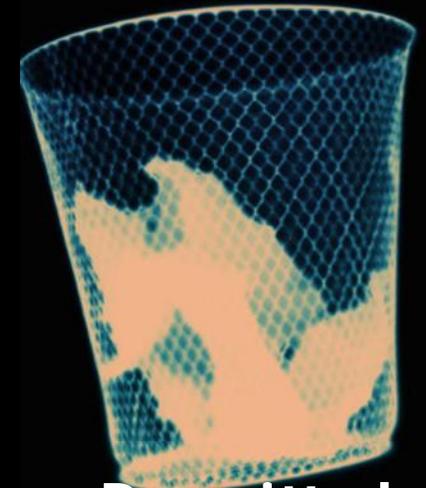
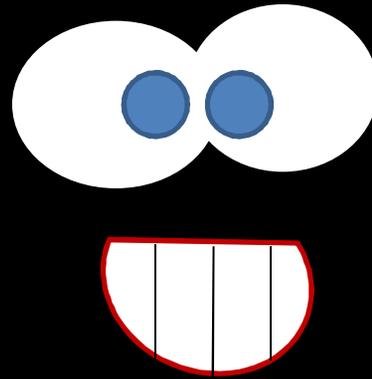


Permitted

Perform maintenance/repair
the building's existing heating
and cooling system

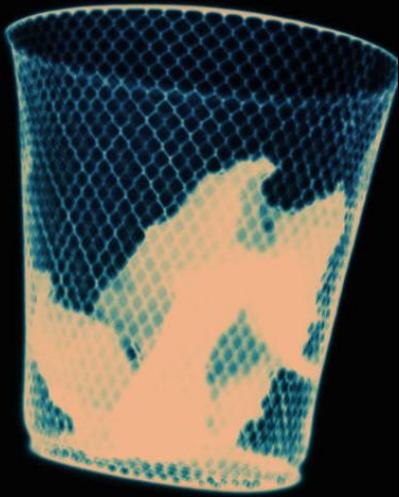


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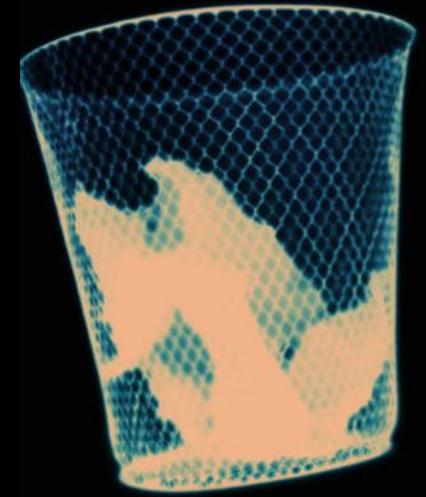
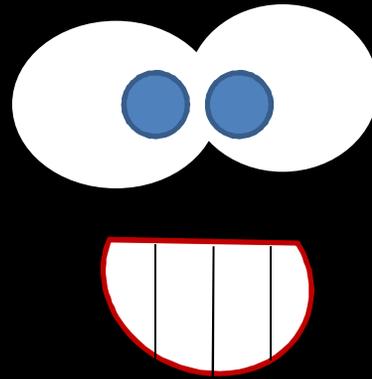


Permitted

Remove and replace weather sealants on building's exterior

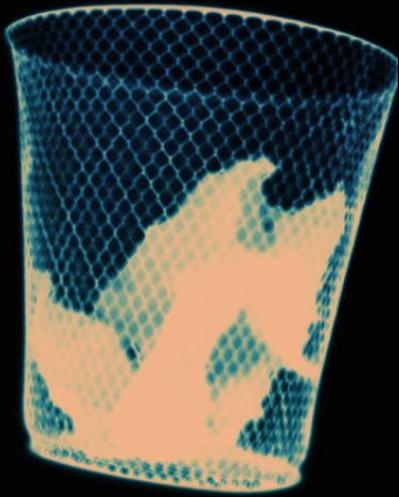


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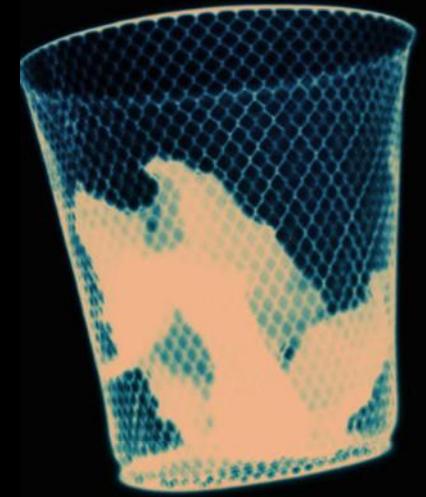
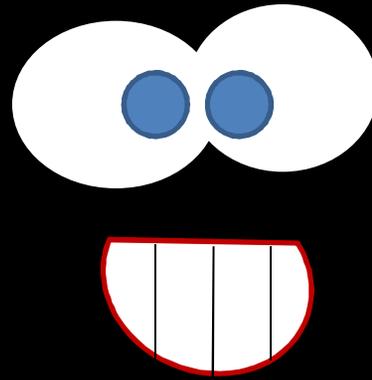


Permitted

Purchase new tables to replace
damaged/worn-out tables in a
correctional facility dining hall

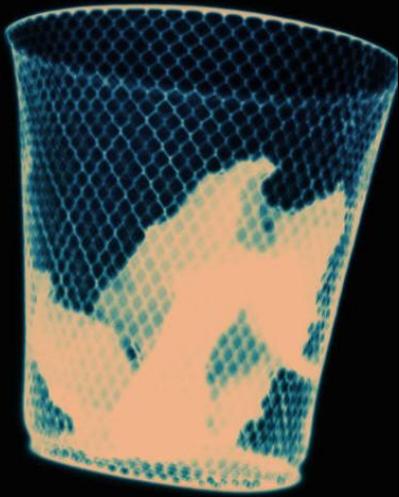


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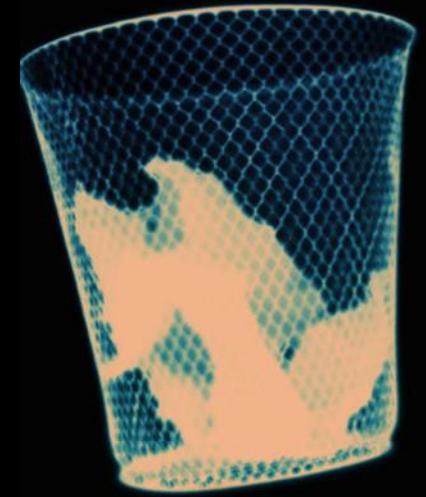
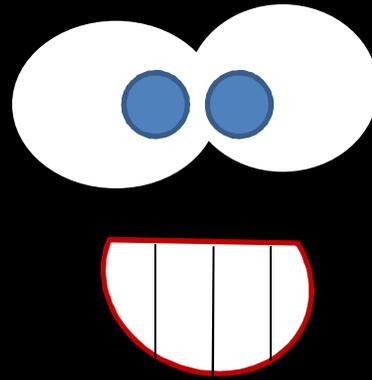


Permitted

Repair damage to dining room
tables in correctional facility
dining hall

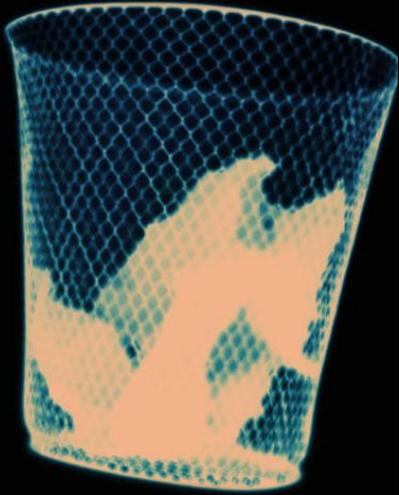


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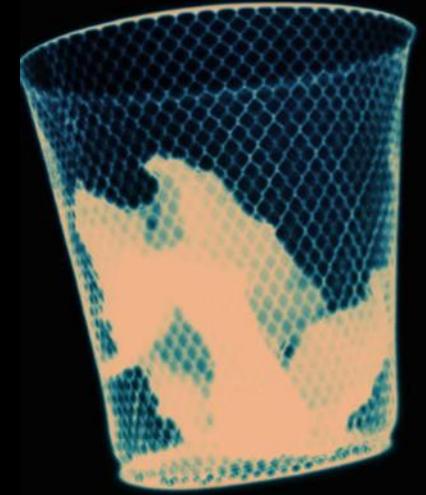
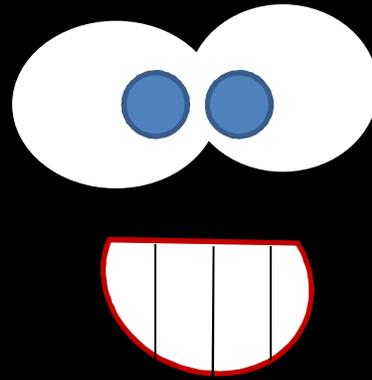


Permitted

Replace windows with new
energy efficient windows.

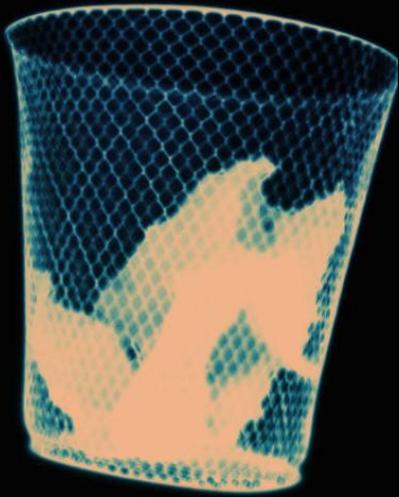


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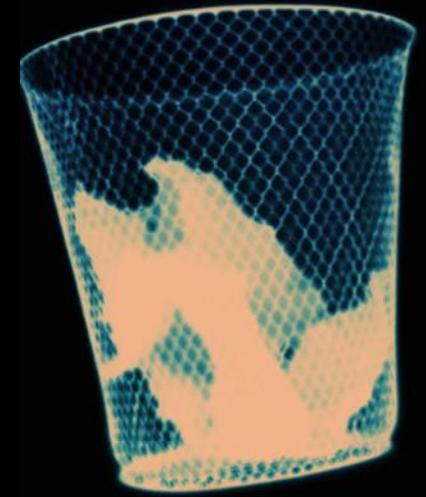
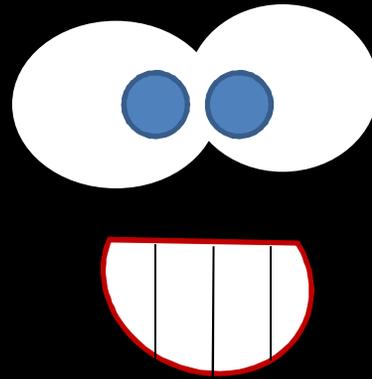


Permitted

Fire extinguisher
replacement throughout a
building

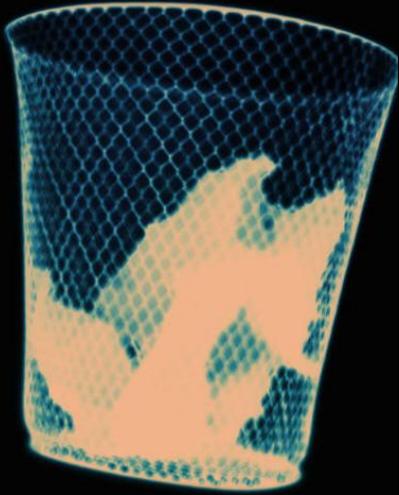


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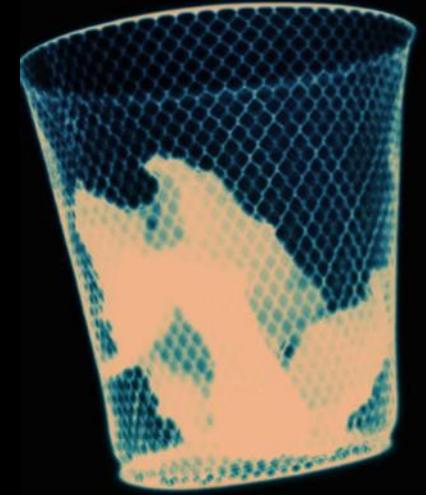
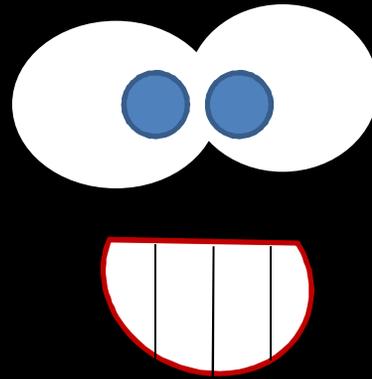


Permitted

Purchase of a tractor used
for lawn mowing and snow
removal at a state institution

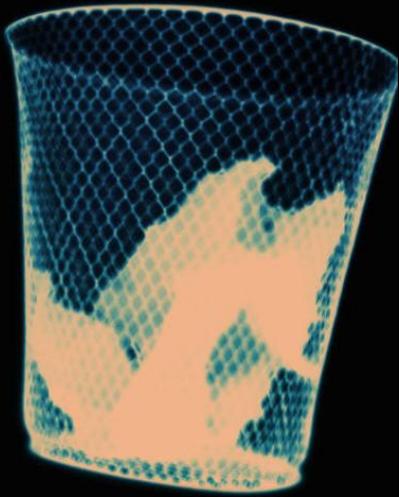


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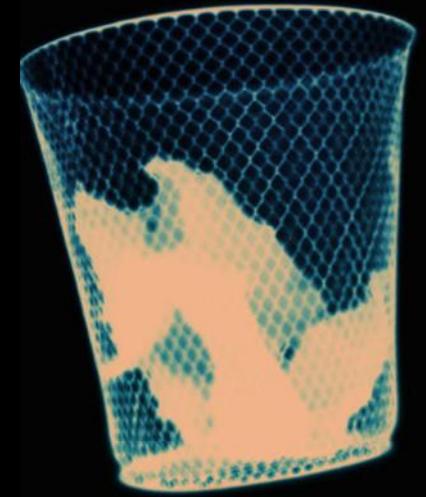
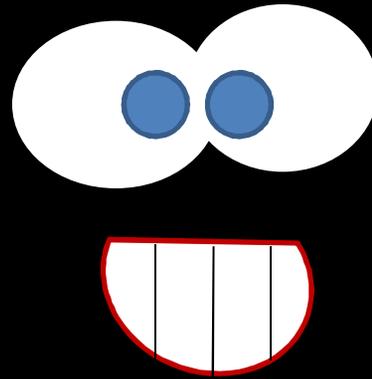


Permitted

Lawn Maintenance Contract

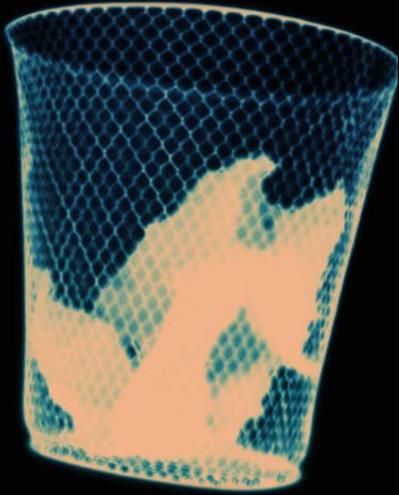


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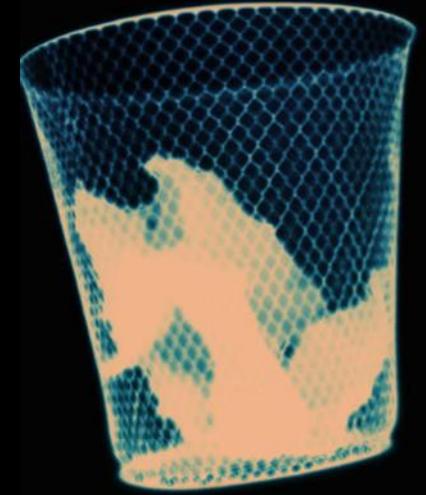
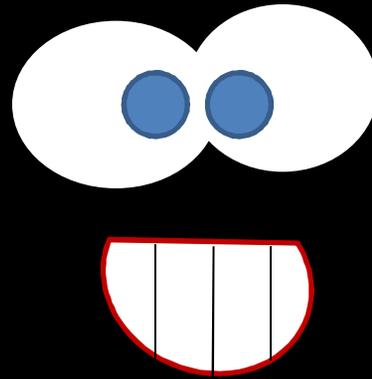


Permitted

Hardware maintenance
contract for statewide
computer system

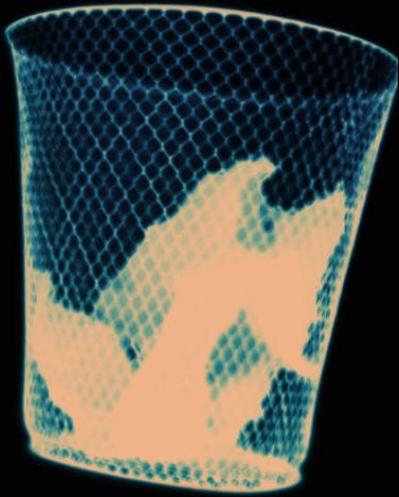


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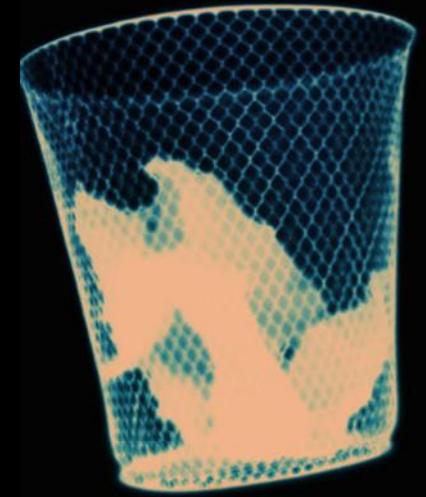
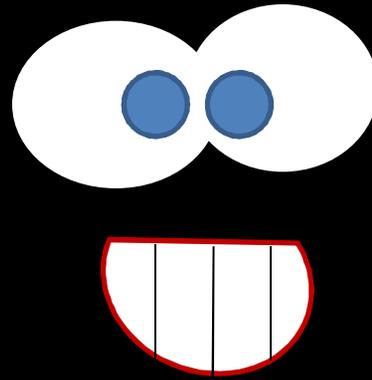


Permitted

Working capital (e.g.,
administrative/operational
expenses)

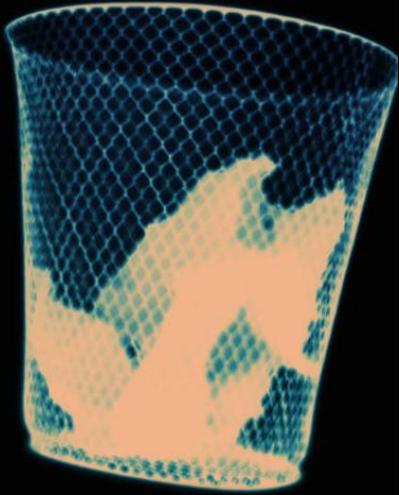


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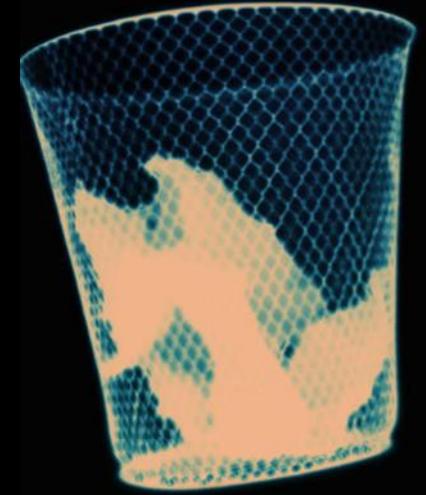
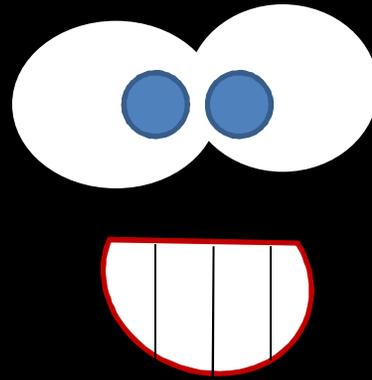


Permitted

Refill propane tank for the
building's heating system

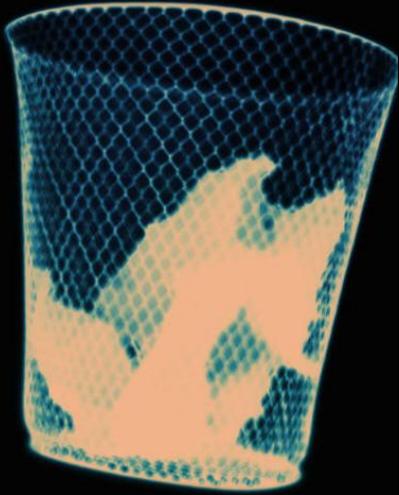


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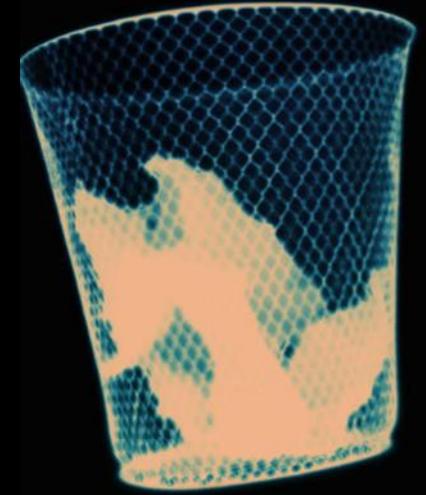
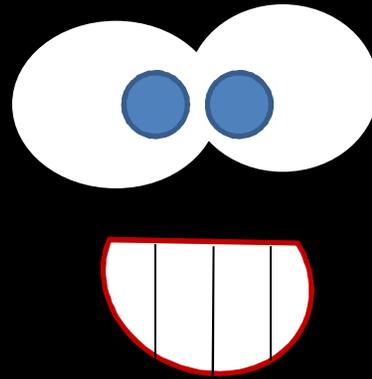


Permitted

Replacement of security
system equipment at a youth
correctional facility

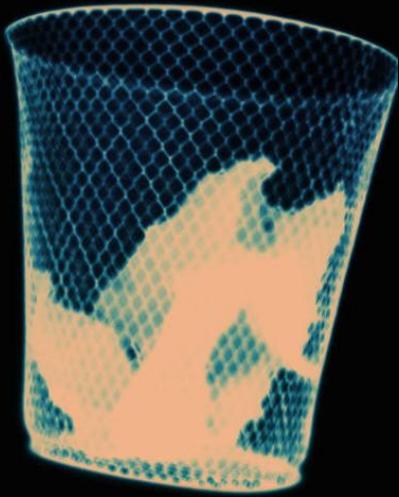


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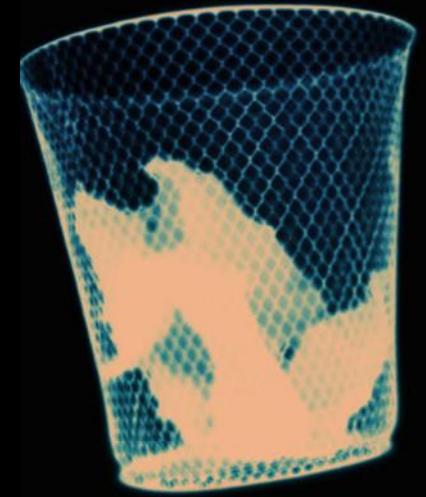
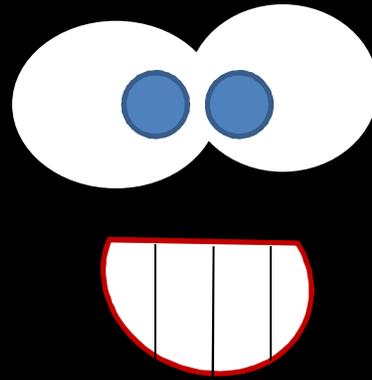


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Purchase vehicles for the
State's motor pool fleet

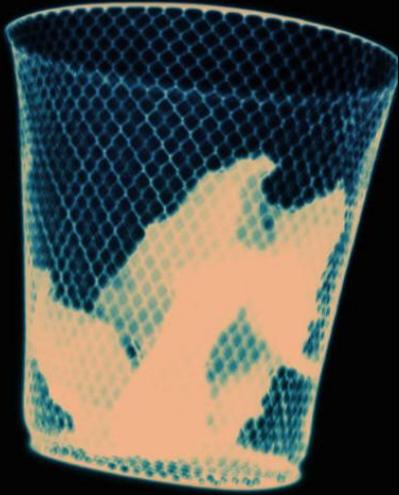


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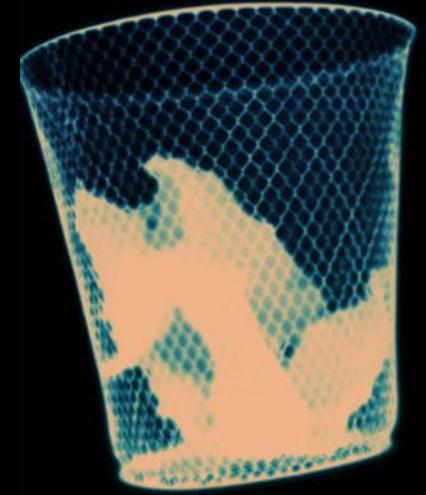
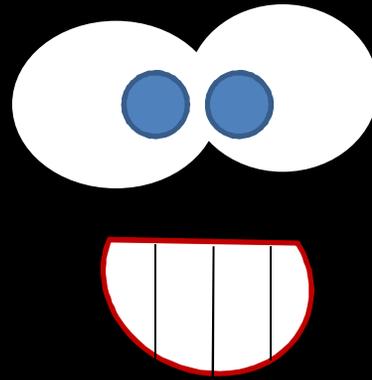


Permitted

Repainting the rooms in a
correctional facility
(materials and labor).

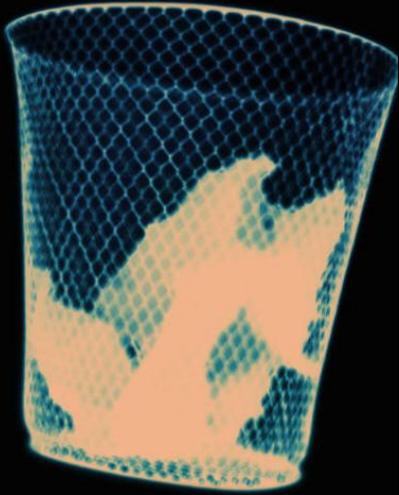


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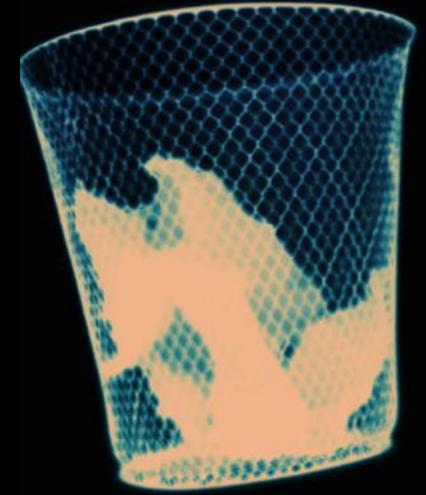
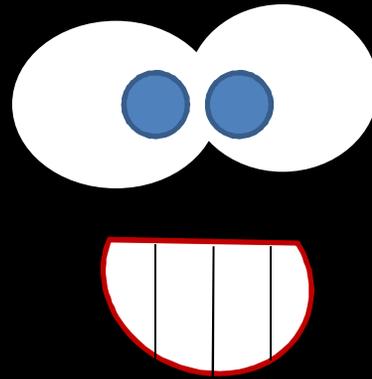


Permitted

Renovations to convert a
storage area into a computer
lab



Not Permitted



Permitted

Are computers, computer software, and printers qualified capital expenses?



OBM's Role in the Capital Release Process

- OBM debt and operating analysts review and approve the release of capital appropriations approved by the Controlling Board or OBM Director.
- As part of this activity, OBM:
 - Confirms federal and state law as well as state policy compliance
 - Consults with bond counsel and agency program managers and fiscal officers when necessary



Federal Tax Law: Public v. Private Use

Governmental v. Private Use

- Tax-exempt bonds are intended to finance governmental projects, but many projects have elements of non-governmental and/or private use
- What entities/users constitute private use?
- What types of contracts/arrangements result in private use?
- What is the Private Activity Bond Test?
 - Private use
 - Private payment/security
 - Private loan
- Requires ongoing monitoring and compliance





Private Activity Bond Test

- Private activity bond test is applied to each bond issuance to determine if private (non-governmental) use in the project precludes the bonds from tax-exempt status:
 - Two parts: i) private use limit and ii) private payment/security limit
 - Private payments refer to cash or other items of value received by the issuer in connection with the tax-exempt financed project used in a private use
 - Private security refers to the security of property in a private use
 - If both limits are exceeded, the bonds are private activity bonds and generally lose their tax-exempt status
 - Allowable private use and private payment limit for governmental bonds is 10%, but drops to 5% if the private use is unrelated to the governmental purpose.
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Private Use Limit Applies to “Use” By Private Persons

- Private use occurs when a private person is involved in the financed project
 - Sale of bond-financed facilities or equipment (i.e., change in ownership)
 - Lease of bond-financed facilities or equipment (i.e., change in usage)
 - Management or service contracts for bond-financed facilities (e.g., property manager, food services)
 - Contract to Fund Research (i.e., sponsored research)
 - Job Training/Workforce Development (e.g., non-credit job training)
 - Joint purchasing or shared-services agreements
 - Sale of naming rights (e.g., sports facilities, medical facilities)
 - Other rights to use property



Private Use Limit Applies to Use By “Private Persons”

- Who is a private person?
 - For-Profit Entities (e.g., private corporations and businesses)
 - Not-for-Profits (e.g., 501(c)(3) charities, private Universities, and Hospitals)
 - Federal Government (including all federal agencies)
 - Not cities, counties, state agencies, public universities, community and technical colleges, etc.
 - Not natural persons as long as they are not using the property in a trade or business



Private Payment

- Cash or other items of value received by the issuer (state agency) in connection with the tax-exempt financed project
 - Loans, not grants, may result in private payments (loan repayments) and/or private loans
 - Rent or lease payments, profit sharing, royalties, sale proceeds
 - Payment does not have to come from the private user or be in cash (e.g., services or usage of facilities, advertising or other “in kind” benefit to State)



Management and Service Contracts

- Not all management or service contracts result in private business use
- IRS regulations and guidelines establish safe harbors that, if satisfied, preclude the use from being treated as private use
- Contracts which compensate the private business based on a share of net profits from operation of the facility generally result in private use



Qualified Management Contracts

- Management or service contracts treated as not giving rise to private use:
 - Contracts for services solely incidental to the primary function of the financed facility (i.e., custodial, landscaping, equipment maintenance/repair, security, or similar services)
 - Contracts in which the only compensation is the reimbursement of actual expenses paid by the service provider to an unrelated party
 - Contracts having a term no longer than 5 years (including renewal options) in which the compensation to the service provider is based on a fixed amount, per unit fee, capitation fee, or a percentage of gross revenues or expenses (not both), or combination thereof.
 - Contracts having a term no longer than 10 years (or 80% of the expected useful life of the financed property, if shorter) if 80% of compensation is based on a fixed fee.
 - Contracts having a term no longer than 15 years (or 80% of the expected useful life of the financed property, if shorter) if 95% of compensation is based on a fixed fee.



Ongoing Monitoring and Compliance

- Private use and private payment limits apply throughout term of bonds
 - Identify *expected* or *potential* private use and private payment prior to issuance
 - Unexpected private use and private payments also subject to same limits
 - State agencies must diligently monitor private use and notify issuer of any expected new private use *before it occurs*
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Discussion Project: EXPO – Quarter Horse Congress

- Quarter Horse Congress (QHC) show at EXPO fairgrounds presents a host of private activity issues because of their non-profit (501(c)5) status and long-term (10-year) contract to use EXPO facilities.
- Facilities use and payments
 - Capital bill appropriated bond moneys to construct a new Agricultural Facility to be used predominately by QHC resulting in “private use”
 - EXPO entered into multi-year contract with QHC to use AG facility and other facilities for a certain number of days each year
 - Contract includes annual payments for use of AG facility resulting in “private payments”
 - Private use and private payments threatened tax-exempt status of Bonds
- Factors potentially mitigating private activity
 - Rental contracts and leases for meeting space may be structured to meet short-term federal exceptions
 - Eliminate “use” payments or structure the payment such that it covers only operations and maintenance costs (i.e., utilities, cleaning, etc.)
 - Structure “use” payments to meet federal de-minimis exceptions
 - Allocate all private use to non tax-exempt bond funding sources (e.g., issue federally *taxable* bonds)



Federal Tax Law: Arbitrage & Rebate



Arbitrage & Rebate

- What is arbitrage and arbitrage rebate?
 - Profit from investing lower-yield tax-exempt bond proceeds in higher-yield taxable investments
 - Rebate payments are required if the investment yield on the bond proceeds is higher than the arbitrage yield
- Spend-down exceptions to rebate
- Temporary periods and yield restriction
- Reasonable expectation basis
- Arbitrage compliance and reporting





Spending Exceptions to Rebate

- If spending meets certain timing thresholds it can be exempted from the rebate requirement
- 24-month spending test for construction issue
 - 75% of available construction proceeds used for construction (no land acquisition)
 - 10% spent in 6-mos; 45% in 12-mos.; 75% in 18-mos.; 100% in two-years
- 18-month test for non-construction issue
 - Often utilized in connection with land acquisition
 - 15% in 6-mos.; 60% in 12-mos.; 100% in 18-mos.



Temporary Period

- A period of time exception to yield restriction and/or yield reduction payments
- 3-year temporary period for new money bonds
 - 85% of proceeds spent within 3-years
 - Substantial binding obligation to spend at least 5% of proceeds within 6-mos.
 - Reasonable expectations basis
- Bond proceeds used to pay capitalized interest are included in determining spending exception and temporary period compliance



Agency/Capital Program Manager Responsibilities



Agency Role in Bond Issuance

- Participate in bond issuance conference calls, document reviews, and rating agency presentations
- Provide and be prepared to discuss:
 - Disbursement schedule
 - Monthly estimates through final disbursement
 - Demonstrates reasonable expectation to spend bond proceeds
 - Program description(s)
 - Use of proceeds
 - Confirms allowable use of proceeds including identification of private activity, reimbursements, and leases
 - Private Management Contracts



Execute Tax Compliance Certificate with Agency Certification

- Tax Compliance Certificate reviews the federal tax law requirements applicable to the bonds
- Agency certification
 - Confirms agency's understanding of its post-issuance responsibilities
 - Includes administrative dollar limit, applicable spend-down exception and temporary period, and records retention requirements
 - Signed by agency director and capital program manager(s) responsible for approving disbursements



Organize and Retain Records

- Project spending detail
 - Project description and summary of scope of work
 - Disbursement detail (amount, date, receipt/vendor, nature of expenditure)
- Grant, loan, joint use, and other spending related agreements
- Records substantiating that the use of proceeds conforms to statute and regulations
- Certain information must be entered into the State's accounting system (OAKS)

Organize and Retain Records

Records to be Captured in the OAKS System	Other Records to be Maintained
Name of the HEI/DHE/State Agency	Total Cost of Project by Funding Source
Appropriation Line Item Name and Number	Vendor Contracts & Agreements
Appropriation Amount	Project Agreements (Grant and Loan)
Project Name and ID#	Joint or Cooperative Use Agreements
Project Description (expanded chartfield for detail)	Invoices and Receipts Documenting each Expenditure
Account Code Description (expanded chartfield for detail)	Revenue or Payments Received
For each Expenditure: date, amount, vendor, and specific services and/or items purchased	Private Activity Reports / Changes in Use (including leases, management contracts, sales, etc)

- Retention period: 3 years after final maturity of bonds
 - More stringent than State records schedule
- Electronic and/or paper are acceptable
 - Data requirements above must be provided for
 - Careful to keep required information when moving from paper to electronic



Notification to Issuer

- State agencies are required to ensure appropriate use of proceeds and monitor spend-down of bond proceeds
 - Provide timely notification of any prospective changes in use or deviation from original expectations
 - Change of use may occur long after funding of long-lived assets
 - Sale/disposition of a facility or asset
 - Leasing a portion of building
 - Non-qualified private management contract
 - Other non-governmental use / privatization
 - Consult with OBM or TOS to determine if private use and payment limits are exceeded.
 - Diligently monitor private use and provide notification of any expected new private use before that new private use occurs
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Review

1. How are most capital projects funded?
 2. Provide an example of private use with respect to state capital projects or facilities.
 3. Administrative costs for bond projects are limited to 10% of bond proceeds? (T/F)
 4. Name the three items an agency should be prepared to provide for a bond issuance.
 5. For how many years do bond-related records need to be maintained?
 6. If federal tax law requirements are not met, bonds may lose their tax-exempt status and result in financial consequences for the State. (T/F)
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Resources

Debt Management Policies, Procedures and Guidelines

<http://obm.ohio.gov/BondsInvestors/PoliciesProcedures.aspx>

Ohio Public Facilities Commission (OBM) Contact:

Larry Scurlock, Assistant Debt Manager, OBM

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Treasurer's Office Contact:

Jonathan Azoff, Director, Office of Debt Management, TOS

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