Borrowing through Tax-Exempt Bonds: An Introduction to Basic Federal Tax Rules and Certifications

When a township issues a bond to finance an upcoming project, the process seems pretty cut and dried. Tax-exempt bonds are subject to strict federal rules, though, and boards of supervisors must make sure they’re in compliance from the start of the process through the life of the bond. Read on to learn more about basic bond requirements that will help your township communicate more effectively with counsel and enhance compliance after the bonds are issued.

By Mark Vacha, Esq. / Member, Cozen O’Connor

Most bonds issued by townships and other state and local government entities, including authorities, pay interest that does not count as gross income when investors are figuring their federal taxes. Congress and the U.S. Treasury view this tax exemption as a form of subsidy. Consequently, the Internal Revenue Code of 1986, as amended, is fairly rigorous in its requirements for tax-exempt bonds.

When a township issues bonds, the appropriate officials must sign certain tax-related documents (commonly referred to as a “tax certificate,” “non-arbitrage certificate,” or “tax compliance agreement”). Township supervisors should understand the basic tax requirements addressed in such documents, be familiar enough with bond tax rules to have a constructive dialogue with bond counsel, identify potential issues in the early stages of a financing, and monitor and manage post-issuance tax compliance requirements throughout the life of a bond issue.

Violations of federal tax rules may result in bonds being declared taxable and, among other concerns, can adversely affect an issuer’s borrowing costs and market access.

Purpose of the tax certificate
The tax certificate states the issuer’s reasonable expectations about the amount and use of the bond proceeds.
Townships issue tax-exempt bonds to finance a variety of projects, from sewage systems to municipal buildings and road and bridge projects. Before starting the process, though, it's wise to talk with bond counsel to make sure all bases are covered.
as of the sale date, plus the facts and estimates those expectations are based on. Bond counsel relies on the tax certificate to deliver its opinion on whether interest on the bonds may be excluded from gross income for federal income tax purposes.

In the tax certificate, the issuer acknowledges that, despite the representations and statements of expectation, certain deliberate action after the delivery date can adversely affect the bond's tax-exempt status. An intent to violate the requirements of the code is not necessary for an action to be considered intentional. Although the tax certificate is evidence of the issuer’s expectations, it does not establish any conclusions of law or presumptions about actual expectations or their reasonableness.

The tax certificate also establishes certain covenants that bond counsel, in developing its opinion, assumes continuing compliance with. This is particularly true with requirements to rebate arbitrage to the U.S. Treasury. (Arbitrage is the interest income that bond issuers might earn by investing the proceeds in higher-yielding taxable securities.)

### Tax certificate basics

The tax certificate will certify the purposes of the bonds, distinguish new money and refunding purposes, and certify the amounts of proceeds to be applied for the respective purposes. Where bonds are issued for refunding purposes (to retire an outstanding bond to reduce financing costs, eliminate covenants, or alter maturities, for example), the tax certificate will certify the original purpose of the financing.

Reserve funds (applicable for certain revenue bond issues but not for general obligation bonds), bond insurance, and costs of issuance are also specified. The tax certificate will describe the security for a bond issue, the funds and accounts pledged to secure bonds, and whether bonds are fixed- or variable-rate.

### Reimbursement

Due to project schedules and other considerations, issuers sometimes advance their own funds to begin work on a project with the intention of using bond proceeds to reimburse themselves later. When an issuer is considering a new capital project, it should consult with its bond counsel to determine what is necessary to make reimbursements.

Among other requirements, an issuer must make a proper declaration of official intent to reimburse itself. The prior expenditures must not have been made more than 60 days before the declaration or must satisfy a proper exception, such as architectural or engineering.

Some issuers make reimbursement declarations as part of the annual adoption of their capital budget. However, an issuer that repeatedly fails to make reimbursements for projects with reimbursement declarations can risk losing the ability to use this option.

### Yield

The yield on the issuer’s bonds is a rough proxy for the issuer’s cost of
funds. Yield on a bond issue is used for two main purposes: to apply investment yield restrictions to certain types of funds or accounts that are prohibited from being invested above the bond yield and to compute liability for rebate owed to the U.S. Treasury.

Yield is expressed as an annual percentage rate. The permitted yield may be increased to take account of fees for qualified guarantees (e.g., bond insurance). This is favorable because it allows the issuer to keep more investment earnings for itself.

Yield is typically calculated to maturity but under certain circumstances may be calculated to an earlier call date.

Yield may also be affected by swaps or other hedging transactions related to the bonds. (Swaps are rarely used for fixed-rate bonds but have often been used in connection with variable-rate bonds.)

**Rebate requirement**

Rebate refers to the requirement for a bond issuer to pay back to the U.S. Treasury certain investment earnings that are above the bond yield. This restricts the issuers’ ability to engage in arbitrage — exploiting the difference between tax-exempt and taxable rates by borrowing at the former and investing at the latter.

Although arbitrage is disfavored, certain forms of it are permissible under the federal tax rules for bonds. Generally, an issuer is required to calculate rebates and make payments, if any, every five years after issuance of the bonds and 60 days after the final retirement of a bond issue.

A significant exception to rebate is available for construction or project fund monies if proceeds are spent quickly enough on projects. A 24-month construction exception requires certain levels of expenditures (10, 45, 75, and 100 percent) within six-month intervals. An 18-month exception (with 15-, 60-, and 100-percent spending requirements at six-month intervals) and a six-month exception are not tied to construction.

These exceptions have certain nuances beyond the scope of this article, such as the calculation of which proceeds must be spent and retainage, a portion of the contract price withheld until the work is substantially complete.

**Private business use**

Tax-exempt government bonds require various limitations on private activity. Tax issues may arise, for example, if bond-financed property is used for private purposes, if bonds are secured by private payments or property, or if bond proceeds are loaned to private parties. (Note that taxes and fees of general applicability would not raise an issue.)

Issuers should discuss with bond counsel the character of any project that will be financed with bond proceeds. Generally, most township projects for essential government purposes (such as public safety and street, water, and sewer improvements) are not likely to run into private business use concerns.

In contrast, certain types of projects will require greater scrutiny. These include projects that involve an economic development component, lease or other use arrangements with nongovernment entities (or the federal government, which is treated as a private entity for various bond rules purposes), or a private operator or manager, such as a private company managing a municipally owned golf course.

Pursuant to a tax certificate, a bond issuer will certify that it does not reasonably expect that the bonds will meet either the private business tests or the private loan financing test. The issuer will also certify that it will not take deliberate action that causes the private business or private loan financing tests to be met.

Beyond the scope of this article are tax provisions that provide amounts for permitted private use (often up to 10 percent of the proceeds of a bond issue), as well as certain exceptions.

**Average project life**

The federal tax rules generally prohibit or disfavor the issuing of bonds that will be outstanding beyond the life of the financed projects. Bonds should not have an average maturity that exceeds 120 percent of the average, reasonably expected economic life of the financed facilities.

Consequently, townships should be sensitive to this issue if they are financing several sub-projects that have equipment or information technology components that tend to have shorter lives. Compliance with “useful life” requirements under Pennsylvania’s Local Government Unit Debt Act may go a long way to ensuring compliance with the related federal requirements.

**Hedge bonds**

The federal tax rules disfavor issuing bonds earlier than necessary and holding onto proceeds without spending them for a significant period of time — also known as hedging.

The tax certificate will require the issuer to certify that it reasonably expects to expend 85 percent of the net proceeds of the bond issue within three years and will not invest 50 percent of the proceeds in certain investments having a guaranteed yield for four years or more.

Hedge bonds can be tax-exempt but become subject to certain other requirements.

**Working capital**

The federal tax bond rules favor expenditures on capital (assets) and disfavor expenditures for working capital. Working capital expenditures not subject to a permitted exception create challenges in terms of arbitrage compliance and monitoring and may require certain investment restrictions.

Permitted exceptions exist for, among other things, expenditures for...
certain startup costs that do not exceed 5 percent of the bond issue price, principal and interest on the bonds paid from unexpected excess sale or investment proceeds, and interest on the bonds for a period of three years after the delivery date.

Post-issuance tax compliance

Compliance with tax-exempt bond rules after bonds are issued has become an object of increased focus in recent years. The IRS has strongly encouraged issuers to adopt post-issuance compliance policies, although this is voluntary, and most bond counsel are advising issuers to do the same.

Whether acting under a formal policy or otherwise, issuers need to monitor expenditure and use of proceeds and financed property, as well as investments. Certain accounting and financial firms that specialize in arbitrage rebate review and calculations can help.

Also, remember that federal tax law specifies certain remedial actions to address private business use in the hopefully unlikely scenario where excess private business use occurs. There are three types of remedial actions:

1) defeasance or redemption of non-qualified bonds;
2) alternative use of disposition proceeds resulting from a sold facility; and
3) alternative use of an affected facility (which is unlikely to be used for general government bonds).

The IRS has also established a Voluntary Closing Agreement Program to address instances of noncompliance identified by an issuer. VCAP is intended to provide issuers more favorable settlement terms through self-reporting of problems. Ideally, the effective administration of post-issuance tax compliance policies will either prevent or quickly identify such problems.

Scheduling a review

When a township enters into a bond transaction, one or more township officials should consider sitting down with bond counsel and spending 15 to 30 minutes going through a tax certificate several days before closing. This can be a useful exercise for township officials to more fully understand bond covenants and can help ensure more effective post-issuance compliance policies.

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About the author: Mark H. Vacha is a member of the Public and Project Finance Practice Group in the Philadelphia-based law firm Cozen O’Connor. He has served as bond, disclosure, and underwriter’s counsel, handling municipal bond transactions for a wide variety of clients. He can be reached at mvacha@cozen.com.

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