



Dormitory Authority of the State of New York

***IRS Form 990 Schedule K
and
Post-Issuance
Tax Compliance Webinar***

January 22, 2010





Agenda

- Welcome / Introduction
- Background on Post Issuance Compliance and the Schedule K
- Tax 101
- Post Issuance Compliance beyond Tax Rules
- DASNY wrap up



What is "Post-Issuance Tax Compliance"?

THE BOND BUYER

Lawyer: 990 Represents 'Sea Change'

Historically, he said, the IRS has mostly focused on bonds at the time they were issued... The IRS and its advisors have clearly been moving in this direction, Oswald said.



Ed Oswald

Ed Oswald's work at the first time the IRS will outline detailed post-issuance compliance information that could provide the foundation for audits to set up state and compliance procedures and post-issuance compliance procedures and policies.

Report Provides Remedies to Issuer's Federal Compliance Concerns

While, however, or other contractual arrangements," it said. "There can be no one-size-fits-all set of procedures... It's an enormously valuable tool for the bond community."

The IRS also sent a questionnaire to the 200 and 500 tax-exempt charities... The agency is expected to send a similar questionnaire to this year.

THE BOND BUYER

Thousands of Charities to Receive IRS Surveys

WASHINGTON — The Internal Revenue Service's post-issuance compliance survey will be sent to thousands of more than 2,000 tax-exempt charities, not just a handful of major organizations.

The survey also will be sent to thousands of more than 2,000 tax-exempt charities, not just a handful of major organizations.

Muni Bond-Borrowing Charities

Investigation division and Office of Professional Responsibility... "We don't really sit at this point, period to pick on charities. It's wrong we started. We also are going to look at the governmental bond side."

ORRICK BONDLOGISTIX

For more information about our post-issuance compliance program please call...

Richard Chris - New York, Jennifer Maginn - Sacramento

Roger Davis - San Francisco, Ed Oswald - Washington, DC

▶ Post-Issuance Tax Compliance

- “Post-issuance tax compliance begins with the debt issuance process itself and provides for a continuing focus on investments of bond proceeds and use of bond-financed property. It will require identifying existing policies, the responsible people, the applicable procedures, and the affected population”

After the Bonds Are Issued Then What?
Advisory Committee on Tax-Exempt and
Governmental Entities
June 13, 2007



► Overview – Basic Elements

Federal Tax Rules – Internal Revenue Code Sections 103 and 141 through 150

- Private Use/Unrelated Trade or Business Use
- Arbitrage



► Overview – Basic Elements

- Continuing Disclosure obligations under Rule 15c2-12
- Bond Resolution/Loan/Reimbursement Agreement covenant compliance
- Other Maintenance Requirements
 - Rating Agency Surveillance
 - Swap Counterparties
 - Bond Insurance



▶ Why Is the IRS Focused on Tax-Exempt Bonds?

- Congress wants to be sure that the federal interest subsidy provided by the interest exclusion is being properly applied
- Interest exclusion cost to federal government estimated to be approximately \$200 billion in Fiscal Years 2008-2012
- Increased focus on activities of 501(c)(3) Organizations



▶ Why is the IRS Focused on Post-Issuance Tax Compliance?

- The typical tax-exempt bond issue has an average life of 20 years or more
- Issuers and conduit borrowers must comply with federal tax rules for the life of the original bonds and any refunding bonds
- Easy for “foot faults” and errors to occur or for borrowers to lack requisite records and detailed information to combat IRS in an audit challenging the tax-exempt status of bonds

▶ The Role of the IRS with Respect to Tax-Exempt Bonds and Enforcement

- Bond Audits – Random and Targeted
- Tax-Exempt Bonds Compliance Check Questionnaire Initiative – 501(c)(3) Organizations
- IRS Form Schedule K – Supplemental Information on Tax-Exempt Bonds
 - IRS Enforcement Branch – over 100 employees
 - Goal – Close 700 Audits in fiscal year 2010



▶ Bond Compliance Check Questionnaire Initiative

- Questionnaires sent to approximately 200 non-profit organizations in 2007 focusing on post-issuance policies and procedures – IRS Form 13907
- The 501(c)(3) community will receive additional IRS questionnaires regarding post-issuance tax compliance, record retention and related matters
- The IRS Report summarizing its findings on the questionnaire responses (dated September 11, 2008) provides the following preliminary conclusions:
 - Lack of written policies and procedures, and
 - Poor recordkeeping

▶ Why Should You Care About the IRS Focus on Post-Issuance Compliance?

- Defending tax-exempt status of bonds in an IRS audit is expensive and time consuming?
- New IRS Schedule K Reporting Requirements
- Better Risk Management
- Avoid financial settlement to protect bondholders
- Better decision making regarding use of bond financed property

▶ Schedule K

- See Copy of Schedule K in Presentation Materials
- Applies to Not-for-Profit Organizations Only
- Comprehensive Information Regarding Tax-Exempt Bonds to be filed with IRS Form 990
- Must be filed annually
- Focus – issue-by-issue



▶ Schedule K

- For Reporting Organizations 2008 Tax Year – Only Part 1 needs to be completed, which asks basic information
- For Reporting Organizations 2009 Tax Year and thereafter – All parts must be completed



▶ Schedule K

- Four Basic Parts
 - Part I Bond Issues
 - Part II Use of Proceeds
 - Part III Private Business Use
 - Part IV Arbitrage



▶ Schedule K

Who Must File – An organization which has a tax-exempt bond issue with an outstanding principal amount of more than \$100,000 that was issued after 12/31/02

Special Rules for Refunding Bonds

Bonds issued after 12/31/02 to refund bonds originally issued before 1/1/03 – Complete parts I, II and IV only

Original Bonds issued in 2003 or after, including any bonds issued to refund such bonds – Complete parts I, II, III and IV



▶ Period Covered - Schedule K

- Same 12-month period as the Form 990 with which it is filed
- May also use any other 12- month period used consistently for a tax-exempt obligation which is in accordance with the requirements of Code Sections 141-150
 - Example: Permissible to use the 12-month “bond year” period chosen for purposes of arbitrage rebate calculations



▶ Schedule K - Part I – Identification of Bond Issues

Name of Issuer	Issuer EIN	CUSIP #	Date Issued	Issue Price	Description of Purpose	Defeased	On behalf of Issuer

- * Instructions – This information should be consistent with information included on IRS Form 8038
- * If refunding purpose, enter issue date of each refunded bond issue



▶ Schedule K - Part II – Use of Proceeds

- Some of the information for Part II is on IRS Form 8038
- Other information for Part II is based on actual post-issuance facts
- There are several important questions contained in Part II to focus on –



► Schedule K - Part II – Use of Proceeds

Line 11 - Has the Final Allocation of Proceeds Been Made?

- A final allocation must be done no later than 18 months after the later of: (i) the date of the expenditure, or (ii) the date the property is placed in service (no later than 60 days after the fifth anniversary of the issue date)
- Important in transactions in which non-bond proceeds need to be used to finance space to be used for a private use which does not fit within the permissible “bad money portion” portion of the bond issue (generally 3%)
 - Example: Cafeteria contract or management contract for book store which is a lease for tax purposes

▶ Schedule K - Part II – Use of Proceeds

Line 12 - Does the Organization Maintain Adequate Books & Records to Support the Final Allocation of Bond Proceeds?

- February 2004 – IRS Published “Frequently asked questions and answers regarding record retention for tax-exempt bonds”



► Schedule K

What Are the Records to be Maintained?

- Basic records relating to the bond transaction, including the trust indenture, bond resolution, loan agreements, and bond counsel opinion
- Documentation evidencing expenditure of bond proceeds
- Documentation evidencing use of bond financed property by public and private sources such as copies of management contracts and research agreements

▶ Schedule K

What Are the Records to be Maintained?

- Documentation evidencing all sources of payment or security for the bonds
- Documentation pertaining to the investment of bond proceeds



▶ Schedule K

How Long Should Records be Kept?

- As long as the bonds are outstanding, plus 3 years
- If the bonds are refunded, need to retain records for the life of the original bonds and refunding bonds, plus 3 years



▶ Schedule K - Part III – Private Business Use

- Are there any lease arrangements with respect to the financed property which may result in private business use?
- Are there any management or service contracts with respect to the financed property which may result in private business use?
- Are there any research agreements with respect to the financed property which may result in private business use?



▶ Schedule K - Part III – Private Business Use

Response to Management Contract and Research Contract Questions

- Need to answer “Yes” even if the organization has determined that the management contract/research agreements meets the IRS Safe Harbor contract rules
- By answering Yes, the organization makes the IRS aware of the fact that the organization conducts research and/or employs outside service providers
- * It’s unclear whether “incidental” service or management agreements for janitorial and other similar service providers need to be reported



▶ Schedule K - Part III – Private Business Use

- Enter the percentage of financed property used in private business use by entities other than a 501 (c) (3) organization or a state or local government

→ Calculation Required: %

- Instructions: Do not include any use relating to management or research contracts that the organization has determined to meet the IRS safe harbor rules



▶ Schedule K - Part III – Private Business Use

- Enter the percentage of financed property used in a private business use as a result of unrelated trade or business activity carried on by your organization, another 501 (c)(3) organization or a state or local government

Calculation Required: %



▶ Schedule K - Part III – Private Business Use

- Does the organization routinely engage bond counsel or other outside counsel to review any management or service contract or research agreements relating to the financed property?
 - Answer should be – Yes



▶ Schedule K - Part III – Private Business Use

- Has the organization adopted management practices and procedures to ensure the post-issuance compliance of its tax-exempt bond liabilities?
 - Answer should be – Yes



► Schedule K - Part IV – Arbitrage

- Has a rebate analysis been performed and an IRS Form 8038-T filed?
- Has the organization identified an interest rate hedge with respect to the bond issue?
 - Related Questions
- Were the proceeds invested in a GIC?
 - Related Questions



▶ Difference in Annual Reporting Requirements v. General Tax Principles

- Schedule K – private use activities measured over a 12 month reporting period (annual snap shot)
- Federal Tax Principles – generally, private use activities measured over the entire life of the bonds, plus any refunding bonds
- *Observation* – An organization could have a situation where the reported private use for Schedule K purposes is significant while at the same time the bond issue remains tax-exempt under general federal tax law principles

▶ Basic Elements of a Post-Issuance Tax Compliance Program - - 6 Primary Elements

- Written procedures and guidelines regarding post-issuance matters to ensure that bonds remain in tax compliance
- Adequate recordkeeping and retention policies
- Individuals identified to monitor and coordinate post-issuance matters
- Educational training for staff responsible for post-issuance compliance



▶ Basic Elements of a Post-Issuance Tax Compliance Program - - 6 Primary Elements

- Active monitoring of private use/unrelated use and arbitrage rebate requirements
 - Coordination between business team and legal staff
- Periodic review of post-issuance policies, management contracts and research contracts by bond counsel or other outside counsel expert in tax matters



▶ Benefits of an Effective Post-Issuance Program

- Facilitates completion of Schedule K
- Remove risk of non-compliance and associated hazards
- Generate efficient and prompt response to any IRS inquiry/questionnaire
- Easy and cost-effective review process at time of a refunding
- Identify remaining portion of bond proceeds allowed for private use



► Overview – 501(c)(3) Bonds

- The bond financed property must be owned by a Section 501(c)(3) organization or a State or local governmental unit
- At least 95% of the net proceeds of the bond issue must be used in a manner related to the exempt purposes of the Section 501(c)(3) organization
- No more than 5% of the net proceeds of the bond issue can be used for a “private use” or an “unrelated trade or business use.” For this purpose, costs of issuance of the bonds paid with bond proceeds are treated as a private use

► Overview – 501(c)(3) Bonds

- Private Use – Use of bond financed property in a trade or business by other than a 501(c)(3) organization or a State or local government
- Example: Lease of bond financed space to a for-profit entity for use as a campus bookstore or college cafeteria



► Overview – 501(c)(3) Bonds

- Unrelated Trade or Business Use – Use of bond financed property by a 501(c)(3) organization in an “unrelated trade or business activity”
- Unrelated trade or business use involving bond financed property will generally constitute “private use” even if it does not give rise to a liability for unrelated business income tax



▶ Examples of Potential Private Use of Bond-Financed Property

- Cafeteria managed by for-profit organization
- Parking facility managed by for-profit organization
- Long or short term space use arrangements:
 - Events held in gymnasium or other meeting space
 - Summer use of dormitories
 - Use of bond-financed facilities by outside organizations

▶ Examples of Potential Private Use of Bond-Financed Property

- Management contracts with non-employee individuals or outside entities, such as physician groups
- Sponsored research contracts



▶ Private Use Exceptions

Management Contract Guidelines – IRS Rev. Proc. 97-13

- Provides framework for contracts with non-employees/outside providers for various services involving the use of bond financed property
- Compensation may be a fixed fee, capitation fee, per-unit fee, percentage of revenue or variable rate or various combinations thereof



▶ Private Use Exceptions

Management Contract Guidelines – IRS Rev. Proc. 97-13

- Form of compensation tied to term of agreement – long term agreements are required to have larger portion of fixed compensation
- Six variations of agreements provided in the Rev. Proc.
- No sharing of net profits permitted



▶ Private Use Exceptions

Research Contract Guidelines – Revenue Procedure 2007-47

- Permits certain types of research to be conducted within bond financed space without resulting in research sponsor being treated as private user
- Applies only to “basic research” – any original investigation for the advancement of science not having a commercial objective



▶ Private Use Exceptions

Corporate Sponsored Research

- Any license or other use of resulting technology by the sponsor is permitted only on the same terms the 501(c)(3) organization would permit that use by an unrelated non-sponsored party (i.e., the sponsor must pay a competitive price)
- The price paid by the sponsor must be determined at the time the license or other resulting technology is available for use
- The sponsor may have exclusive use of the license or resulting technology



▶ Private Use Exceptions

Industry or Federally Sponsored Research Agreements

- A single sponsor or multiple sponsors agree to fund basic research
- The 501(c)(3) organization determines the research to be performed and the manner in which it is to be performed



▶ Private Use Exceptions

Industry or Federally Sponsored Research Agreements

- Title to any patent or other product incidentally resulting from the basic research lies with the 501(c)(3) organization
- The sponsors are entitled to no more than a non-exclusive royalty free license to use the product of any of that research



▶ Private Use Exceptions

Research Contracts – Federal Government Rights Under the Bayh-Dole Act

- The rights of the federal government mandated by the Bayh-Dole Act will not cause a research agreement to fail the safe harbor



▶ Private Use Exceptions

Federal Government Rights Under the Bayh-Dole Act

- Example: the existence of “march-in-rights” or other special rights of the federal government mandated by the Bayh-Dole Act will not cause a research agreement to fail to meet the safe harbor provided that: (i) the 501(c)(3) organization determines the subject and manner of the research, (ii) the 501(c)(3) organization retains exclusive title to any patent or product, and (iii) the nature of any license granted to the federal government (or to any third-party non-governmental person) to use the product or research is no more than a non-exclusive, royalty free license

▶ Private Use Exceptions

- In certain circumstances, if less < 50 days
 - Term of use, including renewal options is not longer than 50 days
 - The agreement is a negotiated arm's-length arrangement and compensation is at fair market rule
 - The property is not financed for a principal purpose of providing that property for use by that party
- * Short term use exceptions do not apply to “unrelated activities” of the 501(c)(3) organization



▶ Private Use Exceptions

Short Term Use Exceptions

- In certain circumstances, if < 200 days of use
- In certain circumstances, if < 100 days of use



▶ Private Use Exceptions

Incidental Contracts or Arrangements

- Small physical use of space
 - ATM, kiosks, vending machines, laundry facilities
 - Cannot exceed 2.5% of proceeds or space of facility
- Contract for services supporting organization activities
 - Janitorial services
 - Equipment repair
 - Billing activities or similar services



▶ How to Measure Private Use

- Square footage
- Time of use
- Time/space analysis
- Expense/revenue



▶ Private Use Calculation Process

- Schedule K Purposes – Analyze private use over the most recent 12 month period
- Federal Tax Principles – Analyze private use over the life of the bond issue



▶ How to Measure Private Use

Example: Issue 40 year bonds to construct dormitory facility and lease 100% of the facility to for-profit entity for 1 year. Subsequent to that period all use will be qualified

Schedule K Reporting: 100% private use

Federal Tax Principles: $\frac{1 \text{ year}}{40 \text{ years}} = 2.5\% \text{ Private Use } \checkmark$



▶ Managing and Monitoring Private Use

Private Use Identified at the Time of Issuance of the Bonds

- Step 1: Quantify the Expected Private Use
- Option A: Contribute equity or other amounts to cover private use
- Option B: Allocate private use to “bad money portion” of the bond issue – if possible



▶ Managing and Monitoring Private Use

Monitoring Private Use After the Bonds are Issued

- Step 1: Review use of bond-financed projects and applicable third party agreements annually
- Step 2: Calculate private use per bond issue



▶ What if You Discover a Private Use Problem?

- Reallocate bond proceeds and other funds if the bond proceeds allocation time frame is still open
- Change use, modify contract terms, avoid future private or unrelated use
- IRS Voluntary Closing Agreement Program



▶ Other Post-Issuance Responsibilities

- Continuing Disclosure Responsibilities
- Provide to nationally recognized municipal securities information repository certain financial and operating information annually
- Provide immediate notice of the occurrence of 11 specific events listed in the continuing disclosure certificate
- FASB 133 and GASB Technical Bulletin No. 2003-1 provides for a number of specific accounting and disclosure requirements for swaps and other hedging instruments
- Material Event Notices



▶ Other Post-Issuance Responsibilities

- Various Bond Document Responsibilities
- Provide audited financial statements by a certain date
- Provide other specified information periodically or upon the occurrence of certain events to bondholders, rating agencies, bond insurers, other credit enhancement, liquidity providers and swap providers



▶ Other Post-Issuance Responsibilities

- Compliance with rate covenants
- Compliance with other financial tests
- Maintenance and periodic certification of insurance



 **DASNY Wrap Up**

- Changes to Documents
- Other New Initiatives
- Other Resources
 - Accountants
 - Your Counsel
 - Tax Counsel
 - Trade Association
 - Other



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