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Bonds 101 - The Federal Tax Code and Related Program Considerations

Permissible Uses

“Governmental bonds are tax-exempt bonds issued by a state or local government, the proceeds of which are generally used to finance activities or facilities owned, operated, or used by that or another government for its own purposes. This can include financing the building, maintenance, or repair of various types of public infrastructure such as highways, schools, fire stations, libraries, or other types of municipal facilities. Ultimately, though, a tax-exempt governmental bond is a state or local bond that is neither a private activity bond, as defined in section 141 of the Code, nor an arbitrage bond within the meaning of section 148 of the Code.”

- *IRS Compliance Guide – Tax-Exempt Government Bonds*

Generally speaking, bonds must be for **capital expenditures** – **NOT working capital** (operating expenditures). The rules for working capital are different – much more restrictive, and as a practical matter will likely result in “arbitrage bonds” discussed above.

Be careful in allowing “repairs” as they may be deemed working capital expenditures. Will the cash outlay result in an increase in assets on the balance sheet or an expense?

Loans to non-governmental entities could result in making the bonds “private activity bonds.”

Useful Life of Assets

For the bond series as a whole, the weighted average maturity of the bonds cannot exceed 120% of the weighted average economic life of the assets financed by the grants/loans. Useful life of assets funded using bond proceeds must be documented by the granting/loaning state agency.

Timing of Spending Proceeds – Arbitrage

Arbitrage rules were established to stop an abuse of tax-exempt bonds. Without the rules, governments could issue tax exempt debt and invest the proceeds in higher yielding taxable instruments thereby making a profit on the “spread.”

The rules establish periods of time by which proceeds must be expended. If proceeds (and related investment earnings) are not spent within the established timeframe, earnings on bonds are subject to arbitrage rebate. Time frames are generally 18 months or two years¹ for complete spending of proceeds with six-month incremental percentage requirements to avoid arbitrage rebate.

There is a three year “temporary period.” If proceeds are not spent within the three year period there may be requirements to “yield restrict” investment of the proceeds.

For a grant, proceeds are considered spent when an agency makes a cash dispersal to the grantee. This may complicate prudent stewardship. Cash flows must be planned carefully.

Loans are more complicated. Some issuers match loan repayment time frame with bond maturity. Once bonds are retired, payments are not subject to restrictions. If bonds are still outstanding, agency has three months to “reuse” the proceeds, or be subject to arbitrage rebate or yield restriction. When loaning tax-exempt proceeds to a local government, it may be advisable to require the local government to structure the borrowing from you as tax-exempt. This eliminates the State’s arbitrage rebate liability. It does require the local government to file Form 8038. You should work with counsel in establishing loan programs.

Arbitrage reporting to the IRS is performed the DAS Capital Investment Section. However, agencies are responsible for maintaining necessary records including separate accounts at the State Treasurer and detailed expenditure and investment earning records. Agencies are also responsible for year-end reporting to the State Controller’s Division and for SFMS recording of arbitrage related transactions.

¹ The two-year period is allowed when at least 75% of the proceeds are spent on construction (as opposed to expenditures for land acquisition or equipment).

Before the Bonds are Sold – Intent Resolutions

Related to closing the door on arbitrage abuses, the IRS requires that an intent resolution be filed prior to any expenditure made before the bond sale for which you plan to reimburse yourself with bond proceeds. This applies to grantees and loan recipients as well. Therefore, you must obtain satisfactory evidence of the date expenditures occurred to construct (or rehab) capital assets under your program. These intent resolutions must be filed with the DAS Capital Investment Section. For grant and loan programs, intent resolutions that pre-date the award of the grant or approval of the loan are not acceptable.

Cost of Administration

Bond counsel has stated that no more than 5 percent of bond proceeds can be used for administration of the program – assuming such administrative costs are necessary to execute the program and get the capital projects completed.

Holding these funds beyond the time periods discussed above could result in arbitrage rebate liabilities. Know that you will incur ongoing costs every year the bonds are outstanding (State Treasury bond administration charges, pass-through of trustee costs from DAS, and possibly special project costs necessary to maintain tax-exempt status of bonds or for other required program needs).

If you are charging a fee to participate in your program, it may be preferable to receive the fee prior to distributing proceeds (and evidence of the prepayment should be retained). If payment of fees is deemed to be from grant or loan proceeds, it will require tracking and compliance with arbitrage rules.

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Records Retention

The general rule on document retention imposed by the tax code is that proper records must be maintained and made available to the IRS. According to the IRS published Frequently Asked Questions (FAQ's), documentation that should be maintained includes bond transcripts, documentation demonstrating the expenditure of bond proceeds, documentation showing sources of payments for the bonds, documentation about the calculation of yield and the investment of bond proceeds, rebate calculations, etc.

As a practical matter, counsel interprets the Code to require the following documents:

- a copy of all grant agreements
- If the grant agreement does not by its terms limit use of the funds to capital expenditures, some documentation showing that the grant proceeds were used for capital expenditures and not non-capitalizable operating costs.
- Records detailing when bond proceeds were spent on each grant. Copies of checks written or other payment instrument documentation prepared by the agencies for disbursements to the grantees, with supporting invoices or other evidence is preferred. DAS will work with state agencies to determine the required level of detail to minimize audit risk.
- Copies of all Form 8038-T, Form 8038-R , or other rebate related document as well as the rebate calculations for each computation period

These records should be retained until at least three years after the last bond in the series is no longer outstanding. That could be as long as 33 years for certain GO bonds.

Tax Reporting

In addition to maintaining separate accounts and records to support the arbitrage rebate calculations performed by the Capital Investment Section of DAS, your agency may be responsible for issuing certain tax forms and reporting that information to the IRS. If you issue grants to a for-profit entity, you are responsible for preparing Form 1099-MISC and providing those forms to the grantee and reporting that information to the IRS. Agencies that use bond proceeds to construct or develop an asset using outside vendors, consultants or contractors are required to issue Form 1099's and report that information to the IRS.

Controls on Grant Funds

Documentation should distinguish between grants and contracts for services. Treasury regulations define the term grant as a transfer for a governmental purpose of money or property to a transferee that is not a related party to or an agent of the transferor. The transfer must not impose any obligation or condition to directly or indirectly repay any amount to the transferor. However, obligations or conditions intended solely to assure expenditure of the transferred moneys in accordance with the governmental purpose of the transfer do not prevent a transfer from being a grant.