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Planning a Financing – Instructions for the Compliance Officer

This memorandum provides an overview of compliance procedures that should be followed in connection with a new tax-exempt bond financing. It is intended for an issuer that already has adopted written procedures governing ongoing tax and securities law compliance for its tax-exempt debt, and it assumes the issuer has selected you to be the "Compliance Officer" – the individual ultimately responsible for continuing compliance with federal tax and securities laws that apply to the issuer's tax-exempt bonds. For an example of a Tax-Exempt Financing Compliance Procedure see Tax-Exempt Financing Compliance Procedure Governmental Project Issuer. For more information concerning the IRS' directive that issuer's draft and implement compliance procedures see TEB Post-Issuance Compliance: Some Basic Concepts.

Overview

As the issuer's Compliance Officer, you are primarily responsible for making certain that the debt obligations ("bonds") of your issuer satisfy the ongoing federal income tax and securities law requirements for tax-exempt debt and publicly offered obligations as long as the bonds remain outstanding. The best way to accomplish this is to keep in mind that ongoing compliance requires the issuer to be "accountable" – (1) for the expenditure of bond proceeds, (2) for the investment of bond proceeds and related funds, (3) for the use the financed property, and finally (4) for timely public disclosure of key operating and financial data. Your goal, as the Compliance Officer, is to address each of these areas before the bonds are issued, so that you are ready to deal with the requirements efficiently on an ongoing basis.

Rely on the Experts

Being "responsible" does not mean you can or should bear the administrative burden of compliance alone. The issuer's regular legal counsel and bond counsel, and its financial advisors all should have a role in providing advice and support – particularly regarding how to best implement and document the compliance plan for a new bond issue.

Threshold Questions

Developing a compliance plan for your financing starts by asking two fundamental questions – one of them related to tax law compliance, and the other related to securities law compliance.

- *Tax Law Compliance.* Is this a "refinancing" of outstanding tax-exempt debt, or is this a "new money" financing (or is it both a refinancing and a new money bond issue)?

If the bonds will only be used to refinance outstanding tax-exempt debt, nearly all of the work the Compliance Officer must do will relate to the debt that is being *refinanced*. However, if all or any part of the financing is for "new money," the Compliance Officer must focus on (1) how bond proceeds of the upcoming new money portion will be spent and invested and (2) how the property that will be financed by the bonds will be used.

- *Securities Law Compliance.* Does the issuer plan to sell bonds in a "public offering" using an official statement or offering memorandum?

If the financing does not involve a "public offering," the issuer probably will not have any new ongoing *public* disclosure requirements under Federal securities law. Instead, the issuer's debt issue will be documented as a private financing transaction (e.g. a bank loan) and any ongoing operational or financial information requirements will be incorporated in the loan documents as part of a contract between the issuer and the lender.

TAX LAW COMPLIANCE

New Money Financing

1. *Reimbursement.* Your issuer may incur and pay costs for the project it intends to finance prior to the delivery/closing date of the bonds. These costs can be "reimbursed" from proceeds of the bonds if the issuer has evidenced in writing an intent to finance and reimburse the cost of the identified project and the total amount of the expected financing. Bond Counsel generally can prepare a "reimbursement" or "intent to finance" resolution. For further guidance see Reimbursement Guidelines.

2. *Accounting for Expenditures*. Generally, federal tax law requires that proceeds of a new money bond financing only be used (A) to pay "capital costs," (B) to fund a debt service reserve or (C) to pay professional and other related costs of issuing and selling the bonds ("costs of issuance"). The issuer must be able to substantiate costs (i) that it paid which qualify for tax-exempt financing and (ii) that are treated as paid from proceeds of the bond issue. This is known as "allocating" bond proceeds to the costs of the project. You should consider and discuss with Bond Counsel the following:

> a. What records need to be retained to substantiate each expenditure? At a minimum this would include the amount spent, payee, payment date and some other identifying accounting reference. For an example of issuer expenditure records see Sample Expenditure Records.
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> b. Should bond funds be deposited with a third party administrator such as a bond trustee or corporate disbursing agent to facilitate better reporting and record keeping?
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> c. If funds other than bond proceeds will be used to pay for part of the physical improvements, then how should the issuer decide what payments will be allocated to bond proceeds?
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> d. How will the issuer identify and account for investment earnings on bond proceeds?
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> e. What procedures should be followed for creating a final written allocation of bond proceeds to the projects; when should the process be initiated; who will create it, who will review it, and how will it be finalized? For an example of a final written allocation see Sample Form of Final Written Allocation.

3. *Accounting for Investments*. Federal tax rules require issuers to track the investment earnings on all bond proceeds and certain related funds that secure the bond issue. Tax Regulations contain procedures for acquiring certain special investment contracts or collateralized repurchase agreements. Most financings are subject to arbitrage rebate or yield reduction payment calculations, and under some circumstances the issuer will be required to limit its investments to special United States Treasury Securities (State & Local Government Series). For a summary of the arbitrage restrictions see Summary of Federal Arbitrage Law. You need to consider and discuss with Bond Counsel the following:

> a. What funds are subject to the arbitrage restrictions? This will include all proceeds of the bonds. It also may include funds and accounts that are required to be held as security for the financing.
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> b. Is it feasible or desirable to segregate money subject to arbitrage restriction so that it can be separately invested and tracked, and if not, how can the issuer allocate an appropriate portion of its

investment earnings to funds that are subject to arbitrage accounting rules? [Please note that this is often a difficult accounting problem.]

c. Will arbitrage rebate calculations be required for the financing, and under what circumstances will the issuer be required to perform yield reduction payments? When must these calculations be performed, and who will do them?

d. Are there any limits on the types of investments that may be acquired with funds subject to the arbitrage rules? When and under what circumstances will these restrictions apply?

4. *Accounting for Use of Financed Property*. Tax law requires that the issuer identify the property financed by tax-exempt debt. In most instances this "financed property" is generally subject to restrictions that require it to be owned by the issuer or another state or local government as long as the financing (or any refinancing) is outstanding. In addition, long-term leases are generally prohibited, and even short-term use arrangements and management agreements are subject to restrictions, particularly if the financed property is security for the bonds or is expected to generate revenues. For more information concerning the types of arrangements that may restricted by the federal tax rules see Management Contract Guidelines (for guidance on private management and operating agreements) and see Short-Term Use Agreements (for guidance regarding short-term use arrangements). Generally, issuers should complete an annual questionnaire in order to monitor and substantiate compliance with ongoing tax restrictions on the use and/or revenues derived from financed property. Prior to closing the bonds you should work with Bond Counsel to determine:

a. What actions/activities or agreements should trigger the obligation that an attorney review?

b. What questions should the issuer include in a written questionnaire? For an example of an annual compliance questionnaire see Sample TEB Annual Compliance Checklist.

Refunding Financing

1. *Accounting for Expenditures*. Tax law requires that in addition to accounting for the expenditure and investment of proceeds of the bonds and related funds, the issuer also must account for the expenditure of proceeds of the refinanced bonds (or the original financing).

2. *Accounting for Use of Financed Property*. Tax law generally requires that issuers monitor and limit the use of financed property beginning on the date it is placed in service. Certain exceptions may apply to property originally financed prior to 1997. For more detail concerning how these rules apply see Refunding Regulations.

SECURITIES LAW COMPLIANCE

Generally, the issuer will not be able to sell any financing in a public offering if it has not complied with prior agreements and commitments to annually file operating and financial information with EMMA. The exact content of the disclosure will depend on the terms of the "continuing disclosure agreement" or the "continuing disclosure undertaking." This document will be contained in the transcript of proceedings for most financings over $10 million issued after 1995 and all publicly offered financings after 2009. For a general discussion of the continuing disclosure obligations see Continuing Disclosure. As the Compliance Officer you should consider the following questions:

1. Is the issuer current for all continuing disclosure filings with EMMA for its outstanding financings?

2. What operating data and financial information is required to be disclosed for the upcoming financing?

3. Can the disclosure for this financing and outstanding financings be standardized?