TAX-EXEMPT BOND ESSENTIALS

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TAX-EXEMPT OBLIGATIONS GENERALLY

- An obligation issued by a state or local government the interest on which is excludable from gross income for federal income tax purposes.
- Holders of tax-exempt obligations will accept lower interests rate due to the tax savings, which in turn provides savings to the governmental issuer.
- By allowing tax-exempt bonds, the federal government is forgoing revenues that it otherwise would receive on taxable bonds. Thus, the federal government is interested in monitoring and limiting the amount of tax-exempt debt on the market.

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TAX-EXEMPT OBLIGATIONS GENERALLY

- In some circumstances, a governmental issuer may issue bonds and lend the proceeds to a 501(c)(3) entity. These "qualified 501(c)(3) bonds" must meet several requirements in addition to those imposed upon "governmental bonds."
- Differences include:
  - 100% of property must be owned by 501(c)(3) or governmental entity
  - Public approval requirement
  - 5% limit on private business use (instead of 10%)
    - Includes both use by a non-501(c)(3) entity AND use by a 501(c)(3) entity in an unrelated trade or business
  - Costs of issuance financed limited to 2% of bond issue
    - Counts toward 5% "bad use"
  - Most 501(c)(3) entities must complete Form 990, Schedule K

TAX-EXEMPT OBLIGATIONS GENERALLY

In order to be able to issue tax-exempt obligations, an issuer must comply with the applicable federal tax rules, including (but not limited to), rules relating to:

- Arbitrage
- Private Business Use
- Record Retention
- Corrective Actions

ARBITRAGE AND REBATE

Arbitrage and Rebate Basics

- Arbitrage is the result of borrowing in the tax-exempt market and investing in the taxable market
  - May be positive or negative
- Yield restriction is tested on an issue-by-issue basis
- Two main rules:
  - YIELD RESTRICTION: Bond proceeds may not be invested at a yield "materially higher" than the bond yield, except for a "minor portion" and any proceeds held during a temporary period or in a reasonably required reserve.
  - REBATE: Any arbitrage earnings must be rebated to the federal government, unless the issuer meets an exception.

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ARBITRAGE AND REBATE

Managing Yield Restriction

- Utilize a consistently applied accounting method for federal tax purposes.
  - Does not have to be the same method used for financial accounting
- Establish a procedure to track investments of bond proceeds, taking into account:
  - Temporary periods
  - Investment returns
  - Fair market value requirements
  - Yield reduction payments

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