

**CITY OF SARASOTA, FLORIDA**  
**Post-Issuance Tax Compliance Policy for Tax-Exempt Bonds**

**I. INTRODUCTION**

In order to maintain their preferential tax status, tax-exempt bonds are subject to certain federal tax law requirements both upon issuance of the bonds and on an ongoing basis for the life of the bond issue. Though many requirements are tested at the closing of the bond issue, the ongoing nature of other post-issuance compliance concerns requires issuers to actively monitor compliance throughout the entire period the bonds remain outstanding.

For the last several years, the Internal Revenue Service (the "IRS") has increasingly focused its initiatives on compelling issuers of tax-exempt and tax-advantaged obligations to adopt written post-issuance compliance procedures. In 2007, the IRS sent questionnaires to over 200 governmental bond issuers to inquire about written post-issuance compliance procedures. In 2010 and 2011, the IRS revised its various 8038 Forms to require an issuer to answer whether it has established written procedures to ensure that all nonqualified bonds are remediated in accordance with the requirements of the Internal Revenue Code of 1986, as amended (the "Code") and regulations promulgated thereunder (the "Regulations"). The revised forms also require an issuer to answer whether it has established written procedures to monitor the arbitrage requirements of Section 148 of the Code. It is recognized that the IRS intends for issuers of tax-exempt bonds to take a more proactive role in monitoring compliance with the Code and Regulations after the issuance of the bonds.

When the City of Sarasota, Florida (the "City") issues tax-exempt and tax-advantaged obligations (the "Bonds") to finance or refinance various capital projects, the City is responsible for ensuring that the Bonds maintain compliance with tax law requirements through the Bonds' maturity date. Bonds may include the following:

1. General Obligation Bonds
2. Special Obligation Bonds
3. Revenue Bonds
4. Qualified private activity bonds
5. Tax-exempt lease arrangements
6. Tax-exempt bank loans and notes
7. Build America Bonds, Recovery Zone Economic Development Bonds and other direct-payment subsidy bonds that may be issued under future programs

8. State Revolving Fund Loans from the Florida Department of Environmental Protection (FDEP)
9. Loans from the First Florida Governmental Financing Commission (FFGFC)
10. Other qualified tax exempt or tax credit bonds

In order to support the compliance initiatives described above, the City of Sarasota hereby adopts these policies and procedures for monitoring compliance with the Code and Regulations (the "Compliance Policy"). The Finance Director may, from time to time, as may be necessary, review and update the Compliance Policy. The Compliance Policy does not address bonds or other financing obligations issued by other city agencies, boards and authorities; it is the intent of the City that such bond-issuing organizations adopt their own post-issuance compliance policies for tax-exempt bonds that they issue. By adopting this Compliance Policy and by requiring staff to adhere to this Compliance Policy, the Finance Director hereby formalizes the appropriate procedures and documents existing practices for complying with the Code and Regulations.

## **II. GENERAL MATTERS**

### **A. Staffing and Education**

The City's compliance initiatives are led by the Finance Director and Deputy Finance Director.

The Finance Director and Deputy Finance Director shall:

- i. Assign post-issuance compliance responsibilities to other City staff, Bond Counsel, the Financial Advisor, the Arbitrage Specialist and others as necessary to ensure compliance with the Compliance Policy.
- ii. Provide education and training to appropriate staff members on federal tax law requirements applicable to tax-exempt bonds. The IRS Tax Exempt Bonds division (TEB) offers specialized information and services to the municipal finance community including education and outreach programs. Information on these programs as well as information related to federal tax law, tax forms, revenue procedures, TEB publications and emerging issues in the industry is available through TEB's website at <http://www.irs.gov/bonds>. The Securities and Exchange Commission and the Municipal Securities Rulemaking Board also provide educational opportunities through their websites.
- iii. Undergo periodic training to keep up to date with changes in tax laws.

- iv. Annually review the Compliance Policy for changes in tax law or changes in procedures. Upon review, the Finance Director shall update the Compliance Policy to reflect any such changes. If any questions arise, the Finance Director may consult with Bond Counsel.

#### **B. Bond Schedule**

The Finance Director or Deputy Finance Director shall:

- i. Maintain an electronic database of the City's outstanding Bonds.
- ii. Maintain an index of refunding transactions, detailing refunding and refunded issues.

#### **C. Asset Schedule**

The Finance Director or Deputy Finance Director shall:

- i. Establish an index of bond-financed facilities and equipment (the "Asset Schedule") for the purpose of maintaining a database for easy reference when compliance issues arise.
- ii. Update the Asset Schedule with additional facilities and equipment after each new issuance of Bonds or other debt obligations. A sample Asset Schedule is attached as Schedule I.
- iii. Review the Asset Schedule at the close of each fiscal year to determine if any changes have occurred to any of the bond-financed facilities that require further attention.

### **III. RECORD RETENTION**

The IRS requires issuers to maintain sufficient records to support bondholders' continued exclusion of interest on the Bonds. Documents required to be held include basic records relating to the bond transaction, documents evidencing the expenditure of bond proceeds, documents evidencing the use of bond-financed property by public and private sources, documents evidencing all sources of payment and security of the bonds and documents pertaining to the investment of bond proceeds.

Material records relating to an issue of Bonds should generally be kept for as long as that issue of Bonds is outstanding, plus 3 years after the final redemption date. If the issue of Bonds is refunded, the tax-exempt status of the refunding bonds depends on the status of the refunded bonds. Thus, records for any refunded issue must be retained through 3 years after the final redemption date of the refunding bonds.

Records should be kept in a manner that ensures their complete access to the IRS for the periods described above. The IRS provides that records may be maintained in an electronic format if certain requirements are satisfied. A list of those requirements is attached as Exhibit A hereto.

The Finance Director or Deputy Finance Director shall:

- i. Establish a permanent file for each issue of Bonds upon its closing date with which all material records shall be kept (the "Permanent File").
- ii. Maintain copies of all material records in the Permanent File for that issue of Bonds through the date that is 3 years after the final maturity date of the issue; or, if the Bonds are refunded, 3 years after the final maturity date of the refunding Bonds.
- iii. Maintain schedules of records retained and their locations for each issue of Bonds (the "Record Retention Schedules"). Sample Record Retention Schedules are attached as Schedule II hereto.
- iv. Review the Record Retention Schedules at the close of each fiscal year for accuracy. If the location of any record has changed, the Finance Director or Deputy Finance Director shall update the Record Retention Schedule.

#### **IV. PRIVATE BUSINESS USE**

Certain uses of proceeds of the Bonds can result in private business use, which could lead to a loss of the Bonds' tax-exempt status. An issue of Bonds will lose its tax-exempt status if it meets both the Private Business Use Test and the Private Payment or Security Test. An issue of Bonds meets the Private Business Use Test if more than 10% of the net proceeds of the bond issue is used for any private business use.

Management contracts between governmental entities and private parties with respect to bond-financed facilities may satisfy the private business use tests and potentially cause the Bonds to lose their tax-exempt status. The IRS has provided certain safe harbors regarding management service contracts between a tax-exempt organization and a for-profit entity under which no private use will be found. Such safe harbors are detailed in Revenue Procedure 97-13, which is attached as Exhibit B hereto.

The Finance Director or Deputy Finance Director shall:

- i. Prior to the City entering into any agreement with respect to any bond-financed facilities, review such agreement to ensure that it will not give rise to a violation of the private business use rules. Agreements that must be monitored include leases, management and service contracts,

sponsored research agreements, potential unrelated trades or business, partnerships, joint ventures and naming rights agreements.

ii. Engage Bond Counsel or other outside counsel to review any agreements which the Finance Director believes may result in private business use.

iii. Conduct a review of the bond-financed facilities listed on the Asset Schedule to identify transactions that could result in private business use. The Finance Director or Deputy Finance Director will complete the Private Use Review Questionnaire (attached as Schedule III hereto) for each facility at the close of each Fiscal Year.

iv. If any private business use exists for a facility, calculate the percentage of financed property used in a private business use by entities other than a state or local governmental unit.

## **V. PRIVATE PAYMENTS**

The private business tests are comprised of two separate tests: the Private Business Use Test described above in Section IV and the Private Payment or Security Test. In those cases where the Private Business Use Test is likely to be met, precautions must be taken to ensure that the Private Payment or Security Test is not also met. An issue of Bonds meets the Private Payment or Security Test if more than 10% of the payment of principal or interest on the Bonds is either made or secured (directly or indirectly) by payments or property used or to be used for a private business use.

The Finance Director shall:

- i. Track the direct and indirect payment of debt service on the Bonds made or secured by payments or property to be used for a private business use. The Finance Director shall compare the present value of private payments or property to the present value of the debt service to be paid over the term of the issue. If it appears that the Private Payment or Security Test will be met, the Finance Director shall notify Bond Counsel immediately.

## **VI. EXPENDITURE OF PROCEEDS**

The Finance Director or Deputy Finance Director shall:

- i. Distribute the Project Manager's Certificate to the appropriate Project Manager on the closing date of each issue of new money Bonds. The Project Manager's Certificate is attached as Schedule IV to this Compliance Policy.

ii. Verify that the actual expenditure of proceeds of each issue of Bonds does not deviate materially from the expectations and limitations in the tax certificate for each issue.

iii. Ensure that, for each bond-financed facility, bond proceeds are allocated to expenditures before the earlier of: (i) 18 months after the placed-in-service date of the project, (ii) five years after the issue date of the Bonds, or (iii) 60 days after the retirement of the Bonds.

iv. Ensure that documentation supporting the allocation of bond proceeds to expenditures is recorded and retained in accordance with Section II of this Tax Compliance Plan.

## **VII. ARBITRAGE REBATE AND YIELD RESTRICTION**

Section 148 of the Code and the related arbitrage Regulations require issuers to “rebate” excess amounts earned as a result of investing tax-exempt bond proceeds. Excess amounts are defined in the Code and Regulations as the amount earned on nonpurpose investments purchased with gross proceeds of an issue over the amount that would have been earned if the yield of such investments equaled the yield on the bonds. Two separate but related sets of rules apply to arbitrage compliance: arbitrage rebate and yield restriction. Under the rebate rules, proceeds may be invested at unrestricted yields, but excess earnings must be timely remitted to the IRS; the yield restriction rules require proceeds to be invested at restricted rates.

The Finance Director or Deputy Finance Director shall:

i. Complete the Arbitrage Summary for each bond issue upon issuance of the debt. The Arbitrage Summary is attached as Schedule V hereto.

ii. Direct the investment and expenditure of bond proceeds to facilitate tracing of proceeds subject to arbitrage. Such proceeds include sale proceeds, investment proceeds (earnings on proceeds), transferred proceeds (unspent proceeds of refunded bonds which are treated for tax purposes as refunding bond proceeds) and replacement proceeds. Replacement proceeds are funds such as pledged amounts or debt service funds which are viewed by the Treasury as having a “direct nexus” to the issue, which as a result are restricted.

iii. Monitor applicable IRS filing dates for arbitrage compliance. At a minimum arbitrage must be computed for each bond issue every fifth bond year and upon retirement of the issue. The Finance Director or Deputy Finance Director shall ensure that a final arbitrage calculation be prepared within 60 days of the redemption of each issue of refunded

bonds. Any rebate amount owed shall be paid and submitted to the IRS with Form 8038-T prior to the date that is 60 days after the final maturity date of the refunded bonds

iv. Monitor proceeds to determine if they are subject to yield restriction, and if so, maintain compliance with such rules.

v. Certain "spending exceptions to rebate" are permitted under the Regulations. The Finance Director and Deputy Finance Director will be familiar with such spending exceptions and monitor the expenditure of proceeds with the goal of qualifying for a spending exception if the bond-financed project lends itself to such exemption. A summary of available spending exceptions and their benchmarks is attached as Exhibit C hereto.

vi. Retain an arbitrage compliance specialist (the "Arbitrage Specialist") to provide arbitrage reports.

vii. Complete the Ongoing Review Arbitrage Checklist (attached as Schedule VII hereto) at the end of each fiscal year and provide checklist to the Arbitrage Specialist.

viii. Provide data as needed to the Arbitrage Specialist as noted on Schedule II under the heading "Arbitrage Rebate Documents".

ix. Retain copies of arbitrage reports and filings with the Internal Revenue Service (IRS Form 8038-T and copy of check) in the Permanent File. All supporting data for arbitrage reports will also be retained in the Permanent File.

## **VIII. REMEDIES**

The IRS provides certain remedies to assist issuers in resolving federal tax violations related to their bonds. In the event that any issue of Bonds exceeds the private business use limitations, certain remedial actions may be available under Section 1.141-12 of the Regulations. In addition, the IRS administers a Voluntary Closing Agreement Program ("VCAP") designed to offer issuers a streamlined process for remedying other post-issuance compliance violations. In general, for the same tax violation, an issuer will receive more favorable resolution terms under VCAP than if discovered during an examination of the Bonds. The IRS has further provided that issuers that have implemented written procedures such as this Compliance Policy will receive even more favorable treatment under VCAP than if such procedures were not in place.

The Finance Director and Deputy Finance Director shall:

- i. Become familiar with the remedial actions of Section 1.141-12, a summary of which is attached as Exhibit D hereto. If the Finance Director determines that a violation has occurred, the Finance Director shall contact Bond Counsel or other outside counsel to take action to correct the noncompliance.
- ii. Become familiar with the IRS's VCAP procedures, attached as Exhibit E hereto. If the Finance Director determines that a violation has occurred, the Finance Director shall contact Bond Counsel or other outside counsel to take action to correct the noncompliance.

## **IX. REISSUANCE**

The Finance Director or Deputy Finance Director shall:

- i. Identify and consult with Bond Counsel regarding any post-issuance change to any terms of an issue of Bonds which could potentially result in the Bonds being treated as reissued for tax purposes.
- ii. Confirm with Bond Counsel whether any remedial action taken or contemplated under Section VIII of this Compliance Policy would be treated as a reissuance for tax purposes and, if so, confirm the filing of a new Form 8038-G.

## **X. BUILD AMERICA BONDS / RECOVERY ZONE ECONOMIC DEVELOPMENT BONDS**

Certain of the City's Bonds have been issued as Build America Bonds or Recovery Zone Economic Development Bonds under the American Recovery and Reinvestment Act of 2009. In order to receive direct subsidy payments on such Bonds, the City must file Form 8038-CP no later than 45 days before each interest payment date and no earlier than 90 days prior to the interest payment date.

The Finance Director or Deputy Finance Director shall:

- i. Monitor that all available project proceeds (sale proceeds minus proceeds allowed for costs of issuance minus amounts in a reasonably required reserve fund plus investment earnings) were used for capital expenditures.
- ii. The City's Sales Tax Payments Revenue Bonds, Series 2010 (the "Series 2010 Bonds") were issued as Recovery Zone Economic Development Bonds. Certain proceeds of the Series 2010 Bonds were transferred to Sarasota County (the "County") pursuant to Interlocal Agreements dated July 24, 2009 and April 20, 2010 to finance a portion of

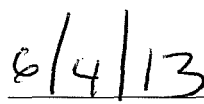


the 2010 Project (as further described in the Tax Certificate for the Series 2010 Bonds). The Finance Director shall coordinate with the County to ensure that proceeds of the Series 2010 Bonds are spent in accordance with item (i) above.

iii. Coordinate with the Accounting Department to ensure that Form 8038-CP is promptly filed no later than 45 days before each interest payment date, comparing the amount requested with the debt service schedule attached to Form 8038-B to ensure that the correct payment is requested at the correct time.

Approved

  
\_\_\_\_\_  
John Lege, CGFO, Finance Director

  
\_\_\_\_\_  
Date

**SCHEDULE I**

**Sample Asset Schedule**

<b>TAX-EXEMPT</b>			
<b>Asset/Facility</b>	<b>Location</b>	<b>Bond Issue(s)</b>	<b>Placed In Service Date</b>

**SCHEDULE II**  
**Record Retention Schedule**  
**Complete for Each Issue of Bonds**

FILE	LOCATION
<b>General</b>	
Audited financial statements	
Appraisals, demand surveys, or feasibility studies, if any, with respect to the facilities	
Trustee or paying agent statements for debt service payments	
Relevant correspondence with respect to the Bonds	
The transcript for the Bonds prepared at issuance	
Resolutions of the City with respect to any of the Bonds	
<b>Arbitrage Rebate Documents</b>	
Records of all investments and gains (or losses) from such investments	
Trustee statements detailing investments, investment earnings and disbursements of bond proceeds	
Reimbursement resolutions, if any, and expenditures reimbursed with the proceeds of the Bonds	
Arbitrage rebate reports and copies of rebate and yield reduction payments	
Copies of all Form 8038-Ts and 8038-Rs filed with the IRS	
Documents related to guaranteed investment contracts, certificates of deposit, or other investment agreements	
Documents related to credit enhancement agreements	
Documents related to financial derivatives such as swap transactions and other hedging agreements	
Formal elections authorized by the Code or Regulations with respect to the Bonds	

<b>Expenditure of Proceeds</b>	
Allocations of proceeds to expenditures (including any requisitions, draw schedules, draw requests, invoices, bills, and canceled checks with respect to such expenditures)	
Contracts entered into for the construction, renovation or purchase of bond-financed facilities	
Records of the purchase or sale of bond-financed assets	
<b>Private Business Use and Private Payments</b>	
Agreements with respect to the bond-financed facilities, such as leases, subleases, management and service contracts, research agreements, naming rights agreements, etc.	
Records and calculations pertaining to the Private Payment or Security Test	

### SCHEDULE III

**Private Use Review Questionnaire**  
**Complete Annually for Each Bond-Financed Facility**

Facility: \_\_\_\_\_

Bond Issue: \_\_\_\_\_

Review Period: \_\_\_\_\_

**With respect to the bond-financed facility, have any of the following been entered into during the Fiscal Year?**  
**(if any answer is yes, attach copies of agreement)**

	YES / NO	INITIALS
Management and other service agreements?		
Research contracts?		
Naming rights contracts?		
Change in ownership?		
Leases or subleases?		
Other business arrangements? (joint venture / partnership / LLC, etc)		
Have any special legal rights been given to any other party with respect to the facilities?		
Have the assets been encumbered in any way?		

**With respect to the bond-financed facility, what percentage of the facility has been used for private business use?**  
**(if greater than zero, attach schedules of calculations)**

By entities other than a state or local government?	
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**SCHEDULE IV**  
**Sample Project Manager's Certificate**

\$ \_\_\_\_\_  
The City of Sarasota, Florida  
\_\_\_\_\_ Bonds  
Series \_\_\_\_\_

**PROJECT MANAGER'S CERTIFICATE**

In connection with the issuance by the City of Sarasota, Florida (the "City") of its \$ \_\_\_\_\_ Bonds, Series \_\_\_\_\_ (the "Series \_\_\_\_\_ Bonds") and as an inducement for the Finance Director to execute the Tax Certificate as to Arbitrage and the Provisions of Sections 141-150 of the Internal Revenue Code of 1986, as amended (the "Tax Certificate"), the undersigned \_\_\_\_\_ (the "Project Managers") hereby certify to the best of our knowledge, information and belief the expectations described below. All capitalized undefined terms used herein shall have the meanings ascribed thereto in the Tax Certificate and the Resolution (as such term is defined in the Tax Certificate).

On the basis of the facts, estimates and circumstances in existence on the date hereof, and for so long as the Series \_\_\_\_\_ Bonds remain outstanding, we reasonably expect the following with respect to (i) the expenditure of the proceeds of the Series \_\_\_\_\_ Bonds deposited in the \_\_\_\_\_ Fund to pay Project costs, (ii) the uses of the proceeds in the \_\_\_\_\_ Fund and (iii) the use of the Project:

- (a) The Project will be completed and at least 85 percent of the proceeds in the \_\_\_\_\_ Fund will be allocated to Project expenditures within three years of the date hereof.
- (b) Funding for the construction and operation of the Project shall be provided solely by the City.
- (c) The Project will be used solely by the City.
- (d) All right and title to the Project will be held solely by the City.
- (e) Upon completion thereof, the assets and operation of the Project will be managed by the City.

The Project Managers further acknowledge that they will:

- (a) Notify the Finance Director of the City immediately upon learning that any of the above described facts, estimates and circumstances may change or have changed during the period the Series \_\_\_\_ Bonds are outstanding.
- (b) Monitor spending exception benchmarks for the [18 month exception / 24 month exception] as outlined in the attached Exhibit.
- (c) Communicate to the Finance Director at the end of each six month period the amount of proceeds spent in the \_\_\_\_ Fund.
- (d) Notify the Finance Director of the City if any of the facilities comprising the Project are sold or leased or are expected to be sold or leased.

IN WITNESS HEREOF, we have hereunto set our hands this \_\_\_\_ day of \_\_\_\_\_, \_\_\_\_.

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Title

## SCHEDULE V

### **Arbitrage Summary** Complete Upon Issuance of Debt

#### **Monitoring**

Bond Issue	
Issue date	
Maturity Date	
Bond Year End (1)	
IRS Arbitrage Computation Dates (2)	

#### **Bond Proceeds Tracking (include sale proceeds and all related bond accounts including debt service funds)**

<b>Fund Name</b>	<b>Bank Account</b>	<b>Deposit Amount</b>	<b>Yield Restriction Date (3)</b>

- (1) Bond Year End – Each one year period that ends on the day selected by the issuer. The first and last bond years may be short periods. If no day is selected, bond years end on each anniversary of the issue date and on the final maturity of the issue.
- (2) IRS Arbitrage Computations occur at a minimum each 5<sup>th</sup> bond year and upon maturity of the issue.
- (3) Proceeds are restricted at the end of the “temporary period” that applies to the proceeds. Temporary periods vary based upon type of financing and type of proceeds. For example, proceeds for capital projects generally have a three year temporary period. The temporary periods are outlined in the tax documents for the financing.



## SCHEDULE VI

### Ongoing Review Arbitrage Checklist

Issue: \_\_\_\_\_

Computation Date: \_\_\_\_\_

#### Initial

	<p>Review records and identify any account deposits which are not interest income. State whether they are:</p> <ul style="list-style-type: none"><li>a) reimbursements of proceeds which effectively reverse prior expenditures, or</li><li>b) other funds which are commingled in the proceeds account. If they are other funds, provide additional detail concerning the source and nature of the transactions.</li></ul>
	<p>Identify and describe the disposition of all funds which leave an account which are not <b>actual expenditures</b> of proceeds. This includes transfers to other accounts. In the case of transfers, describe if the transfers are to reimburse expenses already paid out of the other account, or if they are invested in the other account. If they are invested in the other account, provide detail of the investment and disposition of these funds until spent (including if they are transferred elsewhere). This includes an allocation of interest earnings.</p>
	<p>If credit enhancement or swap terms have been revised, extended or terminated, provide supporting documentation.</p>
	<p>Identify if the bonds have been refunded and/or defeased. If so, provide bond documents for the refunding issue or defeasance documents (including Verification Report).</p>
	<p>Provide copies of all correspondence (including emails) with bond counsel and/or interdepartmental memos concerning proceeds or decisions that relate to the Bonds.</p>

## SCHEDULE VII

### Annual Compliance Checklist

INITIAL	TASK
	Review the Compliance Policy for changes in tax law or changes in internal procedures. If any changes are determined necessary, update the Compliance Policy.
	Review the Asset Schedule to determine if any changes have occurred to any of the bond-financed facilities that require further attention.
	Review the Record Retention Schedule for accuracy. If the locations of any records have changed, update the Record Retention Schedule.
	Complete the Private Use Review Questionnaire for each bond-financed facility
	For each issue of Bonds where Private Business Use may exceed 10%, verify that the Bonds do not meet the Private Payment or Security Test.
	Complete the Ongoing Review Arbitrage Checklist. Provide the completed checklist to the Arbitrage Specialist and consult with the Arbitrage Specialist to determine if it is appropriate to perform an arbitrage calculation at that time. Calculations should be performed annually when proceeds are outstanding, and at a minimum on every fifth anniversary of the date of issuance of the Bonds.
	With respect to any bond proceeds spent during the year, confirm that the actual expenditure of proceeds does not deviate materially from the expectations and limitations in the Tax Certificate for such issue.
	Confirm that no changes have been made to the terms of any issue of obligations that would result in a reissuance of the debt.

Date: \_\_\_\_\_

\_\_\_\_\_  
By: Finance Director

## Exhibit A

### **Record Retention Guidelines for Electronic Storage**

All records should be kept in a manner that ensures their complete access to the IRS for so long as they are material. While this is typically accomplished through the maintenance of hard copies, taxpayers may keep their records in an electronic format if certain requirements are satisfied.

Revenue Procedure 97-22 provides guidance to issuers that maintain books and records by using an electronic storage system that either images their hardcopy (paper) books and records, or transfers their computerized books and records, to an electronic storage media. Such a system may also include reasonable data compression or formatting technologies so long as the requirements of the revenue procedure are satisfied. The general requirements for an electronic storage system of taxpayer records are provided in section 4.01 of Rev. Proc. 97-22. A summary of these requirements is as follows:

1. The system must ensure an accurate and complete transfer of the hardcopy books and records to the electronic storage system and contain a retrieval system that indexes, stores, preserves, retrieves, and reproduces all transferred information.
2. The system must include reasonable controls and quality assurance programs that (a) ensure the integrity, accuracy, and reliability of the system, (b) prevent and detect the unauthorized creation of, addition to, alteration of, deletion of, or deterioration of electronically stored books and records, (c) institute regular inspections and evaluations, and (d) reproduce hardcopies of electronically stored books and records that exhibit a high degree of legibility and readability.
3. The information maintained in the system must be cross-referenced with the issuer's books and records in a manner that provides an audit trail to the source document(s).
4. The issuer must maintain, and provide to the IRS upon request, a complete description of the electronic storage system including all procedures relating to its use and the indexing system.
5. During an examination, the issuer must retrieve and reproduce hardcopies of all electronically stored books and records requested by the IRS and provide the IRS with the resources necessary to locate, retrieve, read and reproduce any electronically stored books and records.
6. The system must not be subject, in whole or in part, to any agreement that would limit the IRS's access to and use of the system.
7. The issuer must retain electronically stored books and records so long as their contents may become material in the administration of federal tax law.

## Exhibit B

### Revenue Procedure 97-13

#### **Rev. Proc. 97-13 1997-1 C.B. 632--Management Contract Guidelines (Supersedes Rev. Proc. 93-19)**

1997-1 C.B. 632; 1997 IRB LEXIS 14; 1997-5 I.R.B. 18; REV. PROC. 97-13  
(Also Part I, §§ 103, 141, 145; 1.141-3, 1.145-2.)  
February 3, 1997

#### **SECTION 1. PURPOSE**

The purpose of this revenue procedure is to set forth conditions under which a management contract does not result in private business use under § 141(b) of the Internal Revenue Code of 1986. This revenue procedure also applies to determinations of whether a management contract causes the test in § 145(a)(2)(B) of the 1986 Code to be met for qualified 501(c)(3) bonds.

#### **SECTION 2. BACKGROUND**

##### *.01 Private Business Use.*

(1) Under § 103(a) of the 1986 Code, gross income does not include interest on any state or local bond. Under § 103(b)(1) of the 1986 Code, however, § 103(a) of the 1986 Code does not apply to a private activity bond, unless it is a qualified bond under § 141(e) of the 1986 Code. Section 141(a)(1) of the 1986 Code defines "private activity bond" as any bond issued as part of an issue that meets both the private business use and the private security or payment tests. Under § 141(b)(1) of the 1986 Code, an issue generally meets the private business use test if more than 10 percent of the proceeds of the issue are to be used for any private business use. Under § 141(b)(6)(A) of the 1986 Code, private business use means direct or indirect use in a trade or business carried on by any person other than a governmental unit. Section 145(a) of the 1986 Code also applies the private business use test of § 141(b)(1) of the 1986 Code, with certain modifications.

(2) Corresponding provisions of the Internal Revenue Code of 1954 set forth the requirements for the exclusion from gross income of the interest on state or local bonds. For purposes of this revenue procedure, any reference to a 1986 Code provision includes a reference to the corresponding provision, if any, under the 1954 Code.

(3) Private business use can arise by ownership, actual or beneficial use of property pursuant to a lease, a management or incentive payment contract, or certain other arrangements. The Conference Report for the Tax Reform Act of 1986, provides as follows:

The conference agreement generally retains the present-law rules under which use by persons other than governmental units is determined for purposes of the trade or business use test. Thus, as under present law, the use of bond-financed property is treated as a use of bond proceeds. As under present law, a person may be a user of bond proceeds and bond-financed property as a result of (1) ownership or (2) actual or beneficial use of property pursuant to a lease, a management or incentive payment contract, or (3) any other arrangement such as a take-or-pay or other output-type contract. 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-687-688, (1986) 1986-3 (Vol. 4) C.B. 687-688 (footnote omitted).

(4) A management contract that gives a nongovernmental service provider an ownership or leasehold interest in financed property is not the only situation in which a contract may result in private business use.

(5) Section 1.141-3(b)(4)(i) of the Income Tax Regulations provides, in general, that a management contract (within the meaning of § 1.141-3(b)(4)(ii)) with respect to financed property may result in private business use of that property, based on all the facts and circumstances.

(6) Section 1.141-3(b)(4)(i) provides that a management contract with respect to financed property generally results in private business use of that property if the contract provides for compensation for services rendered with compensation based, in whole or in part, on a share of net profits from the operation of the facility.

(7) Section 1.141-3(b)(4)(iii), in general, provides that certain arrangements generally are not treated as management contracts that may give rise to private business use. These are--

(a) Contracts for services that are solely incidental to the primary governmental function or functions of a financed facility (for example, contracts for janitorial, office equipment repair, hospital billing or similar services);

(b) The mere granting of admitting privileges by a hospital to a doctor, even if those privileges are conditioned on the provision of de minimis services, if those privileges are available to all qualified physicians in the area, consistent with the size and nature of its facilities;

(c) A contract to provide for the operation of a facility or system of facilities that consists predominantly of public utility property (as defined in § 168(i)(10) of the 1986 Code), if the only compensation is the reimbursement of actual and direct expenses of the service provider and reasonable administrative overhead expenses of the service provider; and

(d) A contract to provide for services, if the only compensation is the reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties.

(8) Section 1.145-2(a) provides generally that §§ 1.141-0 through 1.141-15 apply to § 145(a) of the 1986 Code.

(9) Section 1.145-2(b)(1) provides that in applying §§ 1.141-0 through 1.141-15 to § 145(a) of the 1986 Code, references to governmental persons include section 501(c)(3) organizations with respect to their activities that do not constitute unrelated trades or businesses under § 513(a) of the 1986 Code.

*.02 Existing Advance Ruling Guidelines.* Rev. Proc. 93-19, 1993-1 C.B. 526, contains advance ruling guidelines for determining whether a management contract results in private business use under § 141(b) of the 1986 Code.

### SECTION 3. DEFINITIONS

.01 *Adjusted gross revenues* means gross revenues of all or a portion of a facility, less allowances for bad debts and contractual and similar allowances.

.02 *Capitation fee* means a fixed periodic amount for each person for whom the service provider or the qualified user assumes the responsibility to provide all needed services for a specified period so long as the quantity and type of services actually provided to covered persons varies substantially. For example, a capitation fee includes a fixed dollar amount payable per month to a medical service provider for each member of a health maintenance organization plan for whom the provider agrees to provide all needed medical services for a specified period. A capitation fee may include a variable component of up to 20 percent of the total capitation fee designed to protect the service provider against risks such as catastrophic loss.

.03 *Management contract* means a management, service, or incentive payment contract between a qualified user and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility. For example, a contract for the provision of management services for an entire hospital, a contract for management services for a specific department of a hospital, and an incentive payment contract for physician services to patients of a hospital are each treated as a management contract. See §§ 1.141-3(b)(4)(ii) and 1.145-2.

.04 *Penalties* for terminating a contract include a limitation on the qualified user's right to compete with the service provider; a requirement that the qualified user purchase equipment, goods, or services from the service provider; and a requirement that the qualified user pay liquidated damages for cancellation of the contract. In contrast, a requirement effective on cancellation that the qualified user reimburse the service provider for ordinary and necessary expenses or a restriction on the qualified user against hiring key personnel of the service provider is generally not a contract termination penalty. Another contract between the service provider and the qualified user, such as a loan or guarantee by the service provider, is treated as creating a contract termination penalty if that contract contains terms that are not customary or arm's-length that could operate to prevent the qualified user from terminating the contract (for example, provisions under which the contract terminates if the management contract is terminated or that place substantial restrictions on the selection of a substitute service provider).

.05 *Periodic fixed fee* means a stated dollar amount for services rendered for a specified period of time. For example, a stated dollar amount per month is a periodic fixed fee. The stated dollar amount may automatically increase according to a specified, objective, external standard that is not linked to the output or efficiency of a facility. For example, the Consumer Price Index and similar external indices that track increases in prices in an area or increases in revenues or costs in an industry are objective external standards. Capitation fees and per-unit fees are not periodic fixed fees.

.06 *Per-unit fee* means a fee based on a unit of service provided specified in the contract or otherwise specifically determined by an independent third party, such as the administrator of the Medicare program, or the qualified user. For example, a stated dollar amount for each specified

medical procedure performed, car parked, or passenger mile is a per-unit fee. Separate billing arrangements between physicians and hospitals generally are treated as per-unit fee arrangements.

.07 *Qualified user* means any state or local governmental unit as defined in § 1.103-1 or any instrumentality thereof. The term also includes a section 501(c)(3) organization if the financed property is not used in an unrelated trade or business under § 513(a) of the 1986 Code. The term does not include the United States or any agency or instrumentality thereof.

.08 *Renewal option* means a provision under which the service provider has a legally enforceable right to renew the contract. Thus, for example, a provision under which a contract is automatically renewed for one-year periods absent cancellation by either party is not a renewal option (even if it is expected to be renewed).

.09 *Service provider* means any person other than a qualified user that provides services under a contract to, or for the benefit of, a qualified user.

#### **SECTION 4. SCOPE**

This revenue procedure applies when, under a management contract, a service provider provides management or other services involving property financed with proceeds of an issue of state or local bonds subject to § 141 or § 145(a)(2)(B) of the 1986 Code.

#### **SECTION 5. OPERATING GUIDELINES FOR MANAGEMENT CONTRACTS**

.01 *In general.* If the requirements of section 5 of this revenue procedure are satisfied, the management contract does not itself result in private business use. In addition, the use of financed property, pursuant to a management contract meeting the requirements of section 5 of this revenue procedure, is not private business use if that use is functionally related and subordinate to that management contract and that use is not, in substance, a separate contractual agreement (for example, a separate lease of a portion of the financed property). Thus, for example, exclusive use of storage areas by the manager for equipment that is necessary for it to perform activities required under a management contract that meets the requirements of section 5 of this revenue procedure, is not private business use.

.02 *General compensation requirements.*

(1) *In general.* The contract must provide for reasonable compensation for services rendered with no compensation based, in whole or in part, on a share of net profits from the operation of the facility. Reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties is not by itself treated as compensation.

(2) *Arrangements that generally are not treated as net profits arrangements.* For purposes of § 1.141-3(b)(4)(i) and this revenue procedure, compensation based on--

(a) A percentage of gross revenues (or adjusted gross revenues) of a facility or a percentage of expenses from a facility, but not both;

(b) A capitation fee; or

(c) A per-unit fee is generally not considered to be based on a share of net profits.

(3) *Productivity reward.* For purposes of § 1.141-3(b)(4)(i) and this revenue procedure, a productivity reward equal to a stated dollar amount based on increases or decreases in gross revenues (or adjusted gross revenues), or reductions in total expenses (but not both increases in gross revenues (or adjusted gross revenues) and reductions in total expenses) in any annual period during the term of the contract, generally does not cause the compensation to be based on a share of net profits.

(4) *Revision of compensation arrangements.* In general, if the compensation arrangements of a management contract are materially revised, the requirements for compensation arrangements under section 5 of this revenue procedure are retested as of the date of the material revision, and the management contract is treated as one that was newly entered into as of the date of the material revision.

.03 *Permissible Arrangements.* The management contract must be described in section 5.03(1), (2), (3), (4), (5), or (6) of this revenue procedure.

(1) *95 percent periodic fixed fee arrangements.* At least 95 percent of the compensation for services for each annual period during the term of the contract is based on a periodic fixed fee. The term of the contract, including all renewal options, must not exceed the lesser of 80 percent of the reasonably expected useful life of the financed property and 15 years. For purposes of this section 5.03(1), a fee does not fail to qualify as a periodic fixed fee as a result of a one-time incentive award during the term of the contract under which compensation automatically increases when a gross revenue or expense target (but not both) is reached if that award is equal to a single, stated dollar amount.

(2) *80 percent periodic fixed fee arrangements.* At least 80 percent of the compensation for services for each annual period during the term of the contract is based on a periodic fixed fee. The term of the contract, including all renewal options, must not exceed the lesser of 80 percent of the reasonably expected useful life of the financed property and 10 years. For purposes of this section 5.03(2), a fee does not fail to qualify as a periodic fixed fee as a result of a one-time incentive award during the term of the contract under which compensation automatically increases when a gross revenue or expense target (but not both) is reached if that award is equal to a single, stated dollar amount.

(3) *Special rule for public utility property.* If all of the financed property subject to the contract is a facility or system of facilities consisting of predominantly public utility property (as defined in § 168(i)(10) of the 1986 Code), then "20 years" is substituted--

(a) For "15 years" in applying section 5.03(1) of this revenue procedure; and

(b) For "10 years" in applying section 5.03(2) of this revenue procedure.

(4) *50 percent periodic fixed fee arrangements.* Either at least 50 percent of the compensation for services for each annual period during the term of the contract is based on a periodic fixed fee or



all of the compensation for services is based on a capitation fee or a combination of a capitation fee and a periodic fixed fee. The term of the contract, including all renewal options, must not exceed 5 years. The contract must be terminable by the qualified user on reasonable notice, without penalty or cause, at the end of the third year of the contract term.

(5) *Per-unit fee arrangements in certain 3-year contracts.* All of the compensation for services is based on a per-unit fee or a combination of a per-unit fee and a periodic fixed fee. The term of the contract, including all renewal options, must not exceed 3 years. The contract must be terminable by the qualified user on reasonable notice, without penalty or cause, at the end of the second year of the contract term.

(6) *Percentage of revenue or expense fee arrangements in certain 2-year contracts.* All the compensation for services is based on a percentage of fees charged or a combination of a per-unit fee and a percentage of revenue or expense fee. During the start-up period, however, compensation may be based on a percentage of either gross revenues, adjusted gross revenues, or expenses of a facility. The term of the contract, including renewal options, must not exceed 2 years. The contract must be terminable by the qualified user on reasonable notice, without penalty or cause, at the end of the first year of the contract term. This section 5.03(6) applies only to--

(a) Contracts under which the service provider primarily provides services to third parties (for example, radiology services to patients); and

(b) Management contracts involving a facility during an initial start-up period for which there have been insufficient operations to establish a reasonable estimate of the amount of the annual gross revenues and expenses (for example, a contract for general management services for the first year of operations).

.04 *No Circumstances Substantially Limiting Exercise of Rights.*

(1) *In general.* The service provider must not have any role or relationship with the qualified user that, in effect, substantially limits the qualified user's ability to exercise its rights, including cancellation rights, under the contract, based on all the facts and circumstances.

(2) *Safe harbor.* This requirement is satisfied if--

(a) Not more than 20 percent of the voting power of the governing body of the qualified user in the aggregate is vested in the service provider and its directors, officers, shareholders, and employees;

(b) Overlapping board members do not include the chief executive officers of the service provider or its governing body or the qualified user or its governing body; and

(c) The qualified user and the service provider under the contract are not related parties, as defined in § 1.150-1(b).

## **SECTION 6. EFFECT ON OTHER DOCUMENTS**

Rev. Proc. 93-19, 1993-1 C.B. 526, is made obsolete on the effective date of this revenue procedure.

#### **SECTION 7. EFFECTIVE DATE**

This revenue procedure is effective for any management contract entered into, materially modified, or extended (other than pursuant to a renewal option) on or after May 16, 1997. In addition, an issuer may apply this revenue procedure to any management contract entered into prior to May 16, 1997.

#### **DRAFTING INFORMATION**

The principal author of this revenue procedure is Loretta J. Finger of the Office of Assistant Chief Counsel (Financial Institutions and Products). For further information regarding this revenue procedure contact Loretta J. Finger on (202) 622-3980 (not a toll-free call).

## Exhibit C

### **Spending Exceptions to Arbitrage Rebate**

(a) Generally. All, or certain discrete portions, of an issue are treated as meeting the Rebate Requirement of Section 148(f) of the Code if one or more of the spending exceptions set forth in this Appendix are satisfied. Use of the spending exceptions is not mandatory, except that where an issuer elects to apply the 1-1/2 percent penalty (as described below) the issuer must apply that penalty to the Construction Issue. An issuer may apply the Rebate Requirement to an issue that otherwise satisfies a spending exception. Special definitions relating to the spending exceptions are contained in section (h) of this Appendix.

Where several obligations that otherwise constitute a single issue are used to finance two or more separate governmental purposes, the issue constitutes a "multipurpose issue" and the bonds, as well as their respective proceeds, allocated to each separate purpose may be treated as separate issues for purposes of the spending exceptions. In allocating an issue among its several separate governmental purposes, "common costs" are generally not treated as separate governmental purposes and must be allocated ratably among the discrete separate purposes unless some other allocation method more accurately reflects the extent to which any particular separate discrete purpose enjoys the economic benefit (or bears the economic burden) of the certain common costs (e.g., a newly funded reserve for a parity issue that is partially new money and partially a refunding for savings on prior bonds).

Separate purposes include refunding a separate prior issue, financing a separate Purpose Investment (e.g., a separate loan), financing a Construction Issue, and any clearly discrete governmental purpose reasonably expected to be financed by the issue. In addition, as a general rule, all integrated or functionally related capital projects qualifying for the same initial temporary period (e.g., 3 years) are treated as having a single governmental purpose. Finally, separate purposes may be combined and treated as a single purpose if the proceeds are eligible for the same initial temporary period (e.g., advance refundings of several separate prior issues could be combined, or several non-integrated and functionally unrelated capital projects such as airport runway improvements and a water distribution system).

The spending exceptions described in this Appendix are applied separately to each separate issue component of a multipurpose issue unless otherwise specifically noted.

(b) Six-Month Exception. An issue is treated as meeting the Rebate Requirement under this exception if (i) the gross proceeds of the issue are allocated to expenditures for the governmental purposes of the issue within the six-month period

beginning on the issue date (the "six-month spending period") and (ii) the Rebate Requirement is met for amounts not required to be spent within the six-month spending period (excluding earnings on a bona fide debt service fund). For purposes of the six-month exception, "gross proceeds" means Gross Proceeds other than amounts (i) in a bona fide debt service fund, (ii) in a reasonably required reserve or replacement fund, (iii) that, as of the issue date, are not reasonably expected to be Gross Proceeds but that become Gross Proceeds after the end of the six-month spending period, (iv) that represent Sale Proceeds or Investment Proceeds derived from payments under any Purpose Investment of the issue and (v) that represent repayments of grants (as defined in Treasury Regulation Section 1.148-6(d)(4)) financed by the issue. In the case of an issue no bond of which is a private activity bond (other than a qualified 501(c)(3) bond) or a tax or revenue anticipation bond, the six-month spending period is extended for an additional six months for the portion of the proceeds of the issue which are not expended within the six-month spending period if such portion does not exceed the lesser of five percent of the Proceeds of the issue or \$100,000.

(c) 18-Month Exception. An issue is treated as meeting the Rebate Requirement under this exception if all of the following requirements are satisfied:

(i) the gross proceeds are allocated to expenditures for a governmental purpose of the issue in accordance with the following schedule (the "18-month expenditure schedule") measured from the issue date: (A) at least 15 percent within six months, (B) at least 60 percent within 12 months and (C) 100 percent within 18 months;

(ii) the Rebate Requirement is met for all amounts not required to be spent in accordance with the 18-month expenditure schedule (other than earnings on a bona fide debt service fund); and

(iii) all of the gross proceeds of the issue qualify for the initial temporary period under Treasury Regulation Section 1.148-2(e)(2).

For purposes of the 18-month exception, "gross proceeds" means Gross Proceeds other than amounts (i) in a bona fide debt service fund, (ii) in a reasonably required reserve or replacement fund, (iii) that, as of the issue date, are not reasonably expected to be Gross Proceeds but that become Gross Proceeds after the end of the 18-month expenditure schedule, (iv) that represent Sale Proceeds or Investment Proceeds derived from payments under any Purpose Investment of the issue and (v) that represent repayments of grants (as defined in Treasury Regulation Section 1.148-6(d)(4)) financed by the issue. In addition, for purposes of determining compliance with the first two spending periods, the investment proceeds included in gross proceeds are based on the issuer's reasonable expectations as of the issue date rather than the actual Investment Proceeds; for the third, final period, actual Investment Proceeds earned to date are used in place of the reasonably expected earnings. An issue does not fail to satisfy the spending

requirement for the third spending period above as a result of a Reasonable Retainage if the Reasonable Retainage is allocated to expenditures within 30 months of the issue date. The 18-month exception does not apply to an issue any portion of which is treated as meeting the Rebate Requirement as a result of satisfying the two-year exception.

(d) Two-Year Exception. A Construction Issue is treated as meeting the Rebate Requirement for Available Construction Proceeds under this exception if those proceeds are allocated to expenditures for governmental purposes of the issue in accordance with the following schedule (the "two-year expenditure schedule"), measured from the issue date:

- (i) at least 10 percent within six months;
- (ii) at least 45 percent within one year;
- (iii) at least 75 percent within 18 months; and
- (iv) 100 percent within two years.

An issue does not fail to satisfy the spending requirement for the fourth spending period above as a result of unspent amounts for Reasonable Retainage if those amounts are allocated to expenditures within three years of the issue date.

(e) Expenditures for Governmental Purposes of the Issue. For purposes of the spending exceptions, expenditures for the governmental purposes of an issue include payments for interest, but not principal, on the issue and for principal or interest on another issue of obligations. The preceding sentence does not apply for purposes of the 18-month and two-year exceptions if those payments cause the issue to be a refunding issue.

(f) De Minimis Rule. Any failure to satisfy the final spending requirement of the 18-month exception or the two-year exception is disregarded if the issuer exercises due diligence to complete the project financed and the amount of the failure does not exceed the lesser of three percent of the issue price of the issue or \$250,000.

(g) Elections Applicable to the Two-Year Exception. An issuer may make one or more of the following elections with respect to the two-year spending exception:

(1) Earnings on Reasonably Required Reserve or Replacement Fund. An issuer may elect on or before the issue date to exclude from Available Construction Proceeds the earnings on any reasonably required reserve or replacement fund. If the election is made, the Rebate Requirement applies to the excluded amounts from the issue date.

(2) Actual Facts. For the provisions relating to the two-year exception that apply based on the issuer's reasonable expectations, an issuer may elect on or before the issue date to apply all of those provisions based on actual facts. This election does not apply for purposes of determining whether an issue is a Construction Issue and if the 1-1/2 percent penalty election is made.

(3) Separate Issue. For purposes of the two-year exception, if any proceeds of any issue are to be used for Construction Expenditures, the issuer may elect on or before the issue date to treat the portion of the issue that is not a refunding issue as two, and only two, separate issues, if (i) one of the separate issues is a Construction Issue, (ii) the issuer reasonably expects, as of the issue date, that such Construction Issue will finance all of the Construction Expenditures to be financed by the issue and (iii) the issuer makes an election to apportion the issue in which it identifies the amount of the issue price of the issue allocable to the Construction Issue.

(4) Penalty in Lieu of Rebate. An issuer of a Construction Issue may irrevocably elect on or before the issue date to pay a penalty (the "1-1/2 percent penalty") to the United States in lieu of the obligation to pay the rebate amount on Available Construction Proceeds upon failure to satisfy the spending requirements of the two-year expenditure schedule. The 1-1/2 percent penalty is calculated separately for each spending period, including each semiannual period after the end of the fourth spending period, and is equal to 1.5 percent times the underexpended proceeds as of the end of the spending period. For each spending period, underexpended proceeds equal the amount of Available Construction Proceeds required to be spent by the end of the spending period, less the amount actually allocated to expenditures for the governmental purposes of the issue by that date. The 1-1/2 percent penalty must be paid to the United States no later than 90 days after the end of the spending period to which it relates. The 1-1/2 percent penalty continues to apply at the each of each spending period and each semiannual period thereafter until the earliest of the following: (i) the termination of the penalty under Treasury Regulation Section 1.148-7(1), (ii) the expenditure of all of the Available Construction Proceeds or (iii) the last stated final maturity date of bonds that are part of the issue and any bonds that refund those bonds. If an issue meets the exception for Reasonable Retainage except that all retainage is not spent within three years of the issue date, the issuer must pay the 1-1/2 percent penalty to the United States for any Reasonable Retainage that was not so spent as of the close of the three-year period and each later spending period.

(h) Special Definitions Relating to Spending Expenditures.

(1) Available Construction Proceeds shall mean, with respect to an issue, the amount equal to the sum of the issue price of the issue, earnings on such issue price, earnings on amounts in any reasonably required reserve or replacement fund not

funded from the issue and earnings on all of the foregoing earnings, less the amount of such issue price in any reasonably required reserve or replacement fund and less the issuance costs financed by the issue. For purposes of this definition, earnings include earnings on any tax-exempt bond. For the first three spending periods of the two-year expenditure schedule described in Treasury Regulation Section 1.148-7(e), Available Construction Proceeds include the amount of future earnings that the issuer reasonably expected as of the issue date. For the fourth spending period described in Treasury Regulation Section 1.148-7(e), Available Construction Proceeds include the actual earnings received. Earnings on any reasonably required reserve or replacement fund are Available Construction Proceeds only to the extent that those earnings accrue before the earlier of (i) the date construction is substantially completed or (ii) the date that is two years after the issue date. For this purpose, construction may be treated as substantially completed when the issuer abandons construction or when at least 90 percent of the total costs of the construction that the issuer reasonably expects as of such date will be financed with proceeds of the issue have been allocated to expenditures. If only a portion of the construction is abandoned, the date of substantial completion is the date the non-abandoned portion of the construction is substantially completed.

(2) Construction Expenditures shall mean capital expenditures (as defined in Treasury Regulation Section 1.150-1) that are allocable to the cost of Real Property or Constructed Personal Property. Construction Expenditures do not include expenditures for acquisitions of interest in land or other existing Real Property.

(3) Construction Issue shall mean any issue that is not a refunding issue if (i) the issuer reasonably expects, as of the issue date, that at least 75 percent of the Available Construction Proceeds of the issue will be allocated to Construction Expenditures for property owned by a governmental unit or a 501(c)(3) organization and (ii) any private activity bonds that are part of the issue are qualified 501(c)(3) bonds or private activity bonds issued to financed property to be owned by a governmental unit or a 501(c)(3) organization.

(4) Constructed Personal Property shall mean Tangible Personal Property or Specially Developed Computer Software if (i) a substantial portion of the property is completed more than six months after the earlier of the date construction or rehabilitation commenced and the date the issuer entered into an acquisition contract; (ii) based on the reasonable expectations of the issuer, if any, or representations of the person constructing the property, with the exercise of due diligence, completion of construction or rehabilitation (and delivery to the issuer) could not have occurred within that six-month period; and (iii) if the issuer itself builds or rehabilitates the property, not more than 75 percent of the capitalizable cost is attributable to property acquired by the issuer.

(5) Real Property shall mean land and improvements to land, such as buildings or other inherently permanent structures, including interests in real property. For example, Real Property includes wiring in a building, plumbing systems, central heating or air-conditioning systems, pipes or ducts, elevators, escalators installed in a building, paved parking areas, roads, wharves and docks, bridges, and sewage lines.

(6) Reasonable Retainage shall mean an amount, not to exceed five percent of (i) Available Construction Proceeds as of the end of the two-year expenditure schedule (in the case of the two-year exception to the Rebate Requirement) or (ii) Net Sale Proceeds as of the end of the 18-month expenditure schedule (in the case of the 18-month exception to the Rebate Requirement), that is retained for reasonable business purposes relating to the property financed with the issue. For example, a Reasonable Retainage may include a retention to ensure or promote compliance with a construction contract in circumstances in which the retained amount is not yet payable, or in which the issuer reasonably determines that a dispute exists regarding completion or payment.

(7) Specially Developed Computer Software shall mean any programs or routines used to cause a computer to perform a desired task or set of tasks, and the documentation required to describe and maintain those programs, provided that the software is specially developed and is functionally related and subordinate to Real Property or other Constructed Personal Property.

(8) Tangible Personal Property shall mean any tangible personal other than Real Property, including interests in tangible personal property. For example, Tangible Personal Property includes machinery that is not a structural component of a building, subway cars, fire trucks, automobiles, office equipment, testing equipment, and furnishings.

(i) Special Rules Relating to Refundings.

(1) Transferred Proceeds. In the event that a prior issue that might otherwise qualify for one of the spending exceptions is refunded, then for purposes of applying the spending exceptions to the prior issue, proceeds of the prior issue that become transferred proceeds of the refunding issue continue to be treated as unspent proceeds of the prior issue; if such unspent proceeds satisfy the requirements of one of the spending exceptions then they are not subject to rebate either as proceeds of the prior issue or of the refunding issue. Generally, the only spending exception applicable to refunding issues is the six-month exception. In applying the six-month exception to a refunding of a prior issue, only transferred proceeds of the refunding issue from a taxable prior issue and other amounts excluded from the definition of gross proceeds of the prior issue under the special definition of gross proceeds contained in section (b) above are treated as gross proceeds of the refunding issue and so are subject to the six-month exception applicable to the refunding issue.



(2) Series of Refundings. In the event that an issuer undertakes a series of refundings for a principal purpose of exploiting the difference between taxable and tax-exempt interest rates, the six-month spending exception is measured for all issues in the series commencing on the date the first bond of the series is issued.

(j) Elections Applicable to Pool Bonds. An issuer of a pooled financing issue can elect to apply the spending exceptions separately to each loan from the date such loan is made or, if earlier, on the date on year after the date the pool bonds are issued. In the event this election is made, no spending exceptions are available and the normal Rebate Requirement applies to Gross Proceeds prior to the date on which the applicable spending periods begin. In the event this election is made, the issuer may also elect to make all elections applicable to the two-year spending exception, described in section (g) above, separately for each loan; any such elections that must ordinarily be made prior to the issue date must then be made by the issuer before the earlier of the date the loan is made or one year after the issue date.

## Exhibit D

### **Remedial Actions**

Under the private activity bond regulations, any deliberate act by the issuer after bond issuance that results in a satisfaction of the private business tests or the private loan test will result in private activity bond status unless one or more qualifying remedial actions is taken by the issuer. Specifically, the regulations provide that actions are not treated as deliberate actions if (i) five conditional requirements are met, and (ii) one of three remedial actions is taken with respect to the "disposition proceeds" and (where applicable) the "nonqualified bonds." These are absolute requirements, not "safe harbor" guidelines as in Rev. Proc. 97-13.

The definition of "nonqualified bonds" included at Reg. section 1.141-12(j) from 1997 provides: "the percentage of outstanding bonds that are nonqualified bonds equals the highest percentage of private business use in any 1 year period commencing with the deliberate action." This definition has the effect of requiring redemption or defeasance (where that remedy is elected) of enough bonds to reduce "bad" use to 0%. In the proposed regulation of July 21, 2005 (which by its terms may be applied electively to any bonds) the definition is modified to provide as follows (thus permitting up to 5% "bad" use where otherwise permitted by section 141 of the Code): "Nonqualified bonds" are the portion of the outstanding bonds allocable to the "bad" activity. The technical test is that the "nonqualified bonds" are the portion of the outstanding bonds in an amount that, if the remaining bonds were issued on the date on which the deliberate action occurs, the remaining bonds would not satisfy the private business use test or the private loan financing test, as applicable. For this purpose, the amount of private business use is the highest percentage of business use in any one-year period, commencing with the date of the deliberate action.

**Conditional Requirements.** The five conditional requirements, under Reg. section 1.141-12(a), are:

- i. *Reasonable Expectations.* The issuer must have reasonably expected on the issue date that it would not meet the private business tests or the private loan test for the whole term of the bonds.
- ii. *Reasonable Bond Maturity.* The term of the issue must not be longer than is reasonably necessary for the governmental purposes of the issue.
- iii. *Fair Market Value Consideration.* The terms of any agreement (relating to satisfaction of any private activity bond test) must be bona fide and on an

arm's length basis, and the new user must pay a fair market value consideration for the use of the bond financed property.

- iv. *Disposition Proceeds are Gross Proceeds.* The issuer must treat any disposition proceeds as gross proceeds for purposes of the arbitrage rules of Code Section 148.
- v. *Proceeds Spent for Governmental Purposes.* Except as described with respect to redemption and defeasance options below, prior to the deliberate action, the affected proceeds must have been spent for a governmental purpose.

**Remedial Actions.** Under sections 1.141-12(d), (e) and (f) of the Regulations, at least one of the following remedial actions must be undertaken in order to avoid conversion of the bonds to private activity bond status.

*Redemption of Non-Qualified Bonds.* Under the general rule, all nonqualified bonds of the issue must be redeemed. Tax-exempt bond proceeds (i.e. refunding bond proceeds) cannot be used unless the tax-exempt bonds are qualified bonds, taking into account the purchaser's use of the facility. The bonds must be redeemed within 90 days of the date of the deliberate action or a defeasance escrow for the bonds must be established within such 90-day period. Under a special rule, if the financed facility is transferred exclusively for cash, then the use of all "disposition proceeds" (i.e., proceeds from the sale of the facility) used to redeem a pro rata portion of the non-qualified bonds at the earliest call date after the deliberate action satisfies the redemption requirement even where there are not sufficient amounts to redeem all nonqualified bonds. Under 2004 final regulations, a pro rata call does not have to be undertaken if the weighted average maturity of the non-redeemed bonds is not extended. If the bonds are not redeemed within 90 days of the date of the deliberate action, the disposition proceeds must be used to establish a defeasance escrow for those bonds within 90 days of the date of the deliberate action. The issuer must provide written notice to the IRS of the establishment of the defeasance escrow within 90 days of its establishment.

*Alternative Use of Disposition Proceeds.* The second remedial action involves the alternative use of the disposition proceeds. A classic example would be the use by a city of cash proceeds from the sale of its water and sewer facility to use a new fire station. To meet this requirement, all disposition proceeds must be in cash, the issuer must reasonably expect to expend the proceeds within 2 years, the new use must not meet the private activity bond tests (and the issuer cannot take a deliberate act after the issuance date), and any unused proceeds must satisfy the redemption requirement in the preceding subparagraph. Under a special rule for governmental bonds becoming, instead, qualified 501(c)(3) bonds, such bonds are considered "reissued" for most purposes of the Code (except Section 148) and must, therefore, satisfy current law

requirements and comply with procedural requirements for issuance of 501(c)(3) obligations (i.e., TEFRA and filing a form 8038).

*Alternative Use of Facility.* The third remedial action involves the “alternative use” of the bond financed facility by the non-governmental purchaser. A classic example would be the purchase by a private entity of a governmentally owned facility (e.g., airport), which facility qualifies as an “exempt facility” under the private activity bond rules. The non-qualified bonds are treated as reissued on the date the deliberate action satisfies the redemption requirement and generally must satisfy the provisions of the related tax-exempt sections of the Code (except for arbitrage and rebate) as then in effect. The project cannot be transferred to a purchaser that finances the acquisition with the proceeds of another issue of tax-exempt bonds.

## Exhibit E

IRS Notice 2008-31

### Voluntary Closing Agreement Program

#### **Notice 2008-31 Voluntary Closing Agreement Program for Tax-Exempt Bonds and Tax Credit Bonds**

Notice 2008-31; 2008 IRB LEXIS 219; 2008-11 I.R.B. 592

March 17, 2008

#### **TEXT:**

### **SECTION 1. PURPOSE**

This notice provides information about the voluntary closing agreement program for tax-exempt bonds and tax credit bonds ("TEB VCAP"). In particular, the notice updates procedures whereby issuers of tax-exempt bonds and tax credit bonds can resolve violations of the Internal Revenue Code (the "Code") through closing agreements with the Internal Revenue Service (the "Service"). The Tax Exempt Bonds Compliance & Program Management ("TEB CPM") function of Tax Exempt and Government Entities (TE/GE) is continuing to develop voluntary compliance initiatives to insure compliance by issuers of tax-exempt bonds and tax credit bonds with applicable provisions of the Code. TEB VCAP is part of the TEB CPM voluntary compliance initiatives and provides appropriate remedies when issuers voluntarily come forward and express a desire to resolve violations of the Code. TEB VCAP is intended to encourage issuers and conduit borrowers to exercise due diligence in complying with the Code and to provide a vehicle to correct violations of the Code. It is the continuing policy of the Service to attempt to resolve violations of the Code without taxing bondholders. TEB VCAP reflects this policy.

The Service is continuing to work on more detailed procedures about the program, and intends to provide those procedures in forthcoming guidance. For example, the Service anticipates specifying standardized closing agreement terms and amounts for particular violations.

### **SECTION 2. CHANGES**

This notice modifies and supersedes Notice 2001-60, 2001-2 C.B. 304. In general, Notice 2001-60 is amended by: (1) changing references to Outreach Planning and Review (OPR) to Compliance & Program Management (CPM); (2) incorporating tax credit bonds into the TEB VCAP program; (3) simplifying section 5(a) by referring to Internal Revenue Manual ("IRM") 7.2.3 for the specific information required for a VCAP submission; (4) clarifying that under section 5(b) CPM staff will obtain additional information as needed; (5) clarifying that all information for a VCAP submission must be provided in electronic format; and (6) providing email and regular mail addresses for submissions.

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### **SECTION 3. BACKGROUND**

Gross income does not include interest on any state or local bond that meets the requirements of section 103 and related provisions of the Code. A credit against tax is provided to a holder of a qualified tax credit bond issued under sections 54, 1397E or 1400N that meets the requirements of those sections and related provisions of the Code. Under certain circumstances, an issuer may take remedial action under provisions such as sections 1.141-12, 1.142-2, 1.144-2, 1.145-2, and 1.147-2 of the Income Tax Regulations and similar provisions that are applicable to tax credit bonds in order to cure a violation of the Code.

The Service has previously provided formal tax-exempt bond closing agreement programs such as the program described in Rev. Proc. 97-15, 1997-1 C.B. 635. Violations of section 103 and related provisions of the Code that cannot be remediated under existing remedial action provisions or other tax-exempt bond closing agreement programs contained in regulations or other published guidance may be resolved by entering into a closing agreement under TEB VCAP.

Section 7121 of the Code and the regulations thereunder authorize the Commissioner to enter into written closing agreements with any person in connection with the tax liability of such person (or of the person or estate for which he acts). Section 301.7121-1 of the Income Tax Regulations provides, in part, that a closing agreement may be entered into in any case in which there appears to be an advantage in having the case permanently and conclusively closed, or if good and sufficient reasons are shown by the taxpayer for desiring a closing agreement and it is determined by the Commissioner that the United States will sustain no disadvantage through consummation of such an agreement.

### **SECTION 4. SCOPE OF TEB VCAP**

Under TEB VCAP, an issuer may request a closing agreement with respect to its bonds to resolve violations of sections 103, 54, 1397E, 1400N and related provisions of the Code. TEB VCAP is not available when:

- (a) Absent extraordinary circumstances, the violation can be remediated under existing remedial action provisions or tax-exempt bond closing agreement programs contained in regulations or other published guidance.
- (b) The bond issue is under examination. A bond issue is generally treated as under examination on the date a letter opening an examination on the bond issue is sent.

(c) The tax-exempt status of the bonds or qualified status of tax credit bonds is at issue in any court proceeding or is being considered by the IRS Office of Appeals.

(d) The Service determines that the violation was due to willful neglect.

## **SECTION 5. PROCEDURES FOR REQUESTING A CLOSING AGREEMENT UNDER TEB VCAP**

(a) Information Required in Requests. An issuer or its authorized representative requesting a closing agreement must submit the information specified in IRM 7.2.3 and the information reporting return for the applicable bonds on IRS Form 8038 or other comparable form that was filed with respect to the issue. (For convenience of reference, the relevant portions of the Internal Revenue Manual (IRM) are available on the IRS website, at [www.irs.gov](http://www.irs.gov), in the section on the Tax-Exempt Bond Community, under the subheading of Published Guidance.) All information concerning the closing agreement must be submitted under penalty of perjury signed by an official of the issuer with knowledge of the issue and authorized to make the submissions on behalf of the issuer. The request may also contain a Form 2848 with the name, address, phone number, and fax number of an authorized contact person.

(b) Additional Information for Requests. CPM staff may require additional information depending on the facts and circumstances. All additional information must be submitted under penalty of perjury signed by the person who initially signed the submission or who would have been authorized to make the original submission.

(c) Electronic Format. All information submitted in support of a closing agreement request must be provided in an electronic format that is either emailed in PDF format or provided on a compact disc ("CD") sent via regular mail to the address provided by this notice. Hard copies of the submissions can be provided but are not required.

(d) Anonymous Closing Agreement Requests. An issuer or its authorized representative may initiate discussions regarding the appropriate terms of a closing agreement on an anonymous basis. An anonymous request may be made on behalf of a group of similarly situated issuers. However, the execution of a closing agreement must be between the Service and a disclosed issuer, and all terms of a closing agreement must be consistent with section 7121 of the Code. Until the name of the bond issue is disclosed to the Service, a request for a closing agreement under TEB VCAP will not prevent the Service from beginning an examination of the bond issue. An issue for which a request has been submitted under this paragraph (d) that has been placed under examination prior to the date the issue is identified to the Service will no longer be eligible for TEB VCAP.

(e) TEB VCAP Mailing Address. TEB VCAP submissions should be mailed to:

Internal Revenue Service  
Attn: TEB VCAP  
1122 Town & Country Commons  
St. Louis, MO 63017

(f) TEB VCAP E-Mail Address. In the alternative, VCAP information may be submitted in PDF format to [TEBVCAP@irs.gov](mailto:TEBVCAP@irs.gov). TEB CPM will provide an acknowledgement of receipt of an email request.

## **SECTION 6. CLOSING AGREEMENT TERMS**

Closing agreements under TEB VCAP will generally follow the model closing agreement in IRM 4.81.1, Exhibit 9, as the same may be modified or changed. Specific closing agreement terms will depend on the facts and circumstances of the case, including the degree of diligence exercised by the issuer and any conduit borrower. Any standardized closing agreement terms that are developed for TEB VCAP will be set forth in the Internal Revenue Manual and/or other published guidance.

## **SECTION 7. EFFECT OF CLOSING AGREEMENT EXECUTED UNDER TEB VCAP**

A closing agreement properly executed by the issuer and the Service will protect bondholders from including in their gross income any interest on the bonds or from recapturing tax credits during the period specified in the agreement for any violation described in the agreement. A closing agreement executed under section 7121 of the Code shall be final and conclusive except that: (1) the matter it relates to may be reopened in the event of fraud, malfeasance, or misrepresentation of a material fact; (2) it is subject to the sections of the Code that expressly provide that effect be given to their provisions (including any stated exception for section 7122 of the Code) notwithstanding any other law or rule of law; and (3) it is subject to any law, enacted after the date of the agreement, that applies to a tax period ending after the date of the agreement covered by the agreement.

## **SECTION 8. REQUESTS FOR COMMENTS**

We anticipated that TEB VCAP will continue to be expanded and refined over time based on experience and public comment. The Service welcomes comments regarding the format and operation of TEB VCAP, and suggestions with regard to the general framework of closing agreement terms including standardized closing agreement terms and amounts that may be specified for particular violations. Comments should be submitted in writing and should be emailed to [Steven.A.Chamberlin@irs.gov](mailto:Steven.A.Chamberlin@irs.gov) or

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mailed to the following address:

Steven A. Chamberlin  
Manager, Tax Exempt Bonds Compliance & Program Management  
SE:T:GE:TEB:CPM  
1122 Town & Country Commons  
St. Louis, MO 63017

#### **SECTION 9. EFFECT ON OTHER DOCUMENTS**

Notice 2001-60, 2001-2 C.B. 304, is modified and superseded.

#### **SECTION 10. EFFECTIVE DATE**

TEB VCAP is effective February 27, 2008.

#### **SECTION 11. DRAFTING INFORMATION**

The principal authors of this notice are Steven A. Chamberlin of Tax Exempt Bonds Compliance & Program Management, Tax Exempt & Government Entities, and Carla Young of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this notice, contact Steven Chamberlin at (636) 255-1290 or Carla Young at (202) 622-3980 (not toll-free calls).