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Washington Higher Education Facilities Authority
Nonprofit Guide to Complying with Tax Laws After the Bond Issue

After your bond issue is complete, there are some important Internal Revenue Service ("IRS") rules to be followed in order to maintain the tax-exempt status of your bonds. These rules relate to the spending and investment of bond proceeds, arbitrage rebate, changes to your financing terms, the use of facilities financed with bond proceeds and the maintenance of your status as a 501(c)(3) organization. Failure to comply with these rules may result in penalties, including your bonds being declared taxable. Below is a summary of some of the IRS requirements applicable to 501(c)(3) tax-exempt bonds. You should also review and be familiar with the tax covenants set forth in the bond documents, the Tax Certificates delivered with respect to your bonds and the Authority's Post-Issuance Compliance Policy.

SPENDING & INVESTING BOND PROCEEDS

Draw Down Bonds. Many Authority bonds are issued as draw down bonds, meaning that the borrower receives the proceeds over time as needed for project costs. Because the borrower only receives bond proceeds as needed, the proceeds are generally not invested and the information below in "Three-Year Temporary Investment Period" and "Arbitrage Rebate & Exceptions from Rebate" will not apply to bond proceeds being used for project costs. Investment and rebate requirements may apply to other funds (reserves etc.) relating to the bonds.

Three-Year Temporary Investment Period. Except for refinancings, most Authority bond issues qualify under IRS rules for a "three-year temporary investment period." During this three-year period following the issuance of bonds, the bond proceeds may be invested at the highest yields available and the investment yield may be higher than the yield on the bonds. Many Authority bond issues are structured to require a mandatory redemption of the bonds from unspent bond proceeds three years from the date the bonds are issued. However, if you have requested and received an extension of the mandatory redemption date, you must do one of the following:

- Invest the remaining bond proceeds in a tax-exempt money market fund or in investments that yield less than the yield on the bonds, or
- Make "yield reduction payments" to the IRS, which requires the issuer to complete IRS Form 8038-T and periodically pay to the IRS the earnings in excess of the amount that would have been earned by investing at the bond yield.

ARBITRAGE REBATE & EXCEPTIONS FROM REBATE

The opportunity to invest bond proceeds for three years at yields higher than the bond yield does not necessarily mean that you can keep those higher investment earnings (the "arbitrage"). The general IRS rule is that such arbitrage must be paid back — or rebated — to the IRS. However, if you qualify for one of the following "rebate exceptions" then you will not have to pay arbitrage rebate. The Tax Certificates executed at the time of bond closing will describe the test, if any, expected to apply to your bond issue.

Six-Month, 18-Month and Two-Year Construction Exceptions. Three rebate exceptions are available to the Authority's borrowing institutions. The rebate exceptions relate to how fast the bond proceeds (and investment earnings from the proceeds) are spent.

- The shortest rebate exception allows the bonds to escape from arbitrage rebate if all of the bond proceeds and earnings are spent within **six months** of the date the bonds are issued.
- The next-shortest rebate exception allows the bonds to escape from arbitrage rebate if the bond proceeds and earnings are spent according to the following schedule: 15% within six months, 60% within one year and 100% within **18 months**. All of these periods are measured from the date the bonds are issued.

- The rebate exception allowing the longest period for expenditure of the bond proceeds and earnings is available only if at least 75% of the bond proceeds are spent for construction projects. The exception requires that the bond proceeds be spent according to the following schedule: 10% within six months, 45% within one year, 75% within 18 months and 100% within **two years** (all measured from the date of bond closing).

Failing to meet any one of the targeted expenditure dates results in failure of the entire rebate exception. For example, if you met the 10% and 45% expenditure requirements for the two-year construction rebate exception, but failed the 75% expenditure requirement, the whole rebate exception is failed, and the bond issue is subject to rebate.

There are many nuances involved in satisfying the rebate exceptions, so you should review the Tax Certificates prepared at the time the bonds were issued to determine the exact dates by which the bond proceeds (and the investment earnings) need to be spent and consult bond counsel or a rebate expert with any questions.

Qualifying for a rebate exception means that you do not have to pay the IRS the arbitrage earned during the three-year temporary investment period. However, as discussed above, if bond proceeds remain unspent at the end of that period, those proceeds must be either "yield restricted" or you must make yield reduction payments.

Calculating Arbitrage Rebate. If a bond issue does not qualify for any rebate exception, then the bonds are subject to certain arbitrage rebate requirements. Arbitrage rebate is not owed to the IRS unless the investment earnings average more than the bond yield. Even if you do not owe any arbitrage earnings to the IRS, calculating arbitrage rebate can itself be costly and must be done whether or not you owe anything. To satisfy the IRS rebate rules, you should keep track of the investments made with bond proceeds from the date the bonds are issued until all of the bond proceeds are spent. (It is important to do this even if you expect to qualify for one of the three time sensitive rebate exceptions. If none of the exceptions are satisfied, you will need to compute any rebate payments owed.)

Arbitrage rebate payments are due to the IRS **at least every five years** from the date the bonds were issued. If you make a rebate payment after all the bond proceeds have been spent and, as discussed below, no other funds are subject to rebate, you will not have to make any future computations. Rebate payments are made by filing IRS Form 8038-T. If no rebate is owed, then no filing with the IRS needs to be made. It is important, however, to keep records of the expenditures and investments of bond proceeds (and amounts held in the funds described below) for at least three years from the date all of the bonds are completely paid off (or six years from the date of the record, if longer).

Funds. The Authority bond issues are generally structured to minimize opportunities for arbitrage rebate. The tax certificate signed at the time of bond closing describes the various funds associated with the bonds and the rebate requirements expected to be associated with each. You should review the tax certificate carefully with your counsel.

Reserve Funds. Sometimes Authority bonds, particularly those that are issued with bond insurance or other credit enhancement, have debt service reserve funds. Such funds provide money to pay the debt service due on bonds if project revenues are insufficient and may include reserves required by banks and other lenders in their loan documents. Bond proceeds may or may not be deposited into such reserve funds. Reserve funds that are appropriately sized in compliance with IRS rules may generally be invested for the term of the bonds at yields that exceed the bond yield. However, reserve funds **are** subject to arbitrage rebate regardless of whether they are funded with original bond proceeds and regardless of whether such fund qualifies to be invested at yields that exceed the bond yield.

Bond and Debt Service Funds. Most Authority bond issues also have bond funds or debt service funds (often containing principal and interest accounts) that are used to make regularly scheduled debt service payments. Most of these funds qualify for an exemption to the arbitrage investment and rebate rules.

They generally may be invested at the highest rate of return available, and arbitrage rebate is not required.

Other Funds. Some Authority bonds also have repair, replacement, operating reserves and revenue funds. These funds may not be described in the bond documents, but may be required by lenders and credit providers. Whether these funds are subject to the arbitrage investment and rebate rules generally depends on whether the funds are reasonably expected to be available to pay debt service on the bonds if the borrower encounters financial difficulties. The Tax Certificates will describe any such funds and will state whether the arbitrage restrictions apply. If a lender or credit provider requires funding of additional reserves after closing, you should contact the Authority and bond counsel to determine if any arbitrage restrictions apply.

MAINTENANCE OF 501(c)(3) STATUS

The tax-exemption of the interest on your bonds is derived from your organization's status as a 501(c)(3) organization. It is important to implement good corporate maintenance practices to continue your standing with the IRS. Any number of actions could jeopardize your status, including unreported changes to your mission, lobbying, failure to pay taxes on unrelated business income and excessive executive compensation. The IRS requires that 501(c)(3) organizations file an IRS Form 990 annually and those that benefit from tax-exempt financing provide additional information on Schedule K to the IRS Form 990.

POST-ISSUANCE COMPLIANCE PROCEDURES; RECORDS

The IRS has encouraged 501(c)(3) organizations which have issued tax-exempt bonds to adopt written post-issuance compliance procedures or guidelines to ensure continued compliance with applicable federal tax requirements. The IRS has specifically stated that 501(c)(3) organizations should: conduct due diligence at regular intervals, identify the official or employee responsible for review, train the responsible official or employee, retain adequate records to substantiate compliance, and adopt procedures reasonably expected to timely identify noncompliance and to ensure the issuer will take steps to timely correct the noncompliance. You are encouraged to identify the individual(s) responsible for post-issuance compliance and to adopt procedures to facilitate post-issuance compliance.

You must maintain records with respect to your tax-exempt bonds for the life of the bonds (and any related refunding bonds) plus three years. These records must be adequate to substantiate compliance with all applicable IRS requirements. See the Authority's Post-Issuance Compliance Policy attached to the Tax Certificate for a summary of the records you are responsible for maintaining.

NON-QUALIFIED USE

The facilities financed with the proceeds of your bonds must be owned by you and used in furtherance of your 501(c)(3) exempt purpose. Private use should be avoided and can arise through any of the following arrangements, either directly or indirectly:

i) Selling all or a portion of the facility.
ii) Leasing all or a portion of the facility.
iii) Entering into a management contract for the facility (except for qualified management contracts under IRS Rev. Proc. 97-13).
iv) Use of all or a portion of the facility for research purposes under a research contract (except for qualified research agreements under IRS Rev. Proc. 97-14 and Rev. Proc. 2007-47).
v) Entering into contracts giving "special legal entitlement" to the facility (for example, selling advertising space or naming rights).

CHANGE IN USE

In addition to the investment and arbitrage rebate rules summarized above, another important post-closing issue is the IRS "change in use" regulations. Projects financed with the tax-exempt bond proceeds should not be sold or changed from a qualifying use to a private business use before the bonds are completely paid off. This would include selling the project, using it for a purpose different than that intended at closing, involving third parties in the management of the project, leasing or renting all or parts of the project to third parties or failing to comply with tenant set aside requirements, where applicable. In some instances, the rules also require that the Authority notify the IRS of this action. It is important to contact bond counsel for advice when considering changing the use of a facility financed with tax-exempt bond proceeds.

If a change in use is anticipated, it may be possible to take a remedial action approved by the IRS; which may include that the bonds be redeemed within 90 days or defeased to the first date on which they may be redeemed. In some instances, the rules also require that the Authority notify the IRS of this action. If an allowed remedial action is not taken, it is possible that the change in use could result in penalties, including your bonds being declared taxable.

CHANGING THE DEAL

Changes to the terms of your financing can also adversely affect the tax-exempt status of your bonds. Extending the maturity of the bonds, changing the interest rate or payment dates or restructuring the financing can trigger a "reissuance" of the bonds. Unless properly documented, these types of changes can cause the bonds to lose their tax-exempt status. If you are planning to change the terms of your financing, you should contact the Authority and bond counsel.

This guidance provides brief and general information on the actions non-profit borrowers should take following the issuance of bonds to ensure that the bonds remain tax-exempt. IRS rules are detailed, complex and are subject to change, so it is important to review the specific guidance provided in the Tax Certificates prepared for bond closing and to seek the advice of bond counsel or other professionals if you have any questions or if you would like assistance in complying with post-issuance requirements.