Top (Bottom?) Ten of Tax Headaches (Challenges) for Municipal Bond Issuers
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Sometimes the first step to solving (or mitigating or avoiding) problems is to identify what the problem may be to, among other things, put time on one's side.

For issuers of tax-exempt municipal bonds, there tend to be certain types of situations that are more prone to creating tax-issues. The purpose of this article is to identify certain types of situations that are more likely to create tax headaches (or at least are better navigated with some advance planning) for purposes of the tax-exempt bond rules. We hope this may be useful context for issuer officials as they plan and manage their debt issuance in consultation with their bond advisors, solicitors, and staff. This article is not intended to dissect these issues in a detailed way that often requires a thoughtful analysis of many facts and circumstances. While life does not always nicely imitate art or a favorite colloquialism, we will attempt to frame a number of these tax situations to try to make them easier to remember.

NUMBER 10: "Hurry up and wait" – Annual limits for bank qualification. Bank qualification under many market conditions might provide debt service savings because of the favorable tax treatment for banks for their own interest. (Section 265(b)(3) of the IRC provides an exception to the general rule disallowing a deduction for interest expense related to tax-exempt obligations.) Among other things, one of the significant limits on bank-qualified issues is an annual limit of $10 million (subject to certain nuances). Consequently, sometimes the financing of a larger project needs to be undertaken in phases where different bonds are issued in different calendar years to be able to utilize the bank qualification exception.

NUMBER 9: "Too much of a good thing" – Arbitrage earnings. After many years in a relatively lower interest rate environment, issuers did not see much in the way of opportunities to earn a positive yield on bond-related funds above the related arbitrage yield (roughly the cost of funds). Some of the key things for an issuer to examine with its advisors involve whether a 6-month, 18-month or 24- (construction) month exception to the rebate requirement can be met by spending bond proceeds in required percentages by required times. Also, for certain revenue bond issues, the blending of certain funds may present opportunities to manage arbitrage (e.g., the purposes for which a debt service reserve fund's earnings may be directed).

NUMBER 8: "They're beginning to get on my nerves. Who are those guys?" (from Butch Cassidy and the Sundance Kid); and [Don't] "Don't look down." – Aggregating issuers for bank qualification. Another bank qualification challenge is that Section 265(b)(3) of the IRC requires an issuer to be within the limitation on the amount of obligations that may be issued, the issuer in question, and all entities that issue obligations on behalf of such issuer, shall be treated as one issuer. Consequently, a related entity (possibly an authority for a general governmental issuer) of an issuer may issue bonds itself in a particular year and eliminate bank qualification as a possibility for another issuer.

NUMBER 7: "It seemed like a good idea at the time." – Financing swap termination payments. When well-deployed, interest rate management agreements (swaps and similar derivatives) can help manage interest rate volatility particularly for an issuer with a larger portfolio of debt where a mix of fixed and variable rate debt could be advantageous. Nevertheless, depending on market

conditions and the remaining term of a swap contract, the size of a swap settlements payment (i.e., usually from the bond issuer to the swap provider counterparty) can be significant and unrealistic to be paid from generally available revenues. While some tax counsel have relied on other theories to support the tax-exempt financing of a swap termination payment (in rough terms focusing on the transaction in question involving a capital expenditure), the most prevalent basis supporting tax-exempt financing of the termination payment focuses on the swap and the related bonds being treated as integrated for tax rules. This entails, among other things, certain documentation and certifications substantially contemporaneously with the entry into the swap (or possibly with certain subsequent transactions related to the swap or the bonds.)

NUMBER 6: "Can we take a Mulligan?" – Pledged Funds. The creation of "replacement proceeds" may result in certain adverse consequences including bonds being treated as arbitrage bonds. Amounts are replacement proceeds of an issue if they have a sufficient direct nexus to: the bond issue or the governmental purpose of the issue to conclude that the amounts would have been used for the governmental purpose if the bonds were not used for such purpose. Consequently, issuers should be mindful of situations where there is some expectation that a project will be funded from sources other than tax-exempt bond proceeds and the issuer then wishes to bond finance a project. The tax regulations fortunately provide that the mere preliminary earmarking of funds for a governmental purpose, however, does not establish a nexus to cause the amounts to be replacement proceeds. (There are other situations involving pledged funds, negative pledges and considerations related to the duration of a bond issue that may also raise replacement proceeds issues that are beyond this discussion.)

NUMBER 5: "It's Too Late" (Carol King's Grammy Album "Tapestry") – Reimbursement rules for "back-bonding". Timing is a key issue for meeting certain requirements related to the ability to use tax-exempt bond proceeds to reimburse an issuer for project expenditures it has previously made from its other funds. Among other things, prominent is the need to timely have an official declaration of intent to seek reimbursement for a described project put in place (often contained in an issuer board resolution). Subject to certain exceptions, there is a 60-day look-back period for the time of the expenditure in relation to the declaration. Also, there are certain timing requirements for a proper allocation of bond proceeds to an expenditure involving reimbursement. In general, the reimbursement allocation needs to be made not later than 18 months after the later of – (A) The date the original expenditure is paid; or (B) the date the project is placed in service or abandoned, but in no event more than 3 years after the original expenditure is paid.

NUMBER 4: "Moderation in all things, especially moderation." (Ralph Waldo Emerson) – Private uses of bond-financed property. Bonds will fail to be tax-exempt, among other things, if they are private activity bonds. Private activity bonds involve private business use and private payments or security with respect to the bonds. While both prongs of the test are required to run into the pitfall of a private activity bond, once private business exists, it is likely the case that the second prong will be met. Issuers should be aware that there are certain safe harbors to private business use for certain short-term private uses of bond-financed property. Examples of these types of situations may entail arrangements where the property is used for private events (e.g., at a public museum or historical property) or privately run sports and other camps on bond-financed school property. These safe harbors, which are beyond the scope of our article, tend to be very measurement oriented and should be considered with an issuer's bond and tax counsel.

In shorthand these exceptions include an 100 days limited general public use arrangements exception, a 50-days arm's length fair market value arrangements exception, and an exception for incidental use arrangements (including certain narrow possessory uses such as for kiosks and vending machines.)

NUMBER 3: "Management is, above all, a practice where art, science, and craft meet." (Henry Mintzberg). – Management of bond-financed property. Unfortunately for our purposes (and probably for the best from a broader viewpoint), the best insights and quotes about management (including for managing projects, which sometimes involve bond-financed property) do not seem to focus on tax rules. In the bond world, however, a bond-financed facility that makes sense to be managed by a private expert can raise private business use pitfalls if the management arrangements give the private entity actual or beneficial use of bond-financed property whether directly or indirectly. Compensation provisions (as well as the contract's duration provisions) are key to this analysis and must be reasonable and avoid net profits arrangements. A number of safe harbors are detailed in Rev. Proc. 2017–13 which is extensive and probably deserving of an article to itself.

NUMBER 2: "If you don't know where you are going, you might end up somewhere else." (Yogi Berra); "The best-laid plans of mice and men oft' go awry." (Poet Robert Burns). – Remaining proceeds. There are a host of concerns and issues that can arise when a tax-exempt bond-financed project runs into stumbling blocks of whatever type that prevent bond proceeds from being timely spent (or spent at all) for originally authorized purposes. Some of these concerns involve the possibility of needing to restrict the yield at which bond proceeds can be invested, concerns of an early issuance or an over-issuance and violation of hedge bond rules. Where there is some uncertainty about a project at the outset, but there are practical or other pressures to get a financing in place, an issuer might wish to evaluate the possibility of using a taxable shorter-term financing where the speed of expenditures is less pressing. While subject to certain costs and inefficiencies, as a general matter, taxable borrowings that finance good tax-exempt governmental purposes will be strong candidates to be permanently financed later on a tax-exempt basis. There are certain situations where remaining proceeds may be able to be simply applied on the next upcoming debt service payment date consistent with exceptions to working capital rules.

However, there are some other situations where originally laid plans do not come to fruition and certain remedial action may be needed as discussed below in Number 1.

NUMBER 1: "I'm here to help…" (the character The Wolf from the movie Pulp Fiction (1994)) – sales or other disposition of bond-financed property. In circumstances where property financed on a tax-exempt basis at some point after issuance during the life of the bonds is to be sold, leased, or otherwise conveyed to a party that is not a state or local governmental entity, the issuer is possibly facing a situation where certain remedial action, if eligible, must be taken to preserve the tax-exempt status of the bonds. There are also certain time pressures associated with these actions so that they are taken in a timely manner. While this topic is deserving of its own article, we note, at a high level, that the types of remedial action that are provided for under Treasury Regulations §1.141-12 include: (i) redemption or defeasance of non-qualified bonds, (ii) alternative use of disposition proceeds, and (iii) the alternative use of a facility (this third category is less likely to be applicable for traditional governmental bonds).

Conclusion

Bond tax issues will tend very much to be fact and circumstance dependent. Nonetheless, a number of general types of situations and concerns are more prevalent over time and provide a basis for bond counsel and other advisors to provide guidance to issuers. We hope the foregoing helps to broadly inform your discussions and debt management planning and practices with your internal and external debt teams.

This article is not a substitute for advice of counsel on specific legal issues.