Post-Issuance Tax Compliance Best Practices

HFMA Lone Star Summer Conference

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Why Tax-Exempt Bonds?

Introduction to Tax-Exempt Financings

- Tax-exempt bonds are an important tool for hospitals to grow, serve their communities, and maintain financial health
  - **Lower Borrowing Costs:** Tax-exempt bonds offer hospitals access to capital at lower interest rates, reducing the cost of financing new construction, renovations, and equipment
  - **Support for Mission:** Savings from tax-exempt financing allow hospitals to invest more in patient care, community programs, and facility improvements
  - **Access to Capital Markets:** Enables hospitals to fund large-scale projects that might not be possible through traditional loans or fundraising alone
  - **Long-Term Financial Stability:** Fixed-rate, long-term financing helps hospitals plan for the future and manage resources effectively

Introduction to Tax-Exempt Financings (cont.)

- Certain responsibilities accompany the use of tax-exempt bonds
  - Some are imposed by regulators, such as the Internal Revenue Service and the Securities and Exchange Commission
  - Some are required by the investors who purchase tax-exempt bonds issued for the benefit of hospitals and health systems

Post-Issuance Compliance Overview

Definition

Post-issuance tax compliance begins with the debt issuance…and requires a continuing focus on the investment of bond proceeds and use of bond financed property.

"After the Bonds Are Issued, Then What?"

Advisory Committee on Tax-Exempt and Governmental Entities ("TEGE")

Mitigation of Risk

- Issuers and borrowers must comply with the federal tax rules for the life of the bond issue (typically 20-30 years)
- Failure to comply with the federal tax requirements could jeopardize the tax-exempt status of those bonds
- Tax problem may delay or derail refunding transaction
- May give rise to a disclosure requirement
- Unexpected cures can be expensive $$$

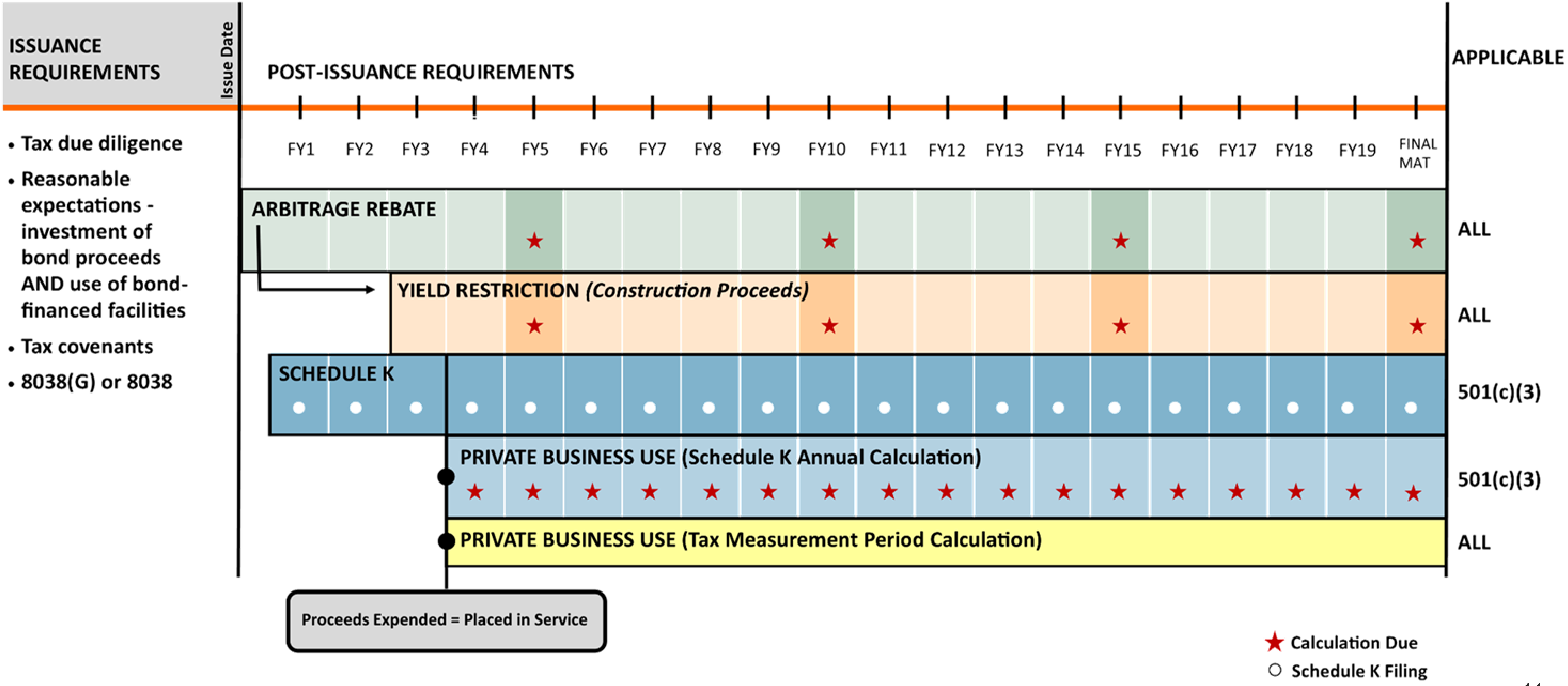
Requirements at Closing of Bond Transaction

- Tax form filings
- Reasonable expectations – requirements for issuing the bonds
  - Investment of proceeds
  - Expenditure of proceeds
  - Use of facilities

Ongoing Requirements

- Arbitrage Rebate and Yield Restriction
  - Identify situations in which the issuer improperly increases the subsidy received
- Qualified Use of Proceeds and Bond Finance Property
  - Identify situations in which nonqualified recipients are receiving too much subsidy
- Continuing Disclosure
  - Ongoing transparency to investors through regular updates on financial and operational developments

TAX-EXEMPT NEW MONEY ISSUE—COMPLIANCE TIMELINE



IRS Enforcement

- 2020 – 2022: Impact of IRS staffing changes and COVID-19 led to fewer audits
- 2023 – 2024: IRS enforcement staff growing given new and increased funding and more audits
- 2025 – : Major cuts to TEGE workforce (down 31% as of March)
  - On track to lose more via second round of the deferred resignation program

IRS Enforcement

- Agents assigned will not specialize in sectors and may need "hands on" training, lengthening duration of audit
  - For inexperienced agents, it is way more feasible to assess the facts than to interpret the law
- Expect use of AI in selection and review of submissions
- Audits are technical and time consuming – outside expertise is practically required

What is Arbitrage?

- Borrow at tax-exempt rates and invest proceeds at higher taxable rates
- Disparity between markets because of federal subsidy
- Negative arbitrage for over a decade, many staffers unaware
- Investment strategies and rebate compliance were moot point
- "Right-size" your issuance to limit over-burdening of tax-exempt market

Arbitrage Rebate and Yield Restriction Requirements

- Two Separate Arbitrage Monitoring Requirements some overlap
- Arbitrage Rebate
  - Every investment for the life of the bond issue
  - Remitting the arbitrage as payment to the IRS
  - Cumulative computation required at five-year intervals
  - "Can earn arbitrage, can't keep it"

Arbitrage Rebate and Yield Restriction Requirements

- Yield Restriction
  - Some of the investments, some of the time
  - Limiting the investment yield after certain periods
  - Yield reduction payment looks and acts like a rebate payment but only relates to yield restricted amounts
  - "Can't earn arbitrage"

Retaining Positive Arbitrage

- Not having to remit positive arbitrage can mean real dollars
- Take advantage of exceptions to the rule – require oversight
  - Spending exceptions
    - Difficult to meet and require advance planning
    - Communication amongst team members
    - Be aware of elections in tax documents

Retaining Positive Arbitrage

- Take advantage of exceptions to the rule – require oversight (cont.)
  - Bona fide debt service fund exception
    - Bring balance down below reasonable carryover amount each year
    - Up to $100,000 income limit per bond year for short-term, variable rate or private activity issues

Retaining Positive Arbitrage

- Invest the proceeds in tax-exempt securities
  - Liquidity?
  - U.S. Treasuries - Demand Deposit State and Local Government Series (SLGS) are considered tax-exempt securities
    - Exempt from rebate and yield restriction

Yield Restriction Hot Topics

- Excess accumulated in pledged accounts or debt service reserve fund – unaware that excess exists
- Amounts deposited to defeasance escrow
  - Limited to yield of defeased bonds
- Are the proceeds even eligible for yield reduction payments?

Best Practices

- Procedures for managing the process and record accessibility
- Reporting frequency – auditors, set aside, etc.
- Make sure having installment computations done timely
  - Within 60 days of the fifth anniversary or bond year
  - Within 60 days of the final redemption date
- Prevent late "missed" payments
  - Require late payment explanation
  - Late interest accruing at 7%

Why Should You Care About Private Business Use ("PBU")?

- PBU occurs after the bonds are issued
- Issuers/borrowers must monitor PBU over the life of the bonds and any refunding bonds
- PBU often occurs without the finance officers being involved
- Often boards are looking to engage in as much PBU as possible to generate revenues

What is PBU?

- A “special entitlement” of a nongovernmental business to use bond-financed property
- In addition, for qualified 501(c)(3) bonds, PBU includes any use of the financed property that constitute unrelated trade or business activities (determined by applying 513(a))
- Ownership
- Nonqualified management and service contracts
  - Physician and medical director agreements
- Nonqualified sponsored research agreements

What is PBU?

- Leases, including cell tower leases
- Naming rights
- Preferential rates for certain customers
- Rights of first refusal
- Use by federal government
- Use by 501(c)(3) organization – governmental bonds only

What is NOT PBU?

- General public use
- Use by a person not engaged in a trade or business
- Use by a state or local governmental entity
- Use according to a uniformly applied rate schedule
- Qualified management and service contracts (Rev Proc 2017-13)
- Qualified sponsored research agreements (Rev Proc 2007-47)
- Certain short-term use
- Incidental use - advertising displays and vending machines

How much PBU is Allowed?

Qualified 501(c)(3) Bonds

- No more than 5% of the proceeds of the bonds
  - 95% qualified use
- Costs of issuance (limited to 2%) count as private business use

How much PBU is Allowed?

Governmental Bonds

- No more than 10% of the proceeds of the bonds
  - 90% qualified use
- No more than 5% of proceeds of the bonds if the use is unrelated to the governmental purpose of the bonds

How much PBU is Allowed?

Both Types

- "Tax Measurement Period" requirement
- Cap of $15,000,000 for all private business uses in a single issue before volume cap is required
- PBU can end up being less than the 10% or 5% detailed above

Schedule K Reporting

- Nonprofit organizations only
- Schedule K (IRS Form 990) – Supplemental Information on Tax-Exempt Bonds
  - Proceeds
  - Private Business Use (1 year snapshot)
  - Arbitrage
- PBU activities measured over a 12-month reporting period (annual snap-shot)

Best Practices

- Perform annual PBU analysis for any outstanding tax-exempt debt
  - Allows for educated decisions about future use of facilities
  - Allows for more precise use of “equity” on future financings
- Annual questionnaires per facility regarding use of facilities by outside parties
- Centralized repository and annual review process for physician, medical director, and sponsored research agreements
  - Structured intake process on sponsored research agreements
- Standardize contract language when possible

Continuing Disclosure Basics

- Securities and Exchange Commission Rule 15c2-12 requires underwriters to reasonably determine that the issuer or an obligor has entered into a binding written commitment to provide continuing disclosure
  - Requires Annual Reports and Listed Events
  - Market often also requires Quarterly Reports
- Rule applies directly to underwriters (broker/dealers)
- Rule indirectly applies to issuers/obligated persons
- Disclosures are posted on EMMA ("Electronic Municipal Market Access") for public viewing

Continuing Disclosure Basics

- **Annual Reports**
  - Audited Financial Statements
  - Annual financial information and operating data
- **Listed Events**
  - Notices due within 10 business days of event
  - Some occur more frequently than others
- **Additional Information**
  - Investors in health care bonds also require quarterly financial information
  - Investor relations may warrant more robust reporting

Listed Events that require notification within 10 business days:

1) Principal and interest payment delinquencies
2) Unscheduled draws on reserves reflecting financial difficulties
3) Unscheduled draws on credit enhancement reflecting financial difficulties
4) ***Substitution of credit or liquidity provider*** or their failure to perform
5) Adverse tax opinion, issuance by the IRS of proposed or final determination of taxability, adverse tax opinions, or Notices of Proposed Issue (IRS Form 5701-TEB)
6) ***Defeasances***
7) ***Rating changes***

Listed Events that require notification within 10 business days:

8) Bankruptcy, insolvency, receivership, or similar event of an obligated person
9) Tender offers
10) Nonpayment related defaults
11) Modification to bondholder rights
12) Bond calls
13) Release, substitution or sale of property securing repayment of bonds
14) ***Merger, consolidation, acquisition, or sale of all or substantially all of the assets of an obligated person***, other than in the ordinary course of business, and the entry into or termination of an agreement to undertake such action

Listed Events that require notification within 10 business days:

15) Appointment of a successor trustee or change in name of a trustee

16) Incurrence of a "financial obligation" of the obligated person, if material, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the obligated person, any of which affect security holders, if material

17) Default, event of acceleration, termination event, ***modification of terms or other similar events under a financial obligation of the obligated person***, any of which reflect financial difficulties

Examples of debt obligations and derivatives

- Commercial Paper
- Private Placements
- Direct Purchase
- Interest Rate Swaps, Futures Contracts, Forward Contracts, Options, etc. ("entered into in connection with….")
- Forward-delivery agreements with termination penalties
- Leases that operate as vehicles to borrow money

Consult with counsel regarding other types of "financial obligations"

Continuing Disclosure Basics

- Non-compliance is not an Event of Default under bond documents or continuing disclosure agreements, but bondholders have right to sue for compliance with continuing disclosure obligations
- Must disclose such failure in future Official Statements for 5 years following the failure
- Can give rise to a securities law fraud case if misstate past compliance in an offering document
- Including only the information specifically required under the continuing disclosure agreement may not be deemed sufficient to satisfy the anti-fraud rules and could result in securities fraud under Rule 10b-5

Best Practices

- Adopt policies and procedures and follow them
  - Reduces chance of making a material misstatement or omitting material information
  - Establish a reasonable care defense for such statements or omissions
- Know what was committed to be disclosed in the CDA and the timing of the filings (understand SEC Rule 15c2-12 and what you contracted to do in your continuing disclosure agreement and by when)
- Update policies and procedures for amendments to SEC Rule 15c2-12
- Set up a tickler system for timing of reports

Best Practices (cont.)

- Assign one or two individuals to be responsible for putting together the filings and for actually posting on EMMA
- Conduct periodic training

Benefits of an Effective Post-Issuance Compliance Program

Benefits

- Preserve tax-exempt status of your bonds
- Supports financial planning
- Enhances operational efficiency
- Promotes transparency and accountability
- Good risk management
- Improves access to future financing
- Easy and cost-effective review process at time of refunding
- Generate efficient and prompt response to any IRS inquiry

Questions?

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