Higher Ed, Exempt Org & Governmental Financings

Tax Presentation

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Qualified Equity - Allocation & Accounting Rules for Private Business Use

New Treasury Regulations regarding measurement and allocation of private business use (PBU) benefit universities that finance a portion of the total cost of capital assets with tax-exempt financing. These new rules apply when facilities are financed in part by tax-exempt bonds and in part by one or more other sources (qualified equity).

The terms "**project**" and "**qualified equity**" are key to the application of the new rules.

A "**project**" can include any number of separate, distinct facilities, provided they are financed, in whole or in part, by the same new money tax-exempt bond issue. Facilities initially financed with interim construction financing, like commercial paper, typically will be eligible to be part of the new money project.

"**Qualified equity**" includes sources of funds other than tax-exempt bond proceeds actually spent on any of the facilities included in the project. Qualified equity is defined as (a) funds from a source other than tax-exempt (or other tax-advantaged) bonds, (b) that are spent on the same project, and (c) that are applied to the project pursuant to the same plan of financing, which is determined by rules similar to the reimbursement rules applicable to tax-exempt bond proceeds.

Qualified Equity - Allocation & Accounting Rules for Private Business Use

Examples of funds that may be treated as qualified equity include:

- Proceeds of taxable debt.
- Accumulated revenues of the university.
- Interim taxable financing, such as commercial paper or taxable construction loans.
- Gifts or donations from university alumni and other supporters.
- Grants from the federal government, state and local governments, corporations and non-profit organizations.

Examples of funds that are <u>not</u> treated as qualified equity include:

- Interests in real property or tangible personal property.
- Funds used to redeem or repay governmental bonds.

Qualified Equity - Allocation & Accounting Rules for Private Business Use

Floating Equity

Under the new allocation regulations, a project can include a single facility or separate and distinct facilities that are all financed with some portion of the same tax-exempt bond issue. Qualified equity may be allocated from year to year to the PBU of the different facilities that constitute the project.

Example

A state university system issues $90 million of tax-exempt bonds and uses $30 million of Qualified equity to finance four buildings on four campuses for a total cost of $120 million ($30 million/building). Subject to some timing limitations, the university system may elect to treat all four buildings as a single project.

By making this election, regardless of how the $30 million of qualified equity is actually spent on the four buildings, the qualified equity automatically will be treated as used to pay for any portions of any of the buildings that, from time to time, have PBU. The university may allocate the qualified equity to "cover" PBU of up to $30 million in any year. Also, if the only PBU during a particular year is 100% private use of one of the four buildings (that cost $30 million), the $30 million of qualified equity will be allocated entirely to that building, and no PBU will be attributed to the bonds. Similarly, if during a different year, there is 100% private use of a different one of the four buildings, the qualified equity will be allocated entirely to that one building, and again no PBU will be attributed to the bonds.

Refunding Into Flexibility: Anticipatory Remedial Action In Connection With A Refunding

- The new **qualified equity** rules can apply in the refunding context. A small amount of taxable refunding bonds, on their own or together with tax exempt refunding bonds, creates PBU flexibility in the future.
- For many years, if non-compliance of a bond-financed facility occurred, taking a "remedial action" was the only available option. Typically, remedial action required the redemption or defeasance of some or all of the bonds relating to that changed use facility.
- The new rules permit a remedial action (a redemption or defeasance of bonds) to occur in anticipation of a later change in use and allows the portion of the bonds redeemed or defeased to be treated as qualified equity from the date of the remedial action.
- The university must make a formal statement of intent that the taxable refunding was undertaken in anticipation of remedial action that could, in the future, be required.

Refunding Into Flexibility - Anticipatory Remedial Action In Connection With A Refunding

Example

A state university originally issued $50 million of bonds to finance a single project and with initially less than 10% PBU. Years later, when $40 million of bonds remain outstanding, the university anticipates that PBU of the project will exceed the amount originally expected (i.e.,10%) in the future. Bonds issued for the project are subject to an optional call that would result in significant debt service savings in a refunding. If 20% of the refunding bonds are issued as taxable bonds and the balance with tax-exempt refunding bonds, the project would be treated (after the date of the refunding) as having been financed 20% with qualified equity that may float among the project facilities. The total PBU would be increased from the original 10% to 30%. The new 30% PBU allowance floats to absorb the first 30% of PBU in the project at any point in the future. The same result would occur if equity of the university was used to redeem or defease 20% of the outstanding tax-exempt bonds.

Refunding Into Flexibility - Anticipatory Remedial Action In Connection With A Refunding

Taxable Refunding Bonds As Qualified Equity

If all of the outstanding bonds are not redeemed or defeased, the taxable refunding bonds must be allocated to the refunding of the original bonds so that the taxable bonds refund maturities of the original bonds that have a weighted average maturity at least as long as the weighted average maturity of all of the outstanding original bonds.

If only a single prior issue is being refunded, this allocation is simple and does not require any special structuring. The taxable refunding bond proceeds are allocated to paying off certain maturities of the refunded bonds, and all of the taxable refunding bonds are allowed to mature before the tax-exempt refunding bonds.

If more than one prior issue is being refunded (or if there is a new money component) and it is important for the different refunding portions (or the separate refunding and new money portions) of the new issue to be allocated other than pro rata, then the taxable refunding bonds have to be structured to more closely match up with the prior bonds they are allocated to pay off.

Maximizing The Insubstantial - Multipurpose Elections &The $15 Million Limitation

- For bond transactions of more than $150 million, PBU is limited to $15 million. (A volume cap allocation can increase the allowed PBU to the 10% amount.) If these large bond issues have more than one purpose (each a **purpose**), multipurpose elections allow a way to structure around the $15 million PBU limit.
- A separate $15 million limitation applies to each purpose.
- The multipurpose allocation can be made at any time but once made, cannot be changed. To maintain flexibility, issuers can set up the allocation at closing and implement it if needed.
- For a large bond issue with significant qualified equity, the flexibility allowed by qualified equity dwarfs the advantage of delaying the multipurpose allocation because the 10% allowable PBU and the qualified equity will be more powerful than attempts to combine disparate facilities into single purposes to maximize the use of the $15 million amount among facilities with and without PBU.
- Now, multipurpose allocations for large bond issues generally should be made at closing which helps clarify the documentation and simplify compliance.

Maximizing The Insubstantial - Multipurpose Elections &The $15 Million Limitation

Example Of Different New Money Purposes

- A single project cannot constitute more than one purpose, but a single purpose can include more than one project. In some cases, this will be a limit to the first premise. For example, $300 of tax-exempt bonds may be issued to finance portions of many facilities that could be a single project and for which there is substantial qualified equity. A multipurpose allocation to split the facilities into two projects and two purposes may be possible so that each project/purpose gets a full 10% allowable PBU amount. This will require splitting of the overall qualified equity as well, so it is possible that having a single purpose and project would provide better results.
- Multipurpose allocations are not forced to be made at the time bonds are issued, but the project decision needs to be made at the closing of the bonds. For larger bond issues, the determination of which facilities will be part of a project must be informed by the use of the multipurpose allocations. This may result in the making of multipurpose allocations more often at closing in order to gain certainty and simplify compliance without losing much flexibility.
- A university system with multiple campuses or departments that handle tax compliance independently of each other will need to take into account existing compliance policies to determine the best approach.

Maximizing The Insubstantial - Multipurpose Elections &The $15 Million Limitation

Example Of New Money & Refunding Purposes

- Refunded facilities cannot be combined with new money facilities into a single project due to plan of finance and timing limitations.
- Refunded facilities can be combined into a single refunded project to the extent the retroactive application of the new regulations can fit into the existing facts. This results in, at most, a single project for each original new money purpose being refunded.
- Note that for refunding of short-term interim financing, the refunded facilities may be able to be combined into a single project with true new money projects.
- Refunded projects and new money projects can be combined into a single purpose. The qualified equity only floats within each project, but the 10%/$15 million allowable PBU can float among projects.

The Changing Landscape Of Private Service Contracts: Revenue Procedure 2016-44

Revenue Procedure 2016-44 - Released August 22, 2016, amended September 6, 2016

This Revenue Procedure eliminates detailed safe harbors involving length of term, termination rights, and limits on non-fixed compensation provided in Revenue Procedure 97-13 (amplified by Notice 2014-67).

The Revenue Procedure allows for significantly longer term service contracts, including contract terms up to the lesser of (a) 30 years or (b) 80% of the weighted average reasonable expected economic life of the bond-financed managed property.

The Revenue Procedure is effective for service contracts entered into on or after August 22, 2016, but qualified users may choose to apply it to service contracts entered into before August 22, 2016.

A qualified user may also choose to apply existing Revenue Procedure 97-13, as amplified, to a contract entered into before August 18, 2017, provided it is not materially modified or extended on or after August 18, 2017 (other than pursuant to certain legally enforceable renewal options).

The Changing Landscape Of Private Service Contracts: Revenue Procedure 2016-44

The Revenue Procedure imposes the following principle-based safe harbor requirements:

- The overall compensation paid to the service provider must be reasonable.
- The contract must not provide the service provider with a share of “net profits” from the managed property. Reimbursements of the service provider’s actual and direct expenses paid to unrelated parties are disregarded; however, employees of the service provider are not unrelated parties with respect to the service provider.
- Compensation is not treated as a share of net profits if none of the eligibility for, timing of, or amount of compensation, takes into account or is contingent upon the net profits of the managed property or both the revenues and expenses of the managed property.
- Incentive compensation (not expressed as a percentage of net profits) will not be treated as providing a share of net profits if awarded based on standards of quality of service, performance or productivity.
- The service provider may not share in the burden of bearing net losses from the operation of the managed property or the risk of loss if the property is damaged or destroyed. Dollar-amount reductions in compensation based on failures to keep expenses below one or more specified targets will not be treated as sharing net losses with the service provider.

The Changing Landscape Of Private Service Contracts: Revenue Procedure 2016-44

- Compensation will not be treated as providing a share of net profits if none of the eligibility for, timing of, or amount of compensation, takes into account or is contingent upon the net profits of the managed property or both the revenues and expenses of the managed property.
- The qualified user must exercise a significant degree of control over the managed property, including approval of the annual operating budget for the property, capital expenditures, disposition of the property, rates charged and general nature and type of use of the property.
- The service provider must agree that it is not entitled to, and will not take, a tax position with respect to the financed property inconsistent with being a service provider (e.g., depreciation of the property or characterization of payments to the qualified user as deductible rent).
- The ability of the qualified user to exercise its rights under the contract must not be limited by its relationship with the service provider. An independent safe harbor based on lack of overlapping governance and shared officers is provided.

The Changing Landscape Of Private Service Contracts: Revenue Procedure 2016-44

Interesting Areas of Interpretation and Practical Rules

- Revenue Procedure 97-13 as a fallback for now (and in the future)
- Existing non-safe harbor guidance continues to apply
- Net Profits/Losses Arrangements
- Control of the Managed Property - Approval of Capital Expenditures, Dispositions of Property, Rates Charged
- Tax law distinguishing service contracts from leases is more relevant.
- Generally, longer term variable compensation contracts are allowed.

Private Business Use – Research Contracts

Research Contract Principles

Many institutions, including universities, enter into contracts relating to basic research which can cause the sponsoring entity or entities to be treated as private business users of tax-exempt bond-financed facilities of the university used for research.

Below are key principles used to analyze research contracts in order to avoid PBU based primarily on the safe harbor guidance found in IRS Revenue Procedure 2007-47:

- The university can always agree to a non-exclusive royalty-free license (a **NERF**) with an individual sponsor or group of sponsors, including the federal government.
- Only in single sponsor circumstances are exclusive licenses to the sponsor (or an entity specified by it) allowed and then only at fair market value determined at the time of the license is granted. Contributions by the university to the research project can be ignored.
- Where the only licenses provided are non-exclusive, the university may charge different sponsors differently. IRS guidance provides a safe harbor so long as no one is allowed anything BETTER than a NERF. It is not better than a NERF to have a non-exclusive license that costs something.

Private Business Use – Research Contracts

- Multiple sponsors or non-sponsors are not required to be treated consistently in terms of cost, but any different or inconsistent treatment of non-sponsors has to be entirely at the discretion of the university.
- No limitations apply to the terms of individual licenses granted to non-sponsors.
- A broad grant of exclusive marketing or other rights to a institution’s present and future intellectual property may result in PBU of the facilities where the research was performed.
- A university must be careful to guard against contractual provisions with sponsors which limit the university’s discretion as to charges to non-sponsors. Sponsors can know initially what they will be charged, but cannot dictate what the university will charge others.
- It is important for the university ultimately to be in control of the manner in which the research is performed and must have the final say by a veto right, a “tie-breaker” vote or other effective majority control.

Private Business Use – Material Transfer Agreements

Material Transfer Agreements (MTAs)

MTA's are research contracts that generally are considered single sponsor contracts, thereby allowing for exclusive licenses to be negotiated with the material provider. There are three basic scenarios.

Single Sponsor Arrangements. The university may enter into a research contract with Company X and also enter into an MTA with Company X to use certain Company X materials in the research.

Multiple Sponsor Arrangements. The federal government may sponsor a specific research project that specifies that Company X material be used in the research, and the university may enter into an MTA with Company X.

Other Single Sponsor Arrangements. Most commonly, the federal government and/or some company sponsors a specific research project and no particular material is specified to be used in the research. The university enters into an MTA with Company X and believes at the Company X material will improve the research. The MTA is a single sponsor contract even though the MTA specifies the same scope of work as the research contract. For this conclusion, it is assumed that the MTA does not directly reference the other contract.

Private Business Use - Incidental Use Exception & Examples & Short Term Use Exception

Incidental Use Exception

Use by a private party that is solely incidental to the governmental use of the bond-financed facility is not PBU. Use is solely incidental (1) if the use is not related to the primary function of the facility; (2) the use does not include use of an entire room as partitioned space; and (3) the aggregate amount of all incidental use is no more than 2.5%. Examples of incidental uses include:

- Rooftop Solar Panels
- Cell Phone Towers
- Vending Machines

Short term contract exception-50 day rule (covers summer use and special events)

- Contract is for 50 days or less
- Includes renewal options
- Negotiations must be arm’s length
- Compensation must be FMV
- The property is not financed for the principal purpose to provide use by the third party

Private Business Use - Naming Rights Principles

The IRS has taken the position, in certain situations, that PBU by a private business entity of a bond financed facility may arise without any possessory rights for the use of such facility by such private business.

The sale of naming rights with respect to athletic or performing arts facilities is often treated as causing PBU. In addition, PBU is more likely to occur when the private party is also given so-called "**Bundled Rights**." The type of Bundled Rights that may cause a PBU problem include the right to use the company's name on all contracts, tickets, signage, advertising space, event programs, newsletters, pocket schedules, employee uniforms, paper products, trash cans, and stationery related to the facilities. Other types of Bundled Rights could include pouring rights, exclusionary rights prohibiting other advertisers, among others.

Private Business Use - Naming Rights Principles

Naming Rights That Typically Do Not Result in PBU

Individuals. Individuals and their families are not business entities; thus, generally naming a tax exempt bond-financed building after an individual or family does not result in PBU of the building. However, in a case where an individual's name may be synonymous with a business entity's name, PBU of the named facility may result.

General Donor Recognition. As part of general fundraising efforts, a university may recognize a donor (either an individual or a business entity) for their generosity and support by unilaterally deciding to place the donor's name on a campus facility, donor wall, plaques, etc.

Naming Opportunity of Exterior of Traditional Educational Buildings. Without any particular right to control or use certain facilities such as an administrative, academic or similar building, the name of a business entity on the exterior of such a building will not, in most circumstances, result in PBU of the building.

Private Business Use - Naming Rights Principles

Naming Opportunities in Interior Spaces. Absent any right to control or physically use the named facility, naming an interior space for a business entity generally will not result in PBU.

Concession, Pouring and Merchandise Rights. An arrangement with a beverage provider for an exclusive right to serve and sell its products either campus-wide or for select events is generally not PBU. But, any physical space, such as for storage, is considered PBU depending on the terms of the contract.

Telecommunication and Broadcasting Rights. These rights generally only affect athletic or performing arts facilities. A contract for the broadcast of events on campus is usually not PBU, other than any use of physical space (e.g., for cameras, satellites, storage).

Marketing Arrangements. An arrangement to market the college or university, a separate campus, its teams or performing arts groups on campus generally is not considered PBU.

Private Business Use - Naming Rights Principles

Concession, Pouring and Merchandise Rights. An arrangement with a beverage provider to give the provider the exclusive right to serve and sell its products either campus-wide or for select events is generally not considered PBU. Note that any physical space, such as for storage, will be considered PBU depending on the length and other terms of the contract. The combination of pouring rights and naming rights could result in PBU.

Telecommunication and Broadcasting Rights. These rights generally only affect athletic or performing arts facilities. A contract for the broadcast of events taking place on campus is usually not considered PBU, other than any use of physical space (e.g., for cameras, satellites, storage).

Marketing Arrangements. An arrangement to market the college or university, a separate campus, its teams or performing arts groups or events taking place on campus generally is not considered PBU.

Private Business Use - Naming Rights Principles

Naming Rights That Typically Result in PBU

Naming Opportunity of Special Purpose Buildings - Athletic or Performing Arts. Naming rights to athletic and performing arts facilities are more likely to result in PBU. Often, due to location or use, particular types of buildings or assets such as these will have potentially more commercial value than administrative or educational buildings. The most common example of this is an athletic facility, such as an arena or stadium. In general, treatment as PBU is limited to circumstances in which the naming opportunity is the right to name the entire facility or a particularly prominent portion of the exterior or interior of the facility. The addition of Bundled Rights may also affect the analysis.

Right to Control Pricing. In connection with athletic venues or other community venues, any right by an outside party to control pricing (or other operational matters) of an otherwise non-PBU facility (for example, parking garages or lots) may be considered PBU depending on the length and other terms of the contract.

Private Business Use - Naming Rights Principles

Special Access Arrangements. The specific terms of arrangements that provide business sponsors with special membership rights, tickets or other pricing benefits may be considered PBU depending on the length and other terms of the contract.

Advertising. Commercial sponsorships or advertising can result in PBU of the physical space holding the advertisement, perhaps limited by the duration when the advertisement is visible. More pervasive sponsorships or advertising may create PBU that is more difficult to measure or isolate. Advertising on scoreboards or video boards often creates PBU and most often entities choose to finance those assets using taxable financing to maximize advertising revenue opportunities.

Improving Post-Issuance Compliance

General Guidelines for Post-Issuance Compliance Procedures

- Perform due diligence at regular intervals
- Identify an official or employee to be responsible for such review and provide the official or employee with education and training.
- Monitor the use of bond proceeds and the use of bond-financed assets (e.g., facilities, furnishings or equipment) throughout the term of the bonds to ensure compliance with covenants and restrictions set forth in the bond documents.
- Maintain records identifying the assets that are financed or refinanced with proceeds of each bond issue, including copies of contracts or arrangements for the use of the bond-financed facilities.
- Consult with bond counsel and other professional experts in the review of contracts or arrangements involving use of bond-financed facilities to ensure compliance;
- Maintain records for any contracts or arrangements involving the use of bond-financed facilities as might be necessary or appropriate to document compliance with all covenants and restrictions set forth in the bond documents.

Improving Post-Issuance Compliance

- Meet at least annually with personnel responsible for bond-financed assets to identify and discuss existing and future use of bond-financed assets and to ensure that those uses are consistent with the bond documents.
- Unless otherwise specified in the bond documents, maintain certain documents for the term of each bond issue (including refunding bonds), plus at least three years, including:
  - a copy of the bond closing transcript(s) and other relevant documentation delivered in connection with closing of the issue of bonds;
  - a copy of all material documents relating to capital expenditures financed or refinanced by bond proceeds, including (without limitation) construction contracts, purchase orders, invoices, trustee requisitions and payment records, as well as documents relating to costs reimbursed with bond proceeds and records identifying the assets or portion of assets that are financed or refinanced with bond proceeds;
  - a copy of all contracts and arrangements involving PBU of bond-financed assets; and
  - copies of all records of investments, investment agreements, arbitrage reports and underlying documents, including trustee statements.
- A multiple campus university system must tailor its compliance program to the manner in which campuses or departments take responsibility for tax compliance for their projects.

Medical Centers and Private Business Use

Service Contracts

The normal service contract rules apply to healthcare providers, but academic medical centers may have special attributes.

The service contract rules (new Revenue Procedure 2016-44) apply to private business entities and independent contractors. Employees, such as doctors employed by the university under a faculty practice plan, cannot be private users.

The special doctor contract rules in IRS Notice 2014-67 and relating to accountable care organizations under the Affordable Care Act continue to apply. The interplay between Notice 2014-67 and Revenue Procedure 2016-44 is expected to evolve.

In addition, the drafters of Revenue Procedure 2016-44 have represented that some of the controversial provisions in the new guidance apply most favorably to doctor contracts.

Medical Centers and Private Business Use

Clinical Trials

Clinical trial arrangements (as defined below) are not research activities, are not subject to the research contract rules, and do not pose PBU concerns. For this purpose, clinical trials are limited to activities:

- performed on selected members of the general patient population (either patients that would always independently be treated or new patients brought in for the trial);
- performed in facilities that serve the general patient population;
- in which the university is paid an objective fee for performing the trials according to the protocols previously developed by the sponsor;
- for which all of the data that is collected is given to the sponsor;
- for which the sponsor does not dictate which facilities are used for the trial; and
- for which there is only a limited possibility of a patented invention being discovered in connection with the clinical trial.

Medical Centers and Private Business Use

Joint Ventures/Acquisition

Changes in the healthcare industry are driving academic medical centers, as well as larger general healthcare organizations, to acquire, affiliate or in some fashion, partner with other healthcare entities (each a target entity).

These joint venture relationships take many forms, including:

- acquisition and liquidation of the target entity into the university;
- the university obtaining control of the target entity by acquiring a membership interest;
- the university and the target entity entering into a joint operating agreement;
- the university and the target entity agreeing to some revenue sharing arrangement relating to specific operating units or practices within a medical center; and
- the university leasing land or providing services to a third-party developer of a capital intensive practice (e.g., proton therapy).

Medical Centers and Private Business Use

All such joint venture arrangements can impact existing and future tax-exempt financing transactions, and the tax conclusion often requires a close analysis of the specific facts. Some of the common tax issues are:

- Does the arrangement cause the target entity to be a private user of existing, bond-financed university facilities? For example, the target entity (including its employees and contractors) might use university land or facilities or share in revenues generated by university facilities?
- Has the target entity been transformed into a governmental instrumentality upon control by the university, even if the target entity retains its nonprofit form? An independent nonprofit that is controlled by a public university has probably transformed into a governmental entity even though it continues to operate as a separate nonprofit and continues to maintain its 501(c)(3) status. This is helpful for tax purposes but may raise Medicare reimbursement issues.
- Should any bonds of the target entity be redeemed or defeased within six months of the acquisition causing bonds issued by the university to be new money bonds? This approach can avoid various tax limitations relating to the university bonds, which can be very helpful, but there are complications as well.

Build America Bonds – Cross-over Refundings

Cross-Over Refundings – First Call – Optional Or Extraordinary Calls

In light of sequestration resulting in reduced federal subsidies for Build America Bonds (“BABs”), much attention has been given to the refunding of BABs with the proceeds of tax-exempt bonds in a manner that preserves the federal subsidy until the call date. In the current market, debt service savings can be significant for BABs that allow for a traditional par call in the near future. A legal defeasance of BABs, in a standard type of refunding, results in the immediate loss of the federal subsidy which offsets the debt service savings resulting from the refunding.

A crossover refunding will permit the proceeds of the refunding bonds to be invested in escrowed securities that pay the interest on the refunding bonds until the traditional call date, at which point the escrowed securities are used to pay the redemption price of the refunded BABs. This structure preserves the federal subsidy until the BABs are redeemed. After some early and negative informal statements, the IRS appears to be comfortable with this legally correct result.

Apart from state law concerns, the primary remaining legal issue relates to any make whole call rights for the BABs. Issuers are required to call refunded bonds on the first call date that generates present value debt service savings. Complying with this limitation is usually simple with a traditional 10-year par call, but optional or extraordinary make whole call rights complicate the analysis. Most tax counsel agree that a typical, optional, make whole call right prevents the use of a tax-exempt crossover refunding because the first call date that may generate debt service savings cannot be known. For an extraordinary make whole call right, we believe the critical point is whether the extraordinary event that triggers the call right has occurred (i.e., can the extraordinary call be used as of the date the refunding bonds are issued).

Replacement Proceeds Issues

Invested Funds

Under certain circumstances, invested funds (e.g., endowment, quasi endowment, and funds functioning as endowment) may become "replacement proceeds" of an issue of tax-exempt bonds. This conclusion requires that the yield on invested replacement proceeds not exceed the yield on the related bonds. The IRS could also assert certain arbitrage anti-abuse theories.

The general definition of replacement proceeds states that replacement proceeds are amounts that have a sufficiently direct nexus to the bond issue or to the governmental purpose of the bond issue to conclude that the amounts would have been used for that governmental purpose if the proceeds of the issue were not used or to be used for that governmental purpose.

The analysis of whether invested funds are replacement proceeds often is a judgment call by tax counsel that takes into account all of the facts and circumstances.

The Permanent University Fund has its own special exception and tax limitations for complying with these requirements.

Replacement Proceeds Issues

Replacement Proceeds

Replacement proceeds include amounts described below:

- Invested funds or the earnings therefrom expected to be used to pay debt service on tax-exempt bonds,
- Invested funds or the earnings therefrom pledged in a manner to provide reasonable assurance as to the payment of debt service on tax-exempt bonds, and
- Invested funds with donor-imposed restrictions on the use that require the invested funds or the earnings therefrom to be used to construct the bond-financed project or to pay debt service on the bonds.

Replacement Proceeds Issues

Sinking Funds

Sinking Funds. Invested funds are replacement proceeds if the invested funds are reasonably expected to be used directly or indirectly to pay debt service on an issue of tax-exempt bonds ("sinking fund proceeds"). A fund created pursuant to the bond documents for the specific purpose of accumulating money and investments for the payment of the bonds, results in those moneys and investments being treated as sinking fund proceeds. Sinking fund proceeds may arise without a clear and intentional trail when bonds are issued with a large bullet maturity coming due in a single year. Invested funds may be expected to be used for such purpose, thereby causing such funds to be treated as sinking fund proceeds.

Hidden Sinking Funds. An issuer of bonds may set aside or identify funds, or may have an allocation and accounting procedures for its own books and records but outside the bond financing documents, that results in investments being expected to be used to pay debt service on the bonds even though the investments are not held in a specific segregated fund.

Replacement Proceeds Issues

Pledge of Invested Funds

Invested funds are replacement proceeds if the invested funds are directly or indirectly pledged to pay debt service on tax-exempt bonds. For this purpose, amounts are pledged only if the pledge creates a reasonable assurance to the owners or guarantors of the bonds that the pledged amount will be available to pay debt service in the event of financial difficulties of the issuer of the bonds.

A pledge can exist by way of a direct pledge or an indirect or negative pledge, such as a promise to bond holders to always maintain a certain balance in liquid investments.

Often, funds that are pledged in a commercial law sense are not treated as pledged for tax purposes, because the university can spend the pledged funds, for example on operating costs, such that the pledged funds in fact, may not be available to pay the bonds.

Replacement Proceeds Issues

Donor-Imposed Restrictions on Gifts and Invested Funds

To the extent gifts are too closely connected to the bond-financed project or the bonds, the donated funds may be treated as replacement proceeds.

Even if the determination under state law and the terms of the gift agreement are that the gift is not required to be used to build the project, an independent tax review should occur to determine if the gift is simply too closely connected to the construction of the project or the payment of debt service on the bonds. The specific language the donor uses in transmitting the gift and the campaign materials are key to this analysis. Care must be taken when drafting the pledge forms and other development materials.

Campaign materials should always stress the need to establish invested funds to support the operating costs and program needs of the new facility. Then, gifts or pledges can be reasonably interpreted to allow the gifts to be invested and used for operating expenses. Donors must be willing to forgo restrictions on the use of their gifts that they might otherwise reasonably impose.

All of the formal and informal documentation and communications (including discussions with campuses and accounting records) for a bond issue should be clear that the expected and actual source of payment of debt service is a revenue source that is not the invested funds or earnings thereon.

Replacement Proceeds Issues

Fundraising Literature and Promotional Materials

If the purpose of the fundraising campaign is too closely tied to the capital costs of a building project, a gift made in response to such campaign may be treated as restricted for such purpose and, therefore, replacement proceeds.

For tax-exempt bond purposes, a pledge form or other materials that restrict the use of gifts to project construction can be changed by the donor to allow use for other purposes so long as the change occurs prior to the time funds are actually received by the university.

As a general matter, it is fine for the university to organize its financial affairs in a manner that allows for an increase in the amount of invested funds and an increase in the amount of tax-exempt bond issuance. If there are no sinking fund proceeds, pledge fund proceeds or replacement proceeds relating to direct donor restrictions, written documentation and public statements made by university officials that create too much of a nexus between the gifts and the bonds can be problematic.

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