The following is provided for information purposes only and should not be considered tax advice. No representations are made as to applicability of this in specific circumstances. It cannot be used for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed within.

Bonds 101 – The Federal Tax Code and Related Program Considerations

Permissible Uses

"Governmental bonds are tax-exempt bonds issued by a state or local government, the proceeds of which are generally used to finance activities or facilities owned, operated, or used by that or another government for its own purposes. This can include financing the building, maintenance, or repair of various types of public infrastructure such as highways, schools, fire stations, libraries, or other types of municipal facilities. Ultimately, though, a tax-exempt governmental bond is a state or local bond that is neither a private activity bond, as defined in section 141 of the Code, nor an arbitrage bond within the meaning of section 148 of the Code."

- IRS Compliance Guide – Tax Exempt Government Bonds

Generally speaking, bonds must be for **capital expenditures – NOT working capital** (operating expenditures). The rules for working capital are different – much more restrictive, and as a practical matter will likely result in "arbitrage bonds" discussed above.

Be careful in allowing "repairs" as they may be deemed working capital expenditures. Will the cash outlay result in an increase in assets on the balance sheet or an expense?

Loans to non-governmental entities could result in making the bonds "private activity bonds."

Useful Life of Assets

For the bond series as a whole, the weighted average maturity of the bonds cannot exceed 120% of the weighted average economic life of the assets financed by the grants/loans. Useful life of assets funded using bond proceeds must be documented by the granting/loaning state agency.

Timing of Spending Proceeds – Arbitrage

Arbitrage rules were established to stop an abuse of tax-exempt bonds. Without the rules, governments could issue tax-exempt debt and invest the proceeds in higher yielding taxable instruments thereby making a profit on the "spread."

The rules established periods of time by which proceeds must be expended. If proceeds (and related investment earnings) are not spent within the established timeframe, earnings on bonds are subject to arbitrage rebate. Time frames are generally 18 months or two years[1] for complete spending of proceeds with six-month incremental percentage requirements to avoid arbitrage rebate.

There is a three year, "temporary period." If proceeds are not spent within the three year period there may be requirements to "yield restrict" investment of the proceeds.

Arbitrage reporting to the IRS is performed by the Oklahoma Capitol Improvement Authority (OCIA) staff. However, agencies are responsible for maintaining necessary records including separate accounts at the State Treasurer if necessary and expenditure and use of facility documentation.

[1]The two-year period is allowed when at least 75% of the proceeds are spent on construction (as opposed to expenditures for land acquisition or equipment).

Before the Bonds are Sold – Intent Resolutions

Related to closing the door on arbitrage abuses, the IRS requires that an intent resolution be filed prior to any expenditure made before the bond sale for which you plan to reimburse yourself with bond proceeds. This applies to grantees and loan recipients as well. Therefore, you must obtain satisfactory evidence of the date of expenditures occurred to construct (or rehab) capital assets under your program. These intent resolutions must be filed with the OCIA. For grant and loan programs, intent resolutions that pre-date the award of the grant or approval of the loan are not acceptable.

Cost of Administration

No more than 5% of bond proceeds can be used for administration of the program – assuming such administrative costs are necessary to execute the program and get the capital projects completed.

Holding these funds beyond the time periods discussed above could result in arbitrage rebate liabilities. Know that you may incur ongoing costs every year the bonds are outstanding (cost of additional rebate calculations and other arbitrage expenses required to maintain the tax-exempt status of bonds issued by OCIA).

Records Retention

The general rule on document retention imposed by the tax code is that proper records must be maintained and made available to the IRS. According to the IRS published Frequently Asked Questions (FAQ's), documentation that should be maintained includes bond transcripts, documentation demonstrating the expenditure of bond proceeds, documentation showing sources of payments for the bonds, documentation about the calculation of yield and the investment of bond proceeds, rebate, calculations, IRS forms, etc. These documents are maintained at OCIA.

State bond recipient entities should maintain all expenditure transactions and requests for reimbursement related to bond projects. All agreements should limit the use of bond funds to capital expenditures and not non-capitalized operating costs. Invoices, payments and contracts should be maintained as required. Project Documentation should be maintained by project and bond series.

These records should be retained until at least three years after the last bond in the series is no longer outstanding.

Tax Reporting

In addition to maintaining separate accounts and records to support the arbitrage rebate calculations performed by the OCIA, your agency may be responsible for issuing certain tax forms and reporting that information to the IRS. If you issue grants to a for-profit entity, you are responsible for preparing Form 1099-MISC and providing those forms to the grantee and reporting that information to the IRS. Agencies that use bond proceeds to construct or develop an asset using outside vendors consultants, or contractors are required to issue Form 1099's and report that information to the IRS.

Controls on Grant Funds

Documentation should distinguish between grants and contracts for services. All transfers to third parties should be approved by OCIA prior to transfer. The transfer must not impose any obligation or condition to directly or indirectly repay any amount to the transferor.