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## **“WORKING WITH BOND COUNSEL – AREAS OF MUTUAL CONCERN”**

Presented by Judith Blank and Douglas Gillette of Day Pitney LLP  
to the  
Connecticut Association of Municipal Attorneys Board of Directors Meeting  
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Included in the following materials are summaries of certain provisions of the Federal tax and securities statutes and regulations, the Connecticut General Statutes and case law. Other provisions of statute, charter, and regulation and other case law may apply to a particular situation. This summary is intended for educational and informational purposes only and is not intended and should not be construed as legal advice or opinion about specific situations, which can only be rendered with regard to the particular facts and a complete review of the applicable law.

## 1. BOND COUNSEL OPINION STANDARDS:

- The role of Bond Counsel arose against a background of 19th century suits in which municipalities challenged their obligation to pay their bonded debt due to irregularities in the issuance proceedings. Investors look to the opinion of Bond Counsel as the primary assurance that a municipality would not be able to avoid payment of its debt.
- Municipal bonds not accompanied by a Bond Counsel opinion became difficult, if not impossible, to market.
- The opinion is to be an objective legal opinion as to the validity of the bonds. See National Association of Bond Lawyers, The Function and Professional Responsibilities of Bond Counsel (1995 second edition) at pages 1-2. In order to render an opinion that the issue is free from any such defect, **bond counsel must be “firmly convinced (also characterized as having a high degree of confidence) that under the law in effect on the date of the opinion, the highest court of [the State of Connecticut], acting reasonably and properly briefed on the issues, would reach the legal conclusions stated in the opinion”**. National Association of Bond Lawyers, Model Bond Opinion Report (2003) at page 7.
- Because of this stringent standard, we cannot render an opinion where there is any unresolved issue as to whether adequate procedures were followed by a municipality in authorizing an issue.
- The opinion standard for bond counsel remains the same whether we are opining to federal or state tax matters, securities laws or local authorization provisions.

## 2. LEASE-PURCHASES:

- To avoid being considered “debt” the payment obligation must be subject to non-appropriation provisions. The lease must permit the municipality to terminate at the end of each fiscal year if legislative body does not appropriate lease payments.
- However, actually terminating the lease would have significant impact on subsequent access to financial market.
- For accounting purposes and rating agency analysis, lease is considered as part of municipality’s debt structure.
- Non-substitution/essential use provisions (enforceability is questionable).
- In order to be issued on a tax-exempt basis, must be pursuant to a municipality’s borrowing power, and must also comply with all other provisions applicable to tax-exempt debt.
- Tax opinions generally required.

### 3. POST ISSUANCE COMPLIANCE:

- **TAX MATTERS-** the tax provisions governing municipal bonds are set forth in very general terms in the attached Primer on Public Finance.
- These provisions include **ongoing restrictions on the use of bond-financed property and the investment of bond proceeds.**
- Whenever municipal property is to be used by a non-governmental entity, consider whether any such restrictions apply. 501(c)(3) entities and the federal government are considered non-governmental entities for this purpose.
- Bond proceeds are subject to federal “arbitrage”<sup>1</sup> restrictions which may limit permissible investment yields and may require “rebate”<sup>2</sup> of excess earnings to the federal government.
- **CONTINUING DISCLOSURE** - Underwriters may not sell municipal obligations unless the issuer has agreed to provide updated financial information on an annual basis and to provide notice of “material events”.
- EMMA Annual Filings- SEC Rule 15c2-12 (indirectly) requires that municipal bond issuers submit annual financial information to EMMA (the MSRB’s Electronic Municipal Market Access system). EMMA is a relatively new, web-based depository of filings. **All filings must be submitted to EMMA in word-searchable portable document format (PDF).** Issuers must submit to EMMA *notice of failure* to provide required annual financial information on or before the date specified in the written continuing disclosure undertaking.
- Material Events - SEC Rule 15c2-12 (indirectly) requires that municipal bond issuers submit notice of any of the following events to EMMA within a *timely manner, if material*:
  - Principal and interest payment delinquencies
  - Non-payment related defaults
  - Unscheduled draws on debt service reserves reflecting financial difficulties

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- <sup>1</sup> Arbitrage
    - “Arbitrage” usually refers to the difference between the interest paid on tax-exempt bonds and the interest earned by investing the proceeds of the bonds in higher-yielding taxable securities
      - The thrust of federal tax laws generally is to restrict the ability of municipal issuers to earn arbitrage profits in connection with tax-exempt bonds.
      - Yield Restriction Rules – govern the circumstances in which an issuer is not permitted to invest bond proceeds at a yield higher than the yield on the bonds
    - Tax-exempt bonds lose their tax-exempt status if they are determined to be “arbitrage bonds”.
  - <sup>2</sup> Rebate
    - Unless an exemption is available under the Code, arbitrage profits must be rebated to the federal government.

- Unscheduled draws on credit enhancements reflecting financial difficulties
  - Substitution of credit or liquidity providers, or their failure to perform
  - Adverse tax opinions or events affecting the tax-exempt status of the security
  - Modifications to rights of security holders
  - Bond calls
  - Defeasances
  - Release, substitution, or sale of property securing repayment of the securities
  - Rating changes
- Note that amendments have been proposed which would, among other things, add additional events to the list of events requiring disclosure and require disclosure of certain events whether or not material

#### **4. DIRECT PAYMENT BUILD AMERICA BONDS ("BABs"):**

- BABs are federally taxable bonds accompanied, at the election of the issuer, by either a direct payment subsidy to the issuer or federal tax credit to bondholders.
- In order to receive the federal subsidy, the issuer must file with the IRS a request for each interest payment or quarterly for variable rate.
- **Even though BABs are taxable, they must comply with tax-exempt bond rules.**

In addition to other restrictions applicable to tax-exempt bonds, generally BABs cannot (1) be “private activity bonds” and (2) be issued with more than a *de minimis* amount of original issue premium.

To qualify for the direct pay BABs, 100% of the bond sale proceeds may be used only for capital expenditures, cost of issuance not exceeding 2% of the issue price, and a reasonably required debt service reserve fund.

- **Failure to satisfy the applicable rules, including underlying tax-exempt bond rules, will result in retroactive loss of BAB status, and loss of federal interest subsidy.**
- IRS has launched a compliance check on direct pay BABs focusing on post-issuance and record retention policies, procedures and practices, and **the IRS is sending questionnaires to all entities that issued direct pay BABs.** These questionnaires are voluntary, but *failure to reply can trigger an audit.*

- Note – BABs are set to expire at the end of 2010, but there is momentum to make them permanent at a reduced subsidy level.

**5. AMERICAN RECOVERY AND REINVESTMENT ACT (“ARRA”):**

- **Davis Bacon/CT prevailing wage** - Section 1601 of the ARRA states that the prevailing wage requirements of subchapter IV of chapter 31 of United States Code title 40 apply to projects financed with the proceeds of clean renewable energy bonds, qualified energy conservation bonds, qualified zone academy bonds, qualified school construction bonds and recovery zone economic development bonds. Connecticut prevailing wage requirements are more stringent. However, there is no minimum contract amount excepted from the ARRA provisions.

**6. CLEAN WATER/DRINKING WATER STATE REVOLVING FUND FINANCINGS:**

- Requires appropriation of full cost of project and requires borrowing authorization as provided in CGS or local charter. We suggest borrowing authorization for full project cost, even portion to be funded with grants.
- Municipality will be required to adopt non-discrimination policy and WPCA contracts will be subject to non-discrimination provisions of CGS 4a-60 and 4a-60a.

**7. USDA FINANCINGS:**

- Requires appropriation of full cost of project and requires borrowing authorization as provided in CGS or local charter. We suggest borrowing authorization for full project cost, even portion to be funded with grants. USDA has form resolution which also must be adopted.
- Contract requirements
- “Buy American” requirements apply.
- USDA financing occurs after project is completed, they do not provide construction period financing. Many issuers must issue notes to temporarily finance construction.
- Municipal attorney will be looked to for opinions as to title to property, etc.

**8. SCHOOL CONSTRUCTION PROJECTS:**

- Requires appropriation of full cost of project and requires borrowing authorization as provided in CGS or local charter. We suggest borrowing authorization for full project cost, even portion to be funded with grants.
- Bidding now required for architectural services.

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**Appendix A – “Issuing Bonds and Notes - A Primer on Public Finance”**

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**“Issuing Bonds and Notes –  
A PRIMER ON PUBLIC FINANCE”**

*Prepared by Day Pitney LLP’s  
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**“Issuing Bonds and Notes –  
A PRIMER ON PUBLIC FINANCE”  
Presented by Day Pitney LLP’s  
Municipal Finance Practice Group  
October 1, 2009**

**I. INTRODUCTION**

**II. AUTHORIZING BONDS AND NOTES**

**A. Connecticut General Statutes and Local Charter**

1. The authorization process is determined by the Connecticut General Statutes and, for special act or home rule charter towns, by the town charter.

2. Matters not addressed by the town charter are governed by the Connecticut General Statutes (C. G. S.).

**B. Freedom of Information Act**

1. All proceedings are subject to the Freedom of Information Act (F.O.I.A.) requirements. (C. G. S. §§1-200 – 1-259.) This includes the proper notice of meetings and the satisfaction of any requirement for the inclusion of a matter on the agenda. Proper posting includes on Town’s Internet website if available.

2. The F.O.I.A. requires at least 24 hours’ notice for special meetings, and permits action only on items included in the notice of such meetings (C. G. S. §1-225(d)).

3. The F.O.I.A. also requires timely recording and filing with the clerk of minutes of all meetings (C. G. S. §1-225).

**C. Notice Requirements (count carefully)**

1. Notice of the meetings and hearings of public bodies must be published in a newspaper having a general circulation in the town.

2. Unless provided otherwise, the day of publication and the day of a meeting or public hearing are not included when counting the days for published notice.

3. The F.O.I.A. excludes Saturdays, Sundays, legal holidays and days on which clerk’s office is closed in determining the time within which a notice, agenda, record of votes or minutes are to be filed. (C. G. S. §1-225.)

D. Planning and Zoning Commission

1. C. G. S. §8-24 requires that municipal projects be “referred to the commission for a report.” The statute is broad, covering projects which “substantially improve” municipally owned property. Action by the commission requires a majority vote of all its members, not just those present and voting (C. G. S. §8-22).

2. The town legislative body may override disapproval by the commission by a two-thirds vote of town council or RTM (simple majority of those present and voting at annual or special town meetings). (C. G. S. §8-24.)

E. Water Pollution Control Authority

1. Projects involving sanitary sewers must be the subject of a public hearing. WPCA hearings require 10 clear days’ published notice. In addition, notice of the hearing must be sent by certified mail, return receipt requested, to the owners of any property (including easements) to be acquired for the project at least 15 clear days prior to the hearing. (C. G. S. §7-247a.)

2. Following the public hearing, the WPCA must approve the project and request an appropriation and financing authorization. (C. G. S. §7-247.)

F. Board of Finance

1. In a non-charter town, prior to the town meeting, the board of finance must recommend the appropriation and bond and note authorization. A quorum of the board consists of at least four members and at least three members must approve recommendation. (C. G. S. §§7-348; 7-342.)

G. Town Meeting

1. When the proceedings above are complete, the Notice of Town Meeting must be posted and published at least five days prior to the town meeting, and the Return of Notice must be filed with Town Clerk.

2. Publication must be in a newspaper having a general and substantial circulation in the Town. The day of the meeting is not included when counting five days for publishing and posting of notice. (C. G. S. §§7-3, 7-4.)

3. Notice of referendum initiated by the Selectmen should be included in notice of town meeting. Town meeting must be held within seven to fourteen days prior to referendum date. (C. G. S. §§7-7, 7-9c.) Absentee ballots must be provided. (C. G. S. §§9-135, 9-1(n), 9-369c.)

## H. School Projects

Board of Education, Building Committee and State Board of Education must approve site and plans. Funding of the local share must be approved before grant application is submitted to the State. State Board of Education must approve grant commitment before construction bids are sought. (C. G. S. §10-291)

## III. MARKETING AND DISCLOSURE

### A. Underwriter Disclosure Requirements

1. Under Federal and state securities laws anti-fraud provisions, when participants in a municipal securities transaction speak to the market (both primary or secondary) liability may arise for material misstatements or material omissions

- a. Stale information – intervening events
- b. Omissions
- c. Official Statements
- d. CAFRs and 15c2-12 Annual Filings
- e. Web sites

2. Tower Amendment prevents direct SEC regulation of municipal issuer's disclosure

a. SEC cannot regulate municipal issuers directly, but therefore regulates actions taken by underwriters involved in municipal security financings

b. Municipal issuers' obligations to provide initial and ongoing disclosure are imposed by contractual undertaking between the Issuer and the Underwriters which the Rule requires the Underwriter obtain

(i) Bond Purchase Agreement

(ii) Notice of Sale

3. SEC Rule 15c2-12 Requirements – For primary offerings (and certain reofferings), Underwriter must:

a. Prior to making a bid for, or purchase, offer or sale of municipal securities, obtain and review an OS, that except for certain specified information (e.g. interest rates) is "deemed final" by the issuer

b. in negotiated sales, provide the most recent POS (if exists) upon request by a potential customer

c. contract with the issuer to receive, within 7 business days after Bond Purchase Agreement signed and in sufficient time to accompany any confirmation that requests payment from any customer, sufficient copies of the Final OS to comply with the next requirement

d. deliver upon request by a potential customer copies of the Final OS for a specified time period

(a) Time period is the earlier of: (i) 90 days from the end of underwriting period or (ii) the time when the official statement is deposited with the MSRB, but in no case less than 25 days following the end of underwriting period. "End of the underwriting period" means the later of such time as (i) Issuer delivers securities to Underwriter or (ii) Underwriter does not retain an unsold balance of securities for sale to the public.

(a) Current repository is the MSRB's Electronic Municipal Market Access System ("EMMA").

e. Rule 15c2-12 Exceptions:

(a) Minimum denominations of \$100,000 and sold to not more than 35 sophisticated investors purchasing for their own accounts and not for resale

(b) Minimum denominations of \$100,000 and maturity of or tender/put option at 9 months or less

(c) Face amount of \$1,000,000 or less

f. SEC Interpretive Releases emphasize the duty of underwriters to have a reasonable basis for believing the accuracy of the key representations in the OS relating to any securities with which they are associated

#### 4. Municipal Securities Rulemaking Board (MSRB)

a. Established by the Securities Acts Amendments of 1975

b. is an independent, self-regulating board of 15 members (5 broker-dealers, 5 bank dealers and 5 public members)

c. MSRB Rules subject to SEC approval

d. Don't directly regulate State and Municipal Issuers

#### 5. MSRB Rule G-32:

a. No broker, dealer or municipal securities dealer (“dealer”) shall sell municipal securities unless first delivers to the customer

(i) copy of the final OS (or a notice that no OS prepared)

(a) OS = Document, other than a notice of sale, prepared by the issuer or its representative setting forth, among other things, information about the issuer and the proposed issue of securities

(ii) if a negotiated sale of new securities, information concerning the underwriting spread, amount of fees paid the dealer and the initial offering price for each maturity offered by the underwriters

b. Managing underwriter must provide final OS to each dealer purchasing the new securities

c. Financial advisors preparing a Final OS must make the OS available to the Managing or sole underwriter promptly after award, and if arranging for printing must deliver OS at least two days before delivery to syndicate members

6. Political Contributions: Rule G-37 prohibits municipal securities dealers from engaging in securities business with any issuer within 2 years after a contribution was made to such issuer’s official

a. exception for up to \$250 to a candidate for whom the contributor could vote

b. Must also file report (public) with MSRB as to amount of contribution, the contributor and the recipient (G-37 Form filings are available on-line)

7. Solicitation of Municipal Securities Business: Rule G-38

a. Prohibits dealer from making direct or indirect payment to any person who is not an “affiliated person” of the dealer for a solicitation of municipal securities business on behalf of the dealer

b. Affiliated person of a dealer is any partner, director, officer, employee or registered person of the dealer or of an affiliated company. An affiliated company is an entity that controls, is controlled by or is under common control with the dealer and whose activities are not limited solely to the solicitation of municipal securities business. A registered person is any associated person of the dealer qualified under MSRB or NASD professional qualification requirements

## B. Providing Secondary Market Disclosure

1. Rule 15c2-12 promulgated by SEC and effective 1/1/90; amendments by the SEC in July 1995 added the secondary market disclosure rules

a. Before a primary offering, Underwriters must obtain commitments from issuers or “obligated persons” for ongoing and event-related disclosures

b. Before a dealer recommends the sale or purchase of a municipal security it must have in place procedures that provide “reasonable assurance” that it will receive promptly any event notices with respect to that security

2. Annual Information Filings

a. Must provide or cause to be provided to MSRB and any SID annual financial information and operating data

(i) may be provided in whole or in part by cross-reference to other documents provided or to be provided to any SID or the MSRB

(ii) may be provided in the form of a comprehensive annual financial report

3. Material event notices must be sent to:

- a. MSRB’s EMMA system
- b. the State Information Depository, if applicable – Not in Conn. at present

4. “Material events”

- a. Principal and interest payment delinquencies
- b. Non-Payment related defaults
- c. Unscheduled draws on debt service reserves reflecting financial difficulties
- d. Unscheduled draws on credit enhancements reflecting financial difficulties
- e. Substitution of credit or liquidity providers, or their failure to perform
- f. Adverse tax opinions or events affecting the tax-exempt status of the security
- g. Modifications to rights of securities holders
- h. Bond calls
- i. Defeasances

- j. Release, substitution, or sale of property securing repayment of the securities
- k. Rating changes
- l. Failure to provide annual financial information as required

5. Failure to Comply with Undertaking

a. required to include in its Final Official Statements “a description of ... any instances in the previous five years” in which it “failed to comply, in all material respects, with any previous undertaking in a written [secondary market disclosure] contract or agreement”.

b. Repeated failures to comply may mean that underwriters can not rely on undertaking and therefore can't purchase or sell

IV. **FEDERAL TAX LAW REQUIREMENTS FOR TAX-EXEMPT BONDS AND NOTES**

A. Use of Bond Proceeds

1. Private Business Use Restriction. Generally, bonds and notes will be “private activity bonds” that must be issued on a taxable basis if:

more than an aggregate 10% (5% for use unrelated or disproportionate to the governmental use of the financed facility) of the property financed by the bonds is used (directly or indirectly) in a trade or business use related to the governmental purpose of the financing by persons or entities (other than state or local governments) on a basis other than as a member of the general public (the “**private business use test**”), AND

the payment of principal of or interest on more than 10% (5% with respect to unrelated or disproportionate use) of the bond proceeds, directly or indirectly, would be derived from payments with respect to private business use property, or secured by any interest with respect to private business use property (the “**private business payment or security test**”).

*Note: In a lease financing, the private business payment or security test is automatically met, as the financed property secures the lease payments.*

**Tax-Exempt Qualified Private Activity Bonds.** Private activity bonds may be issued on a tax-exempt basis for the benefit of certain users or to finance certain facilities if additional, and often onerous, requirements are met, e.g. 501(c)(3) bonds, water and sewage facilities bonds, solid waste disposal bonds.

- a. Private Business Users (“nongovernmental persons”) include:

- (i) any entity other than a natural person or a State or local government, and
- (ii) a natural person acting in an activity with respect to a trade or business.

*Note: "Nongovernmental persons" includes the Federal government and non-profit entities.*

Private Business Use includes both actual and beneficial use by non-governmental persons, and generally arises from a special legal entitlement to use the financed property.

- (iii) Examples of Private Business Use: ownership, actual or beneficial use of property pursuant to a lease, management or incentive payment contract, take or pay or other output-type contract, naming rights contract.
- (iv) Use as Member of the General Public Disregarded. Private business use does not include use as a member of the general public.
  - (a) Applies only if financed facility is intended to be available and in fact is reasonably available for use on the same basis by natural persons not engaged in a trade or business
  - (b) Use arrangements can be made available to the general public at no charge or on the basis of rates that are generally applicable and uniformly applied.
  - (c) Rates may be treated as generally applicable and uniformly applied even if different rates apply to different classes of users, such as volume purchasers, if the differences in the rates are customary and reasonable.
  - (d) Long-term arrangements are not treated as general public use, e.g. the term of the use (including optional renewal terms) is greater than 200 days.
  - (e) General public use of a facility will not prevent use of the facility of a different type or nature or on a different basis to be private business use.
- (v) Incidental Use Disregarded.

- (a) Incidental uses may not exceed use of 2.5% of the proceeds of the issue used to finance the facility.
  - (b) The use may not involve the transfer of possession and control of space that is separated from other areas of the facility by walls, partitions, a night gate, etc. (except for vending machines, pay telephones, kiosks, and similar uses).
  - (c) The use may not be functionally related to any other use of the facility by the same person (other than a different incidental use).
- (vi) Short Term Use Disregarded:
- (a) the arrangement does not result in ownership of the financed property,
  - (b) the term of the use (including renewal options) does not exceed 100 days,
  - (c) use would qualify as general public use except that the property is not available to non-business members of the general public because generally applicable and uniformly applied rates are not available to such persons, or
  - (d) financing is not for the principal purpose of providing the property to the non-governmental person.
- (vii) Temporary use by a developer of an essential governmental function improvement prior to transfer to a governmental unit is disregarded (Tax or Utility District Financings).
- b. **Private Business Payment or Security Test:** Includes payments derived with respect to bond-financed property used in a private business use, or secured by an interest in property used in a private business use (or payments with respect to such property)
- (a) need not be directly applied to payment of debt service or directly used to secure the bonds,
  - (b) need not be derived from the source of the private business use.

2. Use of Bond Proceeds – Private Loan Prohibition. Precludes the direct or indirect use of more than the lesser of (x) \$5 million or (y) 5% of bond proceeds to finance loans to non-governmental persons.
  - a. Captures any transaction which is the economic equivalent of a loan, e.g., non-customary prepayments.
  - b. Does not include true grants.
  - c. May include tax increment financings (“TIFs”) if the grant recipient makes certain special agreements regarding general tax payments, e.g., non-challenge agreements, minimum tax payment guarantees.
  - d. Exceptions provided for assessment financings if:
    - (i) for essential governmental purpose (street paving, sewage treatment facilities, municipal water facilities),
    - (ii) debt service paid from mandatory taxes or assessments (ad valorem, frontage or comparable method resulting in equivalent mandatory assessment to all persons benefiting from governmental improvements),
    - (iii) tax is non-discriminatory, e.g. same basis for business and non-business users,
    - (iv) no special agreements by benefited parties, e.g. guaranties of bonds or of payment amounts.
3. Post-Issuance Change of Use – Private Use Restrictions apply to bond financed property for the life of the bond issue. There are certain remedial actions which issuer may take to avoid having change of use result in the bonds losing tax-exempt status (alternative governmental use of disposition proceeds, defeasance of “bad” bonds, taxable refunding, etc.). Contact bond counsel.

B. Investing Bond Proceeds – Compliance with arbitrage yield restrictions and rebate requirements.

1. General Terms

- a. "Arbitrage" is the profit generated by the spread between two markets -- here the taxable and non-taxable borrowing rates. (Borrow low, invest high)

Why does the Treasury care?

- b. "Yield" is based on reoffering price to general public, not borrowing cost to Issuer. Reoffering yield certificate from underwriter is used to compute yield for arbitrage purposes and to support 8038.
- c. "Proceeds" includes:
  - (i) sale proceeds;
  - (ii) unspent proceeds of refunded issues;
  - (iii) amounts held in debt service, reserve and sinking funds;
  - (iv) other amounts used to pay debt service;
  - (v) amounts received from the sale, condemnation, casualty or other disposition of the project finance with the bonds; and
  - (vi) investment proceeds
- d. "Temporary Period" -- The period of time during which proceeds may be invested without being restricted to the "yield" of the borrowing.
  - (i) Three Years for Capital Projects and Related Working Capital Expenditures. Requires, at time of issue, a reasonable expectation that issuer will:
    - (a) enter into a binding contract within six months to spend at least 5% of total project cost;
    - (b) proceed with due diligence to completion of financed projects; and
    - (c) expend 85% of the amount borrowed on the project within 3 years of the date of issue.
  - (ii) Three months for restricted working capital expenditures (operating expenses).
  - (iii) Two years, or 60 days after last tax payment date for tax anticipation notes (TANs).
  - (iv) 30 days for refunding proceeds.
  - (v) One year from receipt for investment earnings
  - (vi) 13 months from contribution for proceeds in a bona fide debt service fund.

- (vii) *De minimis* amount = lesser of 5% of net proceeds or \$100,000.

*Note: Temporary Period and Rebate Exception are distinct concepts. One may not invest proceeds of tax-exempt bonds at rates above the bond yield unless such bonds qualify for a temporary period; and then, only during the temporary period. Rebate exceptions allow the issuer to retain investment earnings accrued during the temporary period.*

## 2. Yield Restriction

- a. Yield Restriction required for proceeds not allocated to expenditures prior to expiration of Temporary Period. Such Yield Restricted proceeds may be invested at a yield not in excess of  $1/8^{\text{th}}$  % above the Bond Yield. Investment options include:
  - (i) Taxable Investments
    - (a) Treasuries (Investments in open market securities are governed by complex regulations. Be sure to call bond counsel)
    - (b) SLGS (Be sure SLGS window will be open)
  - (ii) Tax-Exempt Securities
    - (a) Reich & Tang's TEPF
    - (b) AMT vs. non-AMT Bonds
- b. Yield Restriction if No Rebate Exception = 0% Over Bond Yield
  - (i) Prohibited Payments -- concern with deflection of arbitrage earnings.
  - (ii) Yield burning concerns, especially where underwriters in negotiated deal work at little margin in exchange for right to provide escrow securities.

*Note: Investments in Guaranteed Investment Contracts and open market securities for refunding escrows are governed by complex regulations. Be sure to contact bond counsel.*

- 3. Arbitrage Rebate -- Unless qualify for an exception, all arbitrage generated by investing proceeds of tax-exempt bonds must be "rebated" to the U.S. Treasury
  - a. Includes earnings on earnings.

- b. Calculated by a future valuing method.
  - c. Payable in installments every 5 years with a final payment within 60 days after final maturity.
  - d. Imputed investment earnings at Bond Yield on uninvested proceeds, including investment proceeds.
4. Rebate Exceptions (assumes bonds are not private activity bonds):
- a. Bona Fide Debt Service Fund ("BFDSF") with less than \$100,000 in annual earnings.
  - b. Small Issuer Exception:
    - (i) Maximum \$5,000,000 new money per calendar year for Issuer and subordinate entities.
    - (ii) Refunding issues:
      - (a) refunding portion may not exceed \$5,000,000;
      - (b) all prior refundings must have been small issuer
    - (iii) \$10,000,000 increase to each test permitted for financing "school construction" costs.
  - c. Two Year "Spend-Down" Exception for Construction Issues:
    - (i) must be 75% construction expenditures (may bifurcate issue to achieve)
    - (ii) must expend
      - (a) 10% of "available construction proceeds" (including projected investment earnings) in 6 months,
      - (b) 45% in 1 year,
      - (c) 75% in 18 months,
      - (d) 100% in 2 years (except for up to 5% reasonable retainage which must be spent in 3 years).
    - (iii) Lesser of \$250,000 or 3% of Issue Price *de minimis* exception for 100% test.
    - (iv) May elect to pay 1 ½ % shortfall penalty in lieu of rebate.

- (v) May elect to use reasonable expectations as to investment earnings for 1st 3 spend-down tests.
  - d. 18 Month "Spend-Down" Exception for Capital Expenditures and Related Working Capital:
    - (i) must qualify for three year temporary period,
    - (ii) must expend,
      - (a) 15% of gross proceeds (including projected investment earnings) in 6 months,
      - (b) 60% in 1 year,
      - (c) 100% in 18 months (except for up to 5% reasonable retainage which must be spent in 30 months),
    - (iii) Lesser of \$250,000 or 3% of Issue Price *de minimis* exception for 100% test.
  - e. Six Month "Spend-Down" Exception for non-TANs, GANs and RANs:
    - (i) Must expend all but the lesser of 5% of proceeds or \$100,000 in 6 months, and
    - (ii) 100% in 1 year.
  - f. Six Month "Spend-Down" Exception for TANs, GANs and RANs:
    - (i) Must spend proceeds within 6 months.
    - (ii) All proceeds treated as expended when the "cumulative cashflow deficit" = 90% of proceeds.
  - g. In multi-purpose issue, refunding portions are each analyzed separately.
5. Reimbursement Bonds (the "Pyramid Bonds" concern)
- a. expenditures were:
    - (i) architectural or other preliminary costs other than land acquisition or site preparation, etc., or
    - (ii) issuance costs, or

- (iii) do not exceed lesser of \$100,000 or 5% of proceeds, or
    - (iv) reimbursed pursuant to Declaration of Official Intent made within 60 days after expenditure which must
      - (a) state that reasonably expects to reimburse from bond proceeds,
      - (b) describe project,
      - (c) state maximum amount of debt for project,
      - (d) must be reasonable.
  - b. Reimbursement intent must be reasonable and consistent with circumstances -- not a blanket declaration.
  - c. Expenditure must be a
    - (i) capital expenditure, or
    - (ii) extraordinary, nonrecurring cost (casualty loss or extraordinary legal expense) or
    - (iii) a grant to an unrelated party.
  - d. Bonds issued and reimbursement made within
    - (i) for bonds qualifying for the "small issuer" rebate exception, 3 years after the later of the date of expenditure or the project placed in service date.
    - (ii) For all other bonds, 18 months after the later of the date of expenditure or the project placed in service date (but not more than three years after the original expenditure).
- 6. Hedge Bonds Prohibited: Not hedge bonds if:
  - a. Reasonably expects 85% of proceeds to be spent in 3 years, and
  - b. Not more than 50% of proceeds are invested in instruments having a substantially guaranteed yield for 4 years or more.
- C. Bank Qualified Bonds – In order to permit the holders of bonds to deduct their cost of carrying:
  - a. Bonds may not be private activity bonds (other than qualified 501(c)(3) bonds);

- b. Maximum \$10,000,000 new money per calendar year for the issuer and its subordinate entities (excluding (a) private activity bonds other than qualified 501(c)(3) bonds and (b) current refunding bonds); and
- c. \$10,000,000 issue amount limit.
- d. Note that for bonds issued in calendar years 2009 and 2010, \$30,000,000 is substituted for each reference above to \$10,000,000. (American Recovery and Reinvestment Act of 2009).

D. Miscellaneous

- 1. Composite Issues - Composite Issue Bonds. Bonds may be treated as a single issue if sold within fifteen days, and:
  - a. to be paid from substantially the same source of funds and pursuant to the same plan of financing; or
  - b. Sold under a common marketing arrangement with obligations of another issuer.
- 2. Registration

Bonds that have a maturity at issue of over one year generally must be in registered form.
- 3. Information Reporting
  - a. IRS Form 8038G or GC must be filed by the fifteenth day of the second calendar month after the calendar quarter in which bonds issued.
  - b. IRS Form 8038-T to accompany arbitrage rebate or yield reduction payments.

E. Refunding Bonds

- 1. Current refundings – issued ninety days or less before redemption of prior obligation.
- 2. Advance refundings – issued more than ninety days before redemption of prior obligation.
  - a. Generally only governmental purpose and qualified 501(c)(3) bonds may be advance refunded.
  - b. Limited to one advance refunding.

- c. Refunded bonds lose temporary period; thirty day temporary period for refunding bonds.
- d. Must redeem bonds at first call date if debt service savings.
- e. Many other rules apply to advance refundings; please contact bond counsel for further discussion.

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## Appendix B -- IRS Compliance Checks

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## **IRS Launches Compliance Check on Direct Pay Build America Bonds**

The Tax Exempt Bonds function (TEB) of the IRS Tax Exempt and Government Entities division has initiated a compliance project to evaluate the post-issuance and record retention policies, procedures and practices of issuers of Direct Pay Build America Bonds issued under section 54AA(g) of the Internal Revenue Code. Issuers of Direct Pay Build America Bonds may receive a refundable credit payment equal to 35% percent of the interest payable on such bonds on each interest payment date. TEB is sending compliance check questionnaires to all entities that issued Direct Pay Build America Bonds, as indicated on either their Form 8038-G, Information Return for Tax-Exempt Governmental Obligations, or their Form 8038-B, Information Return for Build America Bonds and Recovery Zone Economic Development Bonds, which replaced Form 8038-G for Direct Pay Build America Bonds issued after the publication date of Form 8038-B. The questionnaires will be sent out on a continuous basis, beginning the week of February 8, 2010.

Copies of the questionnaire and cover letter are available at the links below:

[Form 14127, Direct Pay Bonds Compliance Check Questionnaire](#)

[Letter 4575, Direct Pay Bonds Post-Issuance and Record Retention Practices](#)

[Publication 4386, Compliance Checks](#)

*Page Last Reviewed or Updated: February 18, 2010*

# Compliance Checks

## Examination, Audit or Compliance Check?

### Tax Exempt and Government Entities Division

- **What is an examination? What is an audit?**

An examination is a review of an organization's books and records. In addition, an examination may involve the questioning of third parties to determine the organization's tax liabilities. Another term for an examination is an audit.

- **What is a compliance check?**

A compliance check is a review conducted by the IRS to determine the following:

- Whether an organization is adhering to recordkeeping and information reporting requirements.
- Whether an organization's activities are consistent with their stated tax-exempt purpose.

It is a review of information and forms that we require organizations to file or maintain – for example, Forms 990, 990-T, 940, 941, W-2, 1099, or W-4. The check is a tool to help educate organizations about their reporting requirements and to increase voluntary compliance.

The 990 series of forms are used by tax-exempt organizations, including charities, private foundations and other nonprofit organizations, to provide information required by section 6033 of the Internal Revenue Code, which includes information about their programs and activities. Information on these returns is generally disclosable to the public as provided by law.

It should be noted that a compliance check is not an examination; it does not directly relate to determining a tax liability for any particular period.

- **What occurs during a compliance check?**

At the beginning of a compliance check, we will inform the officer or director that the review is a compliance check and not an examination. We will not ask to examine any books and records or ask questions regarding tax liabilities. We may ask the organization whether they understand or have questions about filing obligations for required forms. We may also ask questions about an organization's activities. If, during a compliance check, we decide an examination is appropriate, we will notify the organization that we are commencing an examination before asking questions related to tax liability.

- **Is there a penalty for refusing to submit to a compliance check?**

No. The officer or director may refuse to participate in a compliance check without penalty. However, we have the option of opening a formal examination, whether or not the organization agrees to participate in a compliance check.

- **How often can the IRS do compliance checks?**

Because a compliance check only reviews whether an organization is adhering to record keeping and information reporting requirements and/or whether an organization's activities are consistent with its stated tax-exempt purpose and is not an examination, it is possible to have more than one compliance check for a tax year if facts and circumstances warrant.



**Internal Revenue Service**  
Tax Exempt and Government Entities Division

**Department of the Treasury**

**Date:**

**Person to Contact/ID Number:**

**Contact Telephone Numbers:**

**Response Due Date:**

**Employer Identification Number:**

Dear Sir or Madam:

We are conducting a compliance check of your Build America Bonds as part of our ongoing efforts to promote voluntary compliance with Federal tax requirements applicable to Build America Bond issuers. As more fully described below, we are asking you to complete the enclosed compliance check questionnaire about your Build America Bonds and your post-issuance compliance practices.

**What is a Compliance Check?**

This letter constitutes a compliance check. A compliance check is neither an audit nor an investigation under Internal Revenue Code section 7605(b) nor an audit under section 530 of the Revenue Act of 1978. A compliance check is a review by the IRS to determine adherence to certain requirements. This is not a review of an organization's books and records.

We have enclosed Publication 4386, *Compliance Checks*, which answers some frequently asked questions about compliance checks.

**General Information**

The Build America Bonds referred to in this letter are tax-advantaged bonds issued as described in section 54AA(g) of the Internal Revenue Code ("Direct Pay Bonds"). Issuers of Direct Pay Bonds may receive a refundable credit payment equal to a percentage of the interest payable on such bonds on each interest payment date.

The tax-advantaged status of Direct Pay Bonds remains throughout the life of the bonds if all applicable federal tax laws are satisfied while the bonds are outstanding. Various requirements apply under the Internal Revenue Code (the "Code") and Income Tax Regulations (the "Regulations") including information filing and other requirements related to issuance, the proper and timely use of bond-financed property, and arbitrage yield restriction and rebate requirements.

**Unique Requirements for Build America Bonds/Direct Pay**

Direct Pay Bonds have special requirements that must be followed. These special requirements are in addition to other requirements under the Code and the Regulations referred to above which apply generally to tax-exempt governmental bonds.

### Capital Expenditure Requirement

With respect to Direct Pay Bonds, 100% of the excess of (1) *the Available Project Proceeds* of the issue, over (2) the amount in a reasonably required reserve with respect to such issue, must be used for capital expenditures. No amount of proceeds of Direct Pay Bonds may be used for working capital expenditures.

As used above, the term "*Available Project Proceeds*" means: (1) the amount of (a) proceeds from the sale of the issue, minus (b) the issuance costs financed by the issue (to the extent that such costs do not exceed 2 percent of such proceeds) plus (2) the proceeds from any investment of the amount referred to in (1) above.

Put another way, the term "*Available Project Proceeds*" means (1) plus (2), where (1) equals the amount of proceeds from the sale minus the costs of issuance financed by the issue, and (2) equals the amount earned from investing the amount described in (1). The costs of issuance financed by the issue cannot exceed 2 percent of the proceeds from the sale of the issue.

### De Minimis Premium Rule

A bond does not qualify as a Direct Pay Bond if the issue price of the bond has more than a de minimis amount of premium over the stated principal amount of the bond as described in section 54AA(g) of the Code. A de minimis amount of premium on a Direct Pay Bond is an amount that is not greater than 1/4 of 1 percent of the stated redemption price at maturity for the bond, multiplied by the number of complete years to the earlier of the maturity date for the bond or the first optional redemption date for the bond, if applicable. Generally, up to 2.5 percent of premium over the stated principal amount of the bond may be considered to be de minimis premium for bonds that mature in 10 or more years.

### Irrevocable Election

Additionally, the issuer of Direct Pay Bonds is required to make an irrevocable election to have section 54AA(g) of the Code apply and must timely file a correctly completed Form 8038-CP, *Credit for Qualified Bonds Allowed to Issuer*, in order to receive payment of the credit from the government.

### **Continued Compliance**

To comply with these and any other applicable Federal tax requirements, issuers of Direct Pay Bonds must ensure that the rules are met at the time the bonds are issued and throughout the term of the bonds. Generally, this includes the continued maintenance of records sufficient to establish compliance with all applicable Federal tax requirements until three years after the final maturity of the bonds. Also, continued maintenance of records related to periods before the bonds are issued and after the bonds mature is generally necessary, particularly in instances involving the reimbursement of prior expenditures or the refunding of prior bond issues.

### **What You Need To Do**

Please complete the enclosed Form 14127, *Direct Pay Bonds Compliance Check Questionnaire*, and follow the instructions below for sending the questionnaire to us.

### **How To Send The Information To Us**

Attach a copy of this letter to the front of the requested information, and send the information to us, by the due date shown above, using one of the following methods:

- Mail your reply to the address shown in the heading of this letter.
- Email your reply (in PDF format) or questions to [teb.cpm@irs.gov](mailto:teb.cpm@irs.gov) and indicate "Direct Pay Bonds Questionnaire" in the subject line. Be sure to include your name, telephone number and the best time to reach you; as we will be replying to your questions by telephone. Note: This email address is for replies or questions related to this letter only, we cannot respond to other information or questions.

Failure to use the above mailing address or email address may result in processing delays. If an issuer fails to reply by the above date, we may forward one or more of the issuer's Direct Pay Bond issues for examination consideration.

In the spaces below, please provide an official's name, title, telephone number and most convenient time for us to call should we need to speak with someone regarding your Direct Pay Bond issue.

Name of official: \_\_\_\_\_ Title: \_\_\_\_\_

Telephone Number: (     ) \_\_\_\_\_ Convenient Time for us to call: \_\_\_\_\_

**More Information**

Through our website at [www.irs.gov/bonds](http://www.irs.gov/bonds) you can access materials relating to Direct Pay Bonds including Notice 2009-26, *Build America Bonds and Direct Payment Subsidy Implementation* (click on [IRS Releases Guidance on ARRA Bond Provisions](#)) and Publication 4079, *Tax Exempt Governmental Bonds Compliance Guide*, which provides an overview of the Federal tax rules and filing requirements applicable to tax-exempt bonds. You can find answers to frequently asked questions about record retention requirements under "Frequently Asked Questions About Tax Exempt Bonds." In addition, you will find an article entitled, "After the Bonds are Issued: Then What?" in Publication 4344, *Report of Recommendations Advisory Committee on TE/GE*, intended for government officials in developing policies, procedures and systems to ensure that your bonds remain tax-exempt.

If you have any questions about this letter, you can contact the person named in the heading or email your questions to the address shown under How To Send The Information To Us.

Thank you for your cooperation.

Sincerely,

Manager, Tax Exempt Bonds  
Compliance & Program Management

Enclosures:  
Form 14127  
Publication 4386

## Direct Pay Bonds Compliance Check Questionnaire

We are asking for information regarding your Direct Pay Bonds, post-issuance bond compliance and record retention practices. Direct Pay Bonds referred to in this questionnaire are Build America Bonds described in section 54AA(g) of the Internal Revenue Code. Please complete the questionnaire and follow the instructions in the accompanying letter for returning it to us. Please note that section references in this questionnaire are to sections of the Internal Revenue Code unless otherwise indicated. For all accompanying documentation, please clearly label the question to which it relates.

Name of Governmental Entity: \_\_\_\_\_

Employer Identification Number: \_\_\_\_\_

1. Do you have written procedures to ensure that none of the maturities of your Direct Pay Bonds are issued with more than a de minimis amount of premium as required by section 54AA(d)(2)(C)?  Yes  No

If Yes, date they were implemented? \_\_\_\_\_ (dd/mm/yyyy)

If Yes, describe in detail your procedures for ensuring compliance with such de minimis rule and how you implement such procedures, including dates of revisions, if any. In lieu of the above description, you may attach a copy of your written procedures. If you have no written procedures, explain what guidelines you have in place and from what source these guidelines are derived that ensure Direct Pay Bonds issued with premium fall within the de minimis rule. (*Attach sheet with description*)

2. Are records of secondary market trading activity for your Direct Pay Bonds available through the Municipal Securities Rulemaking Board's Electronic Municipal Market Access System (*see <http://www.emma.msrb.org>*)?  Yes  No  Do not know

If Yes, did you or a consultant to the issuer, other than the underwriter or initial purchaser of the Direct Pay Bonds, review the records of the secondary market trading activity for the Direct Pay Bonds after the sale date of the bonds but before the bonds were delivered on the date of issue?  Yes  No  Do not know

If Yes, that is, if such records were reviewed as described above, did any of your Direct Pay Bonds trade at a price greater than the issue price prior to the delivery of those Direct Pay Bonds on the date of issue?  Yes  No  Do not know

3. Do you have written procedures to ensure that your Direct Pay Bonds remain in compliance with the following Federal tax requirements after the bonds are issued:

- a. Timely expenditure of bond proceeds?  Yes  No  
If Yes, date they were implemented? \_\_\_\_\_ (dd/mm/yyyy)
- b. Correct calculation of Available Project Proceeds (See section 54A(e)(4))?  Yes  No  
If Yes, date they were implemented? \_\_\_\_\_ (dd/mm/yyyy)
- c. Use of 100% of Available Project Proceeds less amount in a reasonably required reserve fund only for capital expenditures (See section 54AA(g)(2)(A))?  Yes  No  
If Yes, date they were implemented? \_\_\_\_\_ (dd/mm/yyyy)
- d. Arbitrage yield restriction and rebate?  Yes  No  
If Yes, date they were implemented? \_\_\_\_\_ (dd/mm/yyyy)
- e. Costs of issuance financed by the issue do not exceed 2% of the proceeds of sale (See section 54A(e)(4)(A)(ii))?  Yes  No  
If Yes, date they were implemented? \_\_\_\_\_ (dd/mm/yyyy)
- f. Proper determination of the amount of interest payable on each interest payment date?  Yes  No  
If Yes, date they were implemented? \_\_\_\_\_ (dd/mm/yyyy)
- g. Proper amount of refundable credit reported on Form 8038-CP?  Yes  No  
If Yes, date they were implemented? \_\_\_\_\_ (dd/mm/yyyy)
- h. Timely filing of Form 8038-CP?  Yes  No  
If Yes, date they were implemented? \_\_\_\_\_ (dd/mm/yyyy)
- i. Payment of refundable credit will be made to the proper person?  Yes  No  
If Yes, date they were implemented? \_\_\_\_\_ (dd/mm/yyyy)

If Yes, describe in detail your procedures for each of the above items (a-i) and how you implement such procedures, including dates of revisions, if any. In lieu of the above descriptions, you may attach a copy of your written procedures. If you have no written procedures, explain what guidelines you have in place and from what source these guidelines are derived that ensure bond financings are in compliance with Federal tax requirements. (Attach sheet with description)

4. Do you have written procedures to ensure timely identification of violations of Federal tax requirements after your Direct Pay Bonds are issued and the timely correction of any identified violation(s) through remedial actions described in the Treasury Regulations or through the Tax Exempt Bonds Voluntary Closing Agreement Program described under Notice 2008-31?  Yes  No

If Yes, date they were implemented? \_\_\_\_\_ (dd/mm/yyyy)

If Yes, describe in detail your procedures for timely identification and correction of any such violations and how you implement such procedures, including dates of revisions, if any. In lieu of the above description, you may attach a copy of your written procedures. If you have no written procedures, explain what guidelines you have in place and from what source these guidelines are derived that ensure timely identification and correction of any violations of Federal tax requirements. (*Attach sheet with description*)

5. Do you maintain records necessary to support the status of the bonds as qualified to receive the tax advantaged treatment described in section 54AA(g)?  Yes  No

If yes, for how long?

- Less than life of bonds
- Life of bonds
- Life of bonds plus 3 years

6. How do you maintain your bond records?

- On Paper
- Electronic media (*e.g., CD, disks, tapes*)
- Combination of paper and electronic

Under penalties of perjury, I declare that I have examined this completed questionnaire, including accompanying documents and statements, and to the best of my knowledge and belief, the completed questionnaire contains all the relevant facts relating to the answers to the questionnaire, and such facts are true, correct, and complete.

Signature: \_\_\_\_\_

Date: \_\_\_\_\_

Printed Name: \_\_\_\_\_

Title: \_\_\_\_\_

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**Privacy Act and Paperwork Reduction Act Notice.** We ask for the information on this form to carry out the Internal Revenue laws of the United States. We need it to ensure that you are complying with these laws.

The IRS may not conduct or sponsor, and an organization is not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB number. Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103 and 6104.