Washington State Housing Finance Commission

Multifamily Developer Guide to Complying with Tax Laws

After the Bond Issue

After your bond issue is complete, there are some important Internal Revenue Service ("IRS") rules to be followed in order to maintain the tax-exempt status of your bonds. These rules relate to the spending and investment of bond proceeds, arbitrage rebate, changes to your financing terms and the use of facilities financed with bond proceeds. Failure to comply with these rules may result in penalties, including your bonds being declared taxable.

SPENDING & INVESTING BOND PROCEEDS

Three-Year Temporary Investment Period. Except for refinancings, most Commission multifamily bond issues qualify under IRS rules for a "three-year temporary investment period." During this three-year period following the issuance of bonds, the bond proceeds may be invested at the highest yields available and the investment yield may be higher than the yield on the bonds. Most Commission multifamily bond issues are structured to require a mandatory redemption of the bonds from unspent bond proceeds three years from the date the bonds are issued. However, if you have requested and received an extension of the mandatory redemption date, you must do one of the following:

- Invest the remaining bond proceeds in a tax-exempt money market fund or in investments that yield less than the yield on the bonds, or
- Make "yield reduction payments" to the IRS, which requires the issuer to complete IRS Form 8038-T and periodically pay to the IRS the earnings in excess of the amount that would have been earned by investing at the bond yield.

ARBITRAGE REBATE & EXCEPTIONS FROM REBATE

The opportunity to invest bond proceeds for three years at yields higher than the bond yield does not necessarily mean that you can keep those higher investment earnings (the "arbitrage"). The general IRS rule is that such arbitrage must be paid back — or rebated — to the IRS. However, if you qualify for one of the following "rebate exceptions" then you will not have to pay arbitrage rebate. The No Arbitrage Certificate executed at the time of bond closing will describe the test applicable to your bond issue.

Six-Month, 18-Month and Two-Year Construction Exceptions. Three rebate exceptions are available to borrowers under the Commission's Multifamily Housing Programs. The rebate exceptions relate to how fast the bond proceeds (and investment earnings from the proceeds) are spent.

- The shortest rebate exception allows the bonds to escape from arbitrage rebate if all of the bond proceeds and earnings are spent within **six months** of the date the bonds are issued.
- The next-shortest rebate exception allows the bonds to escape from arbitrage rebate if the bond proceeds and earnings are spent according to the following schedule: 15% within six months, 60% within one year and 100% within **18 months**. All of these periods are measured from the date the bonds are issued.

Failing to meet any one of the targeted expenditure dates results in failure of the entire rebate exception. For example, if you met the 15% and 60% expenditure requirements for the eighteen month rebate exception, but failed the 100% expenditure requirement, the whole rebate exception is failed, and the bond issue is subject to rebate.

There are many nuances involved in satisfying the rebate exceptions, so you should review the No Arbitrage Certificate (the "tax certificate") prepared at the time the bonds were issued to determine the exact dates by which the bond proceeds (and the investment earnings) need to be spent and consult bond counsel or a rebate expert with any questions.

Qualifying for a rebate exception means that you do not have to pay the IRS the arbitrage earned during the three-year temporary investment period. However, as discussed above, if bond proceeds remain unspent at the end of that period, those proceeds must be either "yield restricted" or you must make yield reduction payments.

Calculating Arbitrage Rebate. If a bond issue does not qualify for any rebate exception, then the bonds are subject to certain arbitrage rebate requirements. Arbitrage rebate is not owed to the IRS unless the investment earnings average more than the bond yield. Even if you do not owe any arbitrage earnings to the IRS, the cost of calculating arbitrage rebate can itself be costly and must be done whether or not you owe anything. To satisfy the IRS rebate rules, you should keep track of the investments made with bond proceeds from the date the bonds are issued until all of the bond proceeds are spent. (It is important to do this even if you expect to qualify for one of the three time sensitive rebate exceptions. If none of the exceptions are satisfied, you will need to compute any rebate payments owed.)

Arbitrage rebate payments are due to the IRS **at least every five years** from the date the bonds were issued. If you make a rebate payment after all the bond proceeds have been spent and, as discussed below, no other funds are subject to rebate, you will not have to make any future computations. Rebate payments are made by filing IRS Form 8038-T. If no rebate is owed, then no filing with the IRS needs to be made. It is important, however, to keep records of the expenditures and investments of bond proceeds (and amounts held in the funds described below) for at least three years from the date all of the bonds are completely paid off (or six years from the date of the bond closing, if longer).

Funds. The Commission bond issues are generally structured to minimize opportunities for arbitrage rebate. The tax certificate signed at the time of bond closing describes the various funds associated with the bonds and the rebate requirements expected to be associated with each. You should review the tax certificate carefully with your counsel.

Reserve Funds. Sometimes Commission bonds, particularly those that are issued with bond insurance or other credit enhancement, have debt service reserve funds. Such funds provide money to pay the debt service due on bonds if project revenues are insufficient and may include reserves required by banks, Fannie Mae, Freddie Mac and other lenders in their loan documents. Bond proceeds may or may not be deposited into such reserve funds. Reserve funds that are appropriately sized in compliance with IRS rules may generally be invested for the term of the bonds at yields that exceed the bond yield. However, reserve funds **are** subject to arbitrage rebate regardless of whether they are funded with original bond proceeds and regardless of whether such fund qualifies to be invested at yields that exceed the bond yield.

Bond and Debt Service Funds. Most Commission bond issues also have bond funds or debt service funds (often containing principal and interest accounts) that are used to make regularly scheduled debt service payments. Most of these funds qualify for an exemption to the arbitrage investment and rebate rules. They generally may be invested at the highest rate of return available, and arbitrage rebate is not required.

Other Funds. Some Commission bonds also have repair, replacement and revenue funds. These funds may not be described in the bond documents, but may be required by lenders and credit providers. They generally are not subject to the arbitrage rebate rules and may be invested at yields that exceed the bond yield.

CHANGE IN USE

In addition to the investment and arbitrage rebate rules summarized above, other important post-closing issue are the IRS "change in use" regulations. Projects financed with the tax-exempt bond proceeds should not be sold or changed from a qualifying use to a private business use before the bonds are completely paid off. This would include selling the project, using it for a purpose different than that intended at closing, involving third parties in the management of the project, leasing or renting all or parts of the project to third parties or failing to comply with tenant set-aside requirements, where applicable. If the project is sold or the use changes to a private business use through any of these means, then IRS rules require that the bonds be redeemed within 90 days or defeased to the first date on which they may be redeemed. In some instances, the rules also require that the Commission notify the IRS of this action. It is important to contact bond counsel for advice when considering changing the use of a facility financed with tax-exempt bond proceeds.

CHANGING THE DEAL

Changes to the terms of your financing can also adversely affect the tax-exempt status of your bonds. Extending the maturity of the bonds, changing the interest rate or payment dates or restructuring the financing can trigger a "reissuance" of the bonds. Unless properly documented, these types of changes can cause the bonds to lose their tax-exempt status. If you are planning to change the terms of your financing, you should contact the Commission and bond counsel.

This guidance provides brief and general information on the actions borrowers should take following the issuance of bonds to ensure that the bonds remain tax-exempt. IRS rules are detailed, complex and subject to change, so it is important to review the specific guidance provided in the tax certificates prepared for bond closing and seek the advice of bond counsel or other professionals if you have any questions or if you would like assistance with post-issuance compliance requirements.