Private Use Limitations –
IRS Requirements on Tax-Exempt Bond Funded Facilities at the CSU

Presentation By:
Rosa H. Renaud, Financing and Treasury
At FOA

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Overview

- Our Roles
- CSU Debt
- Tax-Exempt Debt Pros & Cons
- IRS’s Recent Focus
- State & CSU Monitoring
- IRS Audit – Lessons Learned
- Case Study
Our Roles

- Financing and Treasury – an extension of the Board of Trustees as it relates to bond issuance and compliance.
- Capital Planning, Design and Construction – provides the framework for keeping track of facilities.
- Campuses:
  - CFO and staff – provides overall monitoring.
  - Programs and Auxiliaries – focus on their requirements.
CSU’s Debt

- The CSU participates in various forms of debt issuances. Those issued directly by the Board of Trustees are under the Systemwide Revenue Bond (SRB) program. In addition, we issue Commercial Paper (CP).
- We also have a few “standalone” Auxiliary bonds.
- On the State side, there are General Obligation Bonds and State Public Works Board Lease Revenue Bonds.
- This debt represents hundreds of CSU’s facilities.
- In $ millions*:

<table>
<thead>
<tr>
<th></th>
<th>June 30, 2011</th>
<th>December 31, 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Systemwide Revenue Bonds</td>
<td>$3,382</td>
<td>$3,543</td>
</tr>
<tr>
<td>Commercial Paper</td>
<td>135</td>
<td>66</td>
</tr>
<tr>
<td>Auxiliary Standalone Bonds</td>
<td>102</td>
<td>94</td>
</tr>
<tr>
<td>State Public Works Board Bonds</td>
<td>805</td>
<td>868</td>
</tr>
<tr>
<td>Other</td>
<td>73</td>
<td>88</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$4,497</strong></td>
<td><strong>$4,659</strong></td>
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*Does not include G.O. bonds.
Tax-Exempt Debt Pros & Cons

- Investors – receive interest earnings that are not taxed.
- CSU – given its good credit rating, gets a lower cost of borrowing. Projects are more affordable.
- However, the IRS does not receive taxes from investors. Thus, it wants to prevent fraud and minimize its use.
- Bond Issuers – have greater regulations.
IRS’s Recent Focus

- Since 2007, the IRS has heightened its surveillance on tax-exempt bond issuers.
- In 2009, the IRS launched a formal post-issuance compliance check on governmental bond issuance, focusing on:
  - Private Activity Use;
  - Procedures for tax compliance;
  - Record retention and practices.
- Over 200 questionnaires were sent out to bond issuers.
IRS’s Focus on the CSU

- Since then, the CSU has been under audit review for several different bond sales, both SRB and auxiliary issued.
The State Treasurer’s Office has held back cash from sales of General Obligation Bonds and State Lease Revenue Public Works Board Bonds from the CSU and other state agencies.

The CSU had to/and has to sign certificates demonstrating compliance with IRS regulations before receiving funds. The focus is on assuring minimal Private Use and record retention.
CSU Monitoring Process

- The Chancellor’s Office established a Tax Task Force to develop procedures to monitor:
  - Private Activity Usage;
  - Record Retention;
  - State and Nonstate Facilities.

- CPDC requests facility information from campuses in an annual “Facilities and Tax Compliance” memo. Results are tracked in the Space and Facilities (SFDB) database.
CSU Monitoring Process

- The data is only as good or complete as what is sent to us by the campuses.
- In cases where there is private activity use that appears to be at or about 10% of the facility’s space, then tax counsel assists the CSU to identify “safe-harbors”. These may relate to:
  - Grants/research funding;
  - Equity contribution from donations or program reserves.
The Chancellor’s Office and Campuses must retain records for the term of the bonds as required by the IRS, which is generally for 35 years.

Examples of records that are required are:

- Payment of Invoices related to construction project;
- Construction contracts;
- User agreements, Subleases, Management Contracts;
- Accounting records summarizing and tracking expenditure payments for each bond funded project;
- “Requisition statements” which the IRS has accepted as the State Controller’s Tab Runs;
CSU Monitoring Process

- Financing and Treasury asks campuses to complete an Allocation of Bond proceeds analysis at different points in time in order to document expenditures, equity contribution, and private activity use. This is a new process that is being incorporated as a result of lessons learned from our IRS audit.
CSU Monitoring Process

**Summary:**

- At the project planning stage, F&T gets feedback from campuses. At the Bond Sale stage, F&T works with financing team, including tax counsel.

- After a Bond Sale:
  - There is a framework developed by the Tax Task Force leading to an annual “Tax Compliance, space and Facilities Reporting” memo. Campuses respond via Private Activity Checklists and other forms coordinated by CPDC.
  - F&T requests campus feedback on Allocation of Bond Proceeds.
  - Campuses retain records & monitor.

- Training: CABO, FOA, CPDC, Housing & Parking Officers meetings, AOA.
IRS Audit on 2005A & 2005B Bonds
– Lessons Learned

- **Contracts** related to Private Use should be tracked by facility number and name.

- It is important to know **who is the ultimate party on a contract**, for example is the housing facility being leased or managed by an outside vendor? Are there franchise agreements for food service?

- **Record Retention** of Accounting Records and Contracts is for the long term (life of the bonds approx. 25 – 30 years plus 5 years. For simplicity, can assume 35 years).
IRS Audit on 2005A & 2005B Bonds – Lessons Learned

- Campuses need to be able to access records in a timely and systematic manner.
- Points of contacts at campuses need to understand the general limitations and requirements imposed by the IRS.
- Student unions have a higher occurrence of private use. However, housing has potential due to dining facilities.
- Naming Rights and Marketing Agreements do impact calculation of Private Use.
IRS Audit on 2005A & 2005B Bonds
– Lesson Learned

- Research contracts have private use risks, even with Federal Contracts. This affects academic buildings in particular.

- Fundraising efforts can lead to private use, particularly if naming rights are used as an incentive. For example,
  - Corporation vs. Individual name.
  - Is it a Name Brand? Oprah Winfrey versus Jane Doe?
### Case Study**

<table>
<thead>
<tr>
<th>INFORMATION CATEGORY</th>
<th>REASON/RELEVANCE</th>
<th>SAMPLE ANSWER</th>
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<tbody>
<tr>
<td>Original Construction, Expansion or Renovation?</td>
<td>For tax purposes, renovations to existing space is a separate “project” from additions or expansion, even though they sometimes occur at the same time. Tax analysis, in all aspects, must be applied to each separate project.</td>
<td>Renovation</td>
</tr>
</tbody>
</table>
| Sources of funding, and amounts. | For tax analysis, each project is paid for with either (1) tax-exempt bonds (including short-term commercial paper, or a refunding of any prior tax-exempt debt), or (2) everything other than tax-exempt bonds (including equity, taxable debt, donations, revenues). The amounts of each category provide the proportions of the project being financed with each source of funds. | Bonds: $70  
Equity: $30  
Total Cost: $100 |
| Placed in service date | Private business use does not begin until the later of when tax-exempt bonds are issued or the financed project is placed into service. | 1/1/2010 (renovations completed and ready for use) |
| Total Usable Area | Reminder, an Expansion will be treated as a separate project from Renovations, so the answers should have to be given separately for each project. “Usable” area is somewhere between assignable sq ft (as the term is commonly used in CSU circles) and gross sq ft. For some types of projects, such as housing, ASF may be the same as usable sq ft. But for student unions, a lot of open space that can be used and is in fact used by students, is normally not included in ASF. All of the usable space needs to be included because that is the true measurement of what was financed. Please exclude true common areas, such as hallways, bathrooms, engine rooms, telecom space. | Total usable sq ft: 10,000 (total space renovated that is available for use) |

** Source: Winnie Tsien, Esq., Orrick, Herrington & Sutcliffe, LLP **
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<td><strong>Outside users and space used</strong></td>
<td>All entities that are not CSU or CSU auxiliaries occupying or using or having the right to use space should be analyzed as potential private business users, including managers, licensees or tenants. Franchise agreements need to be included, also naming rights or pouring rights. Look to the ultimate user of the space, not just the contracting parties.</td>
<td>Sodexho (food operations): 1,250 ASF (inclusive of storage and food preparation area). Common seating areas do not need to be included.</td>
</tr>
<tr>
<td><strong>Private Use Conclusion – Tax Allocation</strong></td>
<td>All tax-exempt bond proceeds need to be formally allocated to a use or to particular space. Conversely, space that has not been allocated to bonds will be treated as financed with equity. So, a project can be divided into the bond portion and the equity portion. The most common way is to use cost and sq ft to do that: $30 of equity paid for 30% of the total project; $70 of bonds paid for 70% of the project.</td>
<td>Assuming Sodexho is a private business user (not operating pursuant to a qualified management contract), Sodexho is using 1,250 sq. ft. of total usable space, or 12.5%. This number is not more than the equity portion of the project (30%), so Sodexho is not using any bond-financed improvements.</td>
</tr>
</tbody>
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**Source:** Winnie Tsien, Esq., Orrick, Herrington & Sutcliffe, LLP
Case Study

- Keep track of the project’s scope.
- Have accounting records of Sources of Funds (including Equity contributions) and Expenditures.
- Retain agreements related to the project, both of operators and users of space.
- Calculate Private Use taking into account Equity contribution.
- Document for the life of the bonds (approx. 35 years).
Next Steps

- Campus does a comprehensive analysis of facilities and responds via CPDC forms, also coordinates with F&T to submit Allocation of Bond Proceeds analyses.
- Detailed Training – When is it best?
- Contacts:
  - Rosa Renaud, (562) 951-4566, rrenaud@calstate.edu
  - Angelique Sutanto (562) 951-4565, asutanto@calstate.edu
- Thanks for your time.
Reference Material