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Private Activity Use and Tax Requirements for Construction Projects Workshop

Presentation by:
Financing & Treasury and Orrick, Herrington & Sutcliffe
October 12, 2012
Introductions

• Financing & Treasury (F&T)
  • Rosa H. Renaud, Senior Financial Manager
• Orrick, Herrington & Sutcliffe LLP
  • Winnie Tsien, Tax Associate
• Workshop attendees – 23 campuses plus the Chancellor’s Office
Agenda

• Tax-Exempt Bonds Overview & the CSU
  • Non-State: Systemwide Revenue Bonds, Commercial Paper, Auxiliary Bonds
  • State Issued: General Obligation Bonds and Public Works Board Lease Revenue Bonds
• IRS Requirements Overview
  • Private Activity Usage
  • Record Retention
• CSU Review and Monitoring Process
  • Financing Team
  • CPDC Annual Review
• Examples
• IRS Audit Lessons Learned
Tax-Exempt Bonds Overview & the CSU

• Nonstate projects:
  • Systemwide Revenue Bonds (SRB) – issued by the Board of Trustees.
  • Commercial Paper – interim financing generally during the construction period. It has even lower interest rates than SRB due to its short term.
  • Examples: Housing, Parking Structure, Student Unions, Recreation Center, Health Centers, CERF, and Auxiliaries.
Tax-Exempt Bonds Overview & the CSU

• State Issued Bonds:
  • General Obligation (GO) Bonds and Public Works Board Lease Revenue Bonds (PWB)
  • Examples: Classrooms; Labs; Gyms; Administrative Offices; Libraries; Infrastructure; etc.
Tax-Exempt Bond Financing Requires Monitoring

- The IRS drives the Post Issuance Compliance requirements in order to assure that bond issuers comply with regulations to minimize private (profit driven) entities from taking advantage of low interest tax-exempt bonds.
- Misuse of tax-exempt bonds can lead to severe penalties along with negative credit ratings to the CSU.
- The State Treasurer’s Office withholds funds from the CSU and other agencies to assure compliance. We must submit tax certificates and private use checklists to demonstrate compliance.
- The CSU has developed processes to monitor. The requirements affect many departments across campuses.
The process works only if everyone takes responsibility.
Private Use Overview

- Private Use: Types of private use and limits to private use
- Exceptions to private use: Qualified Management Contract and Research Contract
  Safe Harbor
- Excess Private Use and Self Correction
- Allocation: Timelines and Case Study
- Record Keeping
Types of Private Use

• Identifying Private Use: Use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit, including by ownership, lease, management, special legal entitlement, or special economic benefit. For auxiliaries, private use includes activities not in furtherance of their exempt purposes.

• Common tax-exempt financed projects for CSU: Student unions, bookstores, food services, cafeterias, stadiums and athletic facilities, parking, housing, recreation centers, laboratories, classrooms and other academic facilities.

• Common Private Use Arrangements or Activities: managers or operators, lessees and tenants (eg, banks but not ATMs), retail, food operators (food court), franchise agreements, bookstore operators, conference activities, co-generation facilities, solar panels, research activities, and any facility (especially athletic facility or art space) that has commercial partnerships or sponsorships.
Types of Private Use (continued)

- Private Use is broadly defined. Any arrangement with a commercial entity for a right to use or actual use of a facility, or any preferential treatment or recognition, may result in Private Use. These include naming rights, franchises, leases, sponsorships, and management agreements.

- Private Loan as Private Business Activity: Any expectation of, or actual, repayment from another party for project costs originally paid for with tax-exempt proceeds is considered a loan of proceeds. It is similar to Private Use. Private Loans are limited to 5% or $5 million for each issue.
Limits on Private Use

• 10% Private Use AND Private Payment: Need to exceed 10% on both for bonds to be taxable.

  Private Use: Limit of 10% of bond-financed space (ie, 10% of tax-exempt proceeds of issue).

  Private Payment or Security: Payments derived from private use or private security cannot exceed 10% of debt service on an issue of tax-exempt debt.

  Overall $15 million limit for each issue of debt over $150 million.

• Blending Over Time, or with Other Issues and Projects, to not exceed 10%.

  Each “tax issue” has a 10% allowance, but a tax issue can sometimes be separated into multiple purposes, and each purpose has its own 10%/$15 million limit. “Unused” portions of private use from another issue or another purpose can be blended together.
Exceptions to Private Use

• Qualified Management Contracts. Arrangements with outside parties to operate or manage a financed facility do not count as Private Use if the arrangement is a Qualified Management Contract.

• Incidental use capped at 2.5%, such as for advertising, vending machines, and other incidental arrangements that do not involve possession or control of physically separate space. Some solar panels can be incidental.

• Research Contract Safe Harbor. Certain research conducted on bond-financed properties can result in Private Use.

• Short-term use
  - 50-Day: Commercial Use, Arm’s length, Fair Market Value Compensation
  - 200-Day: General Public Use, Fair Market Rates
Qualified Management Contract

- True manager or operator relationship. No joint venture.
- No sharing of net profits. Campus / auxiliary bears risk of profitability.
- Periodic fixed fee preferred for long-term contracts (up to 15 years).
- Compensation can be variable in shorter-term contracts.
- Limits on performance-based bonuses. Bonus cannot be based on profitability.
- Incidental services exempt: janitorial, equipment maintenance and repair, or reimbursement contracts.
Research Contract Safe Harbor

Arrangements with state and local governmental entities to perform research usually do not result in Private Use.

Arrangements with charitable or non-profit (501(c)(3)) organizations may constitute Private Use.

Grants have to be true grants. Grantor can impose no material requirements except for the issuer to conduct the research as per the conditions of the grant. Grantor generally cannot own the product or results of the research.
Research Contract Safe Harbor (continued)

- Research Contract Safe Harbor

  Safe harbor applies to basic research only. Research does not constitute Private Use if:

  Federally-sponsored research is under Bayh-Dole Act and no expectation that march-in rights would be exercised.

  Corporate Sponsor. License or other use of resulting technology is granted to the sponsor on the same terms as any unrelated, non-sponsoring party (that is, the sponsor must pay a competitive price for its use), and the price paid for that use must be determined at the time the license or other resulting technology is available for use.

- Measuring Private Use from Research – by actual space and/or time, or by percentage of revenues generated from research.
Do I really have excess Private Use?

• Where is the private use?
  Whenever there is another source of funds involved in the financing of the project, it can be used to decrease or eliminate private use activity. That be achieved if private use is occurring in “equity-financed” space and not in bond-financed space. See allocation discussion and timing rule.

• For how long did the facility have private use?
  Most private activity arrangements are not for the entire term of the bonds, so private use may also be blended down if supported by records.
Excess Private Use – Self Correction

After issuance of bonds / Change in Use: Unexpected Private Use after issuance has retroactive effect on original tax-exempt debt. Cannot simply refund on taxable basis.

All self-correction must be coordinated through the Chancellor’s Office.

• Qualified Remediation to Cure Excess Private Use: Reasonable Expectations, Equity or Taxable Bonds Escrow, Yield Restriction, or Alternate Use of Disposition Proceeds.

• Excess Private Use can also be blended down through time, by stopping the Private Use.
Mixed-Use Projects are projects with excess Private Use, but have other sources of financing in addition to an issue of tax-exempt bonds.

Proposed Guidance from IRS regarding allocation: Use a reasonable and consistently applied accounting method, including allocating bond proceeds to discrete portions (e.g., based on actual costs, total space, or fair market value), or an undivided portion allocation (e.g., time).

For example, specific areas of a mixed-use facility can be allocated to tax-exempt proceeds, or allocated to equity or taxable debt, done on a cost per sq/ft basis. Tax restrictions would not apply to areas that are financed with equity or taxable debt. Temporal allocations, which are by the time or duration a mixed-use facility has Private Use, are more complicated and less certain.
Timelines for Allocation

• General Rule: Allocation of tax-exempt proceeds to expenditures must occur by the later of 18 months after the date the expenditure is paid or the date the financed project is placed in service. This allocation must be made in any event by the date that is 60 days after the fifth anniversary of the issue date or the date 60 days after the retirement of the issue, if earlier.

Note: allocation of proceeds for private use and rebate must be consistent.

• Rebate Rule: Rebate is due at least every five years until the maturity date of the issue, or until there are no more proceeds subject to rebate. Final rebate is due within 60 days of redemption of issue.

For commercial paper, final computation date need not occur before the end of 8 months after the issue date or while the issuer reasonably expects to meet a rebate exception.
# Allocation Case Study

<table>
<thead>
<tr>
<th>INFORMATION CATEGORY</th>
<th>REASON/RELEVANCE</th>
<th>SAMPLE ANSWER</th>
</tr>
</thead>
<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 of Student Union</td>
</tr>
<tr>
<td>Sources of funding, and amounts.</td>
<td>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.</td>
<td>Bonds: $70, Equity: $30, Total Cost: $100</td>
</tr>
<tr>
<td>Placed in service date</td>
<td>Private business use does not begin until the later of when tax-exempt bonds are issued or the financed project is placed into service.</td>
<td>1/1/2010 (renovations completed and ready for use)</td>
</tr>
<tr>
<td>Total Usable Area</td>
<td>Reminder, an Expansion will be treated as a separate project from Renovations, so the answers should have to be given separately for each project.</td>
<td>Total usable sq ft: 10,000 (total space renovated that is available for use)</td>
</tr>
</tbody>
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“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. But exclude true common areas, such as hallways, bathrooms, engine rooms, telecom space.
## Allocation Case Study (continued)

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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>
</tbody>
</table>

| **Private Use Conclusion – Tax Allocation** | 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. | 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. |
Record Keeping and Allocations

• General Rule: All records for the entire financing (including use of proceeds, use of the financed project, investments, expenditure, etc.) have to be kept until three years after the original financing and all subsequent refinancings.

• Final allocation of proceeds in writing – F&T Form.

For Mixed-Use projects, or for projects with any excess Private Use, tax-exempt proceeds must be allocated to particular expenditures, in writing, within the proper time period. Otherwise, direct tracing by invoice is used.

Keep good and complete records, including back-up documentation regarding costs, square footage, project details, requisitions, invoices, and agreements relating to use.

• Consistent allocation between private use and arbitrage and rebate. For example, equity that is allocated as spent first (before proceeds) should not be allocated to the last-completed portions of a long-term project.
Review and Monitoring Process

• CSU Roles:
  • F&T - is an extension of Board of Trustees as it relates to bond issuance and compliance.
  • CPDC – provides the framework for keeping track of facilities.
  • Campuses – CFO, Budgets, Procurement, Sponsored Programs provide overall monitoring related to their areas.
  • Enterprise Programs & Auxiliaries – focus on their specific requirements too.
• State Treasurer’s Office – monitors CSU for compliance.
  • Private Use Checklists and Tax Certificates.
CSU Review and Monitoring Process

- Project Development – as a campus develops a project scope, use, and funding it shares this information with CPDC and F&T. *Campuses fill out Private Use Checklist Form.*

- Financing – F&T consults tax and bond counsel during the financing stage prior to the Board of Trustees financing approval. *Campuses fill out Allocation of Bond Proceeds Form.*

- Commercial Paper Issuance – IRS requires an annual report documenting that CSU has evaluated private use.
CSU Review and Monitoring Process

• Bond Issuance – financing team along with outside parties such as underwriters, financial advisors, and tax counsel review and evaluate. Private use position of a specific project is documented in the Tax Certificate.

• Annual CPDC Call Letter – requests campuses to evaluate and report changes to private use and fill out various forms.

• Life of Bonds – 25 – 30 years campuses need to monitor. (Refunding opportunities during time too).
CSU Monitoring Process for Records

• 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.

* We added two years since State projects have multiple bond issuance dates over a construction period. We included SRB projects to standardize it.
CPDC Annual Process for Monitoring

• CPDC requests facility information on building space and usage in the “Facilities and Tax Compliance” memo. Results are tracked in the Space and Facilities (SFDB) database.

• This is a coordinated effort with a Tax Task Force involving CPDC, Financing & Treasury and, Sponsored Programs.
CPDC Forms
Focusing on IRS Requirements

• Facilities and Property Survey, Private Use Checklist (Attachment B) – provides an starting point to flag potential private use.

• Form 4-2, Facility Information Sheet (Attachment C) – campus identifies leased property including private entity’s square footage. Form is used by Tax Counsel for analysis when private usage is noted.
CPDC Forms
Focusing on IRS Requirements

• Form 4-4, Exclusions for Research Projects (Attachment D) – details information on Grants; Joint Research with State and Local government entities; Research agreements under IRS Revenue Procedure 2007-47; Exceptions.

• Records Retention Checklist (Attachment F).
IRS Audit Lessons Learned

• In 2011, the IRS audited the CSU on two bond issuances (SRB Series 2005A and 2005B). This involved 20 projects built in 2004 – 2006 and two refundings involving 15 projects originally built between 1983 and 1999.

• CSU received a favorable outcome in the IRS Audit. The process led us to learn of potential weaknesses and areas of improvement.
IRS Audit 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 the contract.
- **Record Retention** – information was not easily accessible.
- **Points of contact** at campuses need to understand the IRS requirements.
IRS Audit Lessons Learned

• Student Unions have a higher occurrence of private use. However, housing has potential risks due to dining.

• Naming Rights and Marketing Agreements do impact the calculation of Private Use.

• Research contracts have private use risks, even with Federal Contracts.
Conclusion

• CSU, as bond issuer, relies on every department, program and auxiliary to monitor and assure compliance with IRS regulations.

• If problems occur in one area, the impact can be far reaching and potentially affect all campuses and the credit of the CSU.

• We need everyone to focus to assure that bonds remain tax-exempt providing the CSU with the lowest cost of borrowing.
Questions?