VENABLE LLP

nonprofit alert

October 2013

THE EVOLVING SCHEDULE K TO IRS FORM 990:

SUPPLEMENTAL INFORMATION ON TAX-EXEMPT BONDS

HINTS FOR THE WISE AND TRAPS FOR THE UNWARY

AUTHORS:

Walter R. Calvert
wrcalvert@Venable.com
410.244.7726

Tammara F. Langlieb
tflanglieb@Venable.com
410.244.7821

IN COLLABORATION WITH:

Caryn G. Pass
cgpass@Venable.com
202.344.8039

Davis V. R. Sherman
dvsherman@Venable.com
410.244.7810

Jeffrey S. Tenenbaum
jstenenbaum@Venable.com
202.344.8138

A 501(c)(3) organization with outstanding tax-exempt debt generally is required to file Schedule K "Supplemental Information on Tax-Exempt Bonds" with its annual IRS Form 990. This article seeks to assist the preparer of Schedule K by focusing on questions that are confusing or that could trigger an audit if answered inappropriately or without complete explanations. We will not address Part I of Schedule K which relates to basic information about bond issues or every line on the remaining parts of Schedule K, but instead will provide explanations on tricky topics and suggest best practices for topics that most frequently raise questions or concerns.

Background

In 2007, the IRS revamped the Form 990 and introduced Schedule K. Schedule K has been a work in process ever since, having been modified several times in the intervening years. Currently, Schedule K is divided into six sections. Part I focuses on basic information about the bond issues, Part II analyzes the use of proceeds, Part III reviews the amount of the private business use, Part IV discusses arbitrage, Part V inquires about the conduit borrower's remediation actions and Part VI is space for the conduit borrower to provide additional information. The regular filing deadline for a 501(c)(3) organization with a tax year ending June 30 is the immediately following November 15th.

Schedule K provides an excellent audit tool for the IRS to track outstanding tax-exempt bonds and monitor their compliance status based on self-reporting by the conduit borrowers. The two primary areas of potential misuse of tax-exempt bond proceeds covered in some detail by Schedule K are (i) arbitrage – the potentially abusive investment of bond proceeds at a yield greater than the bond yield, and (ii) private business use ("PBU") – the use of bond proceeds or bond-financed facilities by other private businesses or in furtherance of unrelated trade or business activity in the case of 501(c)(3) organizations.

Rules to Prepare by

Three "golden rules" are worth remembering and applying when completing Schedule K:

1. Get It Right the First Time

Schedule K filings form a database for a particular bond issue from year to year, so consistency is important in preparing the Schedule. For the first year of filing for a particular bond issue, extra care should be taken to ensure that the correct baseline information is entered, as much of it will be carried forward from year to year and/or form the basis for updating in the following years.

2. Remember to Review Previous Bond Information

To complete the Schedule K, review the bond transcript, your own records as to uses of proceeds and uses of bond-financed facilities, and any records of trustees or other third parties as to the investment and disbursement of bond proceeds. Use the Form 8038 filed by the issuer with the IRS as the source to complete the general information needed in Schedule K, Part I, "Bond Issues."

3. Check Your Compliance Procedures

Parts II, III, IV, and V of Schedule K each have a separate question involving the same theme: Has the 501(c)(3) organization adopted procedures for monitoring the bond(s) post-closing to ensure compliance with federal income tax law and is the organization maintaining the records necessary to support such compliance? The sheer number of repetitious questions on this theme is designed to convey a warning—if 501(c)(3) organizations do not adopt compliance procedures, there is a good chance that the IRS will audit their bonds.

Certain lines on Schedule K ask questions that merit some explanation to yield good answers. Below, we discuss the lines that we encounter as most frequently raising questions or generating issues in the answers filers provide.

Part II: Use of Bond Proceeds

Schedule K, Part I relates to basic information regarding a bond issue. Due to its straightforward nature, Part I will not be discussed in detail. Schedule K, Part II focuses on how the conduit borrower has used the bond's proceeds.

Refunding and Defeased Bonds

A legal defeasance occurs when funds have been irrevocably escrowed to pay the remaining debt service on particular bonds at it comes due and/or at an upcoming call date. Funds for the defeasance escrow usually come from some combination of proceeds from the sale of refunding bonds (an "advance refunding"), borrower equity, and left over proceeds of the prior bonds issue, such as proceeds held in a debt service reserve fund. When filling out Part II, it is important to remember whether the prior bonds were fully paid off and retired, or were merely defeased or "advance refunded" and remain outstanding.

If all of the prior bond issue has been fully paid off or legally defeased, then the bond issue need no longer be reported on Schedule K. If a portion of the prior issue has been defeased, then the "yes" box in Part I, column (g) gets checked and the principal amount of the defeased portion of the prior bonds is reported at Part II, line 2. If bonds have been paid off, their principal amount is reported on Part II, line 1. If any of the sale proceeds of the refunding bond issue have been deposited into an escrow to refund prior bonds, then the amount of those sale proceeds plus investment earnings thereon are reported on Part II, line 6.

Reconciling Proceeds

The reporting of the usage and status of "proceeds" in Part II is where it starts to get a little confusing at times because of the various categories of "proceeds" into which tax law categorizes funds related to a bond issue. Most of the entries in Part II require reporting with respect to "proceeds," which includes both the original proceeds from the sale of the Bond issue together with any earnings on those proceeds that are allocable to the same use. Because amounts other than the original sale proceeds are to be reported for certain of the Part II entries, they will not add back to either the original aggregate issue price or principal amount of the bond issue.

Reserve Funds

Part II, Line 4 requires information on any reserve funds. Typically, a reserve fund is funded with sale proceeds and invested in interest-bearing assets. Interest on the reserve fund assets builds up in the reserve fund until moved to some other use under the terms of the governing indenture. However, a reserve fund may be funded partly or wholly from sources other than sale or investment proceeds, such as the conduit borrower's own equity. Line 4 generally requires the reporting of all amounts that have been pledged to secure the bonds. Note the use of the term "gross proceeds" in line 4. "Gross proceeds" is the broadest of the various tax law categories of proceeds and includes any amounts pledged to secure the payment of debt service on the bonds in addition to the sale and investment proceeds.

Issuance Costs

Part II, Line 7 inquires about the issuance costs paid from proceeds of the sale of the bonds. This amount can usually be found on and copied from the Form 8038 for the issue, although in some instances the actual amounts paid for issuance costs deviate from amounts reported on the Form 8038. In such cases, report the actual amount on Schedule K. No more than 2% of an issue's proceeds can be used to pay the issuance costs. Issuance costs also count against the 5% limit on private business use (discussed in greater detail below.) To help preserve the full 5% allowance for private business use, the best practice may be to elect to pay all costs of issuance with your equity, if possible. This preserves flexibility for unforeseen private business uses that may arise in the later years of a bond-financed project.

Final Allocation

Part II, Line 16 asks if the borrower has made a final allocation of bond proceeds. Recall that for almost every type of bond issue with the exception of pure refunding issues, the facts stated in the tax certificates about how bond proceeds will be spent or allocated are based on good faith expectations at the time the bonds are issued. For tax planning reasons, such as accommodating private business use, specific allocations of bond proceeds and other sources such as borrower equity or fundraising proceeds may have been important original assumptions. However, final, actual expenditures may differ for a variety of reasons, such as delays, change orders or project amendments.

A best practice is to carefully prepare such a final allocation taking careful account of any discrete allocations needed to address private business use or other tax law limitations. Once the final allocation is complete, the conduit borrower generally must live with the allocations for the life of the bond issue. Absent an affirmative documentation of such a final allocation by the borrower, the allocation is deemed made by a direct tracing of bond proceeds into expenditures. Such a direct tracing can lead to unintended and undesirable consequences for the conduit borrower as the resulting allocations may differ from those needed to reach a desired tax law compliance objective as could easily have been accomplished with allocations properly documented in a "final allocation" by the borrower. Under tax law and the tax certificates for the issue, timing deadlines are imposed as to when such a final allocation of proceeds to uses must be completed, which is typically 18 months after the in-service date of the financed property (and in no event later than 5 years and 60 days after the issuance of the bonds). You will want to assure that the "yes" box is checked in compliance with that timing deadline.

Supporting Books and Records

Part II, Line 17 questions whether the conduit borrower has maintained adequate books and records to support its final allocations. For this question, along with several others on the Schedule, a conduit borrower should have taken all necessary action to be able to answer "yes," or should take such action before the filing of the Schedule K. Of course, if a final allocation of proceeds has not been made yet, then "not applicable" may be the appropriate answer for the current year.

Part III: Private Business Use

No more than 5% of bond proceeds of a particular issue or of the facilities financed with such proceeds can be used in a PBU. Whether the 5% limit is exceeded is determined over the life of a bond issue by taking annual snapshots of the amount of PBU during a year and then averaging those numbers. Thus, if the total PBU for years 1-4 is 0% and during year five it spikes temporarily to 15%, the PBU at the end of year five is the average, namely 3%. Part III of Schedule K provides a list of questions designed to capture the annual snapshots of PBU information necessary for this measurement process. Often, this is the most difficult section to complete.

PBU – Joint Ventures

Generally all assets financed with tax-exempt debt proceeds must be owned by a 501(c)(3) organization. Assets owned by a partnership, limited liability company or other joint venture agreement create the potential that ownership may be shifted, at least in part, to a participant in the venture that is other than a 501(c)(3) organization. Part III, Line 1 inquires about such ventures and creates a flag for audit if ownership by other than a 501(c)(3) organization is acknowledged without an explanation being provided as to how the particular structure does not result in a prohibited ownership of bond-financed assets.

Bond counsel typically is careful to evaluate any such agreements that are disclosed at the time of bond closing and require structuring of ownership in compliance with this requirement. Ventures that are modified or initiated post-closing and that involve bond-financed assets need to be carefully evaluated to assure that no change occurs that inadvertently results in ownership shifting to a participation other than a 501(c)(3) organization or that otherwise results in PBU.

PBU – Leases

Part III, Line 2 asks whether any leases exist that may result in PBU. The general rule is that any lease to a third party involving bond-financed facilities will give rise to PBU. Among the exceptions are leases to another 501(c)(3) organization for use in fulfillment of its exempt purposes. Assuming that the 501(c)(3) tenant is not using the leased space in unrelated trade or business activity or private business use, then the lease will not give rise to PBU.

In some financings, a conduit borrower may have intended at the time of bond issuance to allocate equity to a discrete portion of a facility in anticipation of a lease or other PBU tainting the space. For example, a school or hospital may know that a for-profit food service provider or other vendor will be leasing space in its facility and the organization will therefore fund the costs of that space with its own equity and demonstrate that this was done in its "final allocation" of bond proceeds. In this situation, the lease does not involve "property financed by the bond issue," and therefore a "no" answer is appropriate (assuming no other leases affect the bond-financed portions of the facility).

Outside Legal Review of Contracts

Part III, Lines 3b and 3d asks if outside counsel is routinely engaged to review management and other professional service contracts, sponsored research agreements and similar contracts that may give rise to PBU. Inherent in these questions is the warning that these types of agreements (often involving complex compensation, term, and termination provisions) frequently require difficult technical legal analysis to evaluate whether they satisfy the "safe harbors" against PBU. Reviewing a contract for such compliance can require familiarity with various Treasury regulations, "safe harbor" IRS guidelines, letter rulings and industry practice. A "yes" answer signals that the borrower is aware of the difficulty of assessing contract compliance, and is less likely to make errors that could be found on audit. For hospitals, colleges and universities, senior care facilities, museums, and similar organizations that typically have a range of needs for professional service, management, and/or research agreements, review by outside counsel is the norm and "yes" responses are expected. Venable, like other firms with counsel devoted to the tax law area of public finance, has the professional expertise needed in this area and we are available to assist in providing the guidance that may be needed.

PBU – Management and Other Service Contracts

The instructions for Line 3a advise that in evaluating whether there are any management or service contracts that may result in PBU, a "yes" answer is appropriate even if the conduit borrower has determined that PBU does not result from a contract based on qualification under one of the safe harbor exceptions. As most 501(c)(3) organizations will have in place some type of professional service contract related to its bond-financed facilities, a "yes" answer will typically be appropriate on Line 3a. Assuming that the conduit borrower has determined, with the assistance of its counsel or otherwise, that all such contracts do conform to some of the safe harbors against PBU, then consideration should be given to including a statement to that effect in Part VI (see discussion below). As discussed above with respect to leases, if the conduit borrower has financed discrete portions of a facility with equity, then professional service contracts related strictly to such discrete space do not involve "property financed by the bond issue" and do not require a "yes" answer.

PBU – Sponsored Research

"Research agreements" come in many varieties and include sponsored agreements with funding provided by the federal government, by private industry or by other non-profit organizations. And the uses of bond financed facilities can be complex, with sponsored research from more than one sponsor utilizing the same facilities on a simultaneous basis with the exempt organization's own activities. As a result of the diversity of forms of agreements, sponsors and rights to any resulting intellectual property, the evaluation of whether such agreements give rise to PBU or satisfy a safe harbor against PBU can be a challenging analysis in some instances. As discussed above with respect to management and other service contracts, a "yes" answer is called for on Part III, Line 3c, if any such sponsored agreements involving bond-financed facilities exist, even if the conduit borrower has determined that PBU does not result from the agreement based on qualification under one of the safe harbor exceptions.

PBU Percentage

Part III, Line 4 requests the percentage of financed property used in a private business by non-501(c)(3) entities. Some organizations will be able to consistently report zero PBU because their bond-financed facilities have no PBU. For a typical exempt organization that has some small amount of PBU of its bond-financed facilities, this question will likely require some complicated homework to generate an accurate answer.

The instructions contemplate a percentage resulting from comparing PBU to all use of the bond financed facilities for the specific tax year of the Schedule K. We typically approach this calculation by converting usage to dollars so that comparison involves (i) bond proceeds allocated to the costs of the portions of a facility that are subject to PBU compared to (ii) all bond proceeds. Other methodologies may be appropriate, depending on the circumstances. Note that for this PBU calculation, proceeds used for issuance costs are not included as PBU (even though they are included in the overall evaluation of whether the 5% limitation on PBU has been exceeded). Note also that any use involving private persons under lease, service agreements or other similar arrangements that meet the requirements of one of the contract “safe harbors” need not be included in the numerator as PBU.

PBU and UBIT

Part III, Line 5 focuses on the percentage of bond-financed facilities which are used in unrelated trade or business activity. Any unrelated trade or business activity results in PBU even if the activity does not generate a profit or is not reported on IRS Form 990-T for some other reason. The calculation here done in similar fashion to that for the PBU percentage on Line 4, as discussed above.

The Private Payment and Security Test

Part III, Line 7 poses another somewhat tricky question: “Does the bond issue meet the private security or payment test?” Resist the temptation to assume that “yes” is the appropriate answer. The private security or payment test is one of the tests used to establish that bonds are “private activity bonds” and as such are ineligible for tax exemption. The test is generally satisfied (not desired) if more than 5% of the debt service is secured by or paid from parties other than the exempt organization. For example, a private payment results when a portion of the bond-financed facility is leased to a for-profit food service provider and the rental income is to be used to pay debt service on the bonds.

PBU Compliance Procedures

By now every organization that is a conduit borrower of tax-exempt bond proceeds should have adopted written procedures for monitoring the post-issuance compliance requirements of federal income tax law. An exempt organization should always be in a position to check the “yes” box for the question posed on Part III, Line 9. If procedures haven’t yet been adopted or are more than a few years old, check with your counsel for current samples of best practices appropriate for your organization. While review, understanding and adoption of written procedures at the highest approval levels of the organization (e.g., the board of trustees or directors) is a “best practice,” no particular level of approval is required for Schedule K purposes. Approval by the chief financial officer or the finance committee is adequate if that will ensure that the procedures are put in place in a timely manner and followed consistently. There should be a clear understanding within the organization of who will be responsible for monitoring and ensuring that the organization complies with all of the requirements of federal income tax rules and regulations applicable to tax-exempt debt.

Part IV: Arbitrage

Schedule K, Part IV addresses very focused topics under the rules that apply to the investment of tax-exempt bond proceeds. These rules and the related questions generally fall into two categories: (i) the rules (and exceptions thereto) that limit the yield on the investment of bond proceeds to no more than the bond yield; and (ii) the rebate rules (and the exceptions thereto) that require the payment to the IRS of arbitrage profits realized on the investment of bond proceeds.

Arbitrage Extended Investment

Part IV, Line 6 focuses on whether any gross proceeds were invested beyond an available temporary period. Bonds issued for construction projects typically have a three-year "temporary period" following issuance during which bond proceeds can be invested without restriction as to yield. The most common situation for 501(c)(3) organizations that would trigger a "yes" response is when delays in construction or acquisition plans extend the construction period beyond the usual three-year period. If three years have passed and proceeds remain unspent, a "yes" answer will be required and discussion with your counsel and/or bond counsel to the issuer will be appropriate to evaluate whether any action with respect to investments is required. Whether rebate may apply is a separate question not relevant to answering this question.

Arbitrage Compliance Procedures

Part IV, Line 7 asks whether the borrower maintains compliance procedures to ensure that the arbitrage rules are followed. As discussed above with respect to PBU compliance procedures, a 501(c)(3) organization should be in a position to answer this question affirmatively.

Part V: Remediation

Schedule K, Part V asks whether the borrower has plans and procedures for identifying and correcting violations of tax law requirements with respect to tax-exempt bonds. The importance of this topic to the IRS is shown by the fact that it gets its own section for just one question – Has the organization established written procedures to ensure that violations of federal tax requirements are timely identified and corrected? Again, as with the several other questions on Schedule K inquiring with respect to post-issuance compliance procedures, any 501(c)(3) conduit borrower should have in place one or more sets of procedures enabling "yes" responses for each of these questions. We frequently assist new borrowers with putting such procedures in place and have forms that can be tailored to fit the needs of each particular borrowing situation to comply with the IRS's expectations for their adoption.

Part VI: Supplemental Information

Part VI provides space to provide additional detail on any questions where the simple filling in of a number or completion of a yes/no query does not adequately respond to the question. A best practice for any question as to which the mere filling in of the blank or yes/no response is inadequate to fully answer the query or could be misleading is to take advantage of Part VI to provide a more thorough answer. Many of the tax law topics addressed on Schedule K are complex and reducing them to mere one-word or one-number answers will not tell the full story.

Due Date

Schedule K must be filed along with Form 990 with the IRS. The filing deadline for 501(c)(3) organizations is five-and-a-half months after the close of the organization's tax year.

* * * * * *

For questions or more information, please contact Walter Calvert at wrcalvert@Venable.com or 410.244.7726; or Tammara Langlieb at tflanglieb@Venable.com or 410.244.7821.