



**Tax Exempt &
Government Entities**

Your Responsibilities as a Conduit Issuer of Tax-Exempt Bonds



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Introduction

Municipal bonds provide tax-exempt financing for certain qualified purposes including the construction of hospitals, residential rental housing, solid waste facilities, colleges and universities and cultural institutions. Tax-exempt financing also is available for the furtherance of governmental purposes.

This publication provides an overview for state and local governments of the responsibilities of the conduit issuer on tax compliance in municipal financing arrangements commonly known as conduit financings. The term “conduit issuer” refers to an issuer of tax-exempt bonds in a conduit financing. A conduit financing is generally a situation where tax-exempt bonds are issued by a state or local government and the proceeds are used for a defined qualified purpose by an entity other than the government issuing the bonds (the conduit borrower). For tax-exempt bonds, all applicable federal tax law requirements must be met to ensure that interest earned by bondholders is exempt from taxation under Internal Revenue Code (IRC) Section 103. For information about the more specific rules that apply to qualified 501(c)(3) bonds, other qualified private activity bonds and governmental bonds, see IRS Publications [4077, Tax-Exempt Bonds for 501\(c\)\(3\) Charitable Organizations](#), [4078, Tax-Exempt Private Activity Bonds](#), and [4079, Tax-Exempt Governmental Bonds](#). IRS provides additional information at [irs.gov/bonds](https://www.irs.gov/bonds).

Background

Tax-exempt bonds are valid debt obligations of state and local governments, commonly referred to as “issuers”— the interest on which is tax-exempt. This means that the interest paid to bondholders is not includable in their gross income for federal income tax purposes. This tax-exempt status continues throughout the life of the bonds provided that all applicable federal tax laws are satisfied. Various requirements apply under the IRC and Income Tax Regulations (Treas. Reg.) including, but not limited to, information filing and other requirements related to issuance, the proper and timely use of bond-financed property, and arbitrage yield restriction and rebate requirements. The benefits of tax-exempt bond financing can apply to the many types of municipal debt financing arrangements through which government issuers obligate themselves, including notes, loans, lease purchase contracts, lines of credit and commercial paper.

Tax-Exempt Conduit Bonds

Bonds issued to make loans to entities other than state or local governments are known as “conduit bonds” or “conduit issues” and state or local governments that issue these bonds are known as “conduit issuers.” Generally, to be tax-exempt, bonds issued by conduit issuers must be either governmental bonds or qualified bonds defined in IRC section 141(e) (for example, exempt facility bonds, qualified small issue bonds or qualified 501(c)(3) bonds) that are not arbitrage bonds under IRC Section 148 and meet the requirements of IRC Section 149.

The federal tax compliance rules covered in this publication are those that are the responsibility of the conduit issuer. To meet these requirements, conduit issuers must ensure that certain rules are met at the time the bonds are issued and throughout the term of the bonds. The IRS encourages conduit issuers and borrowers to implement written tax compliance procedures that will enable them to timely identify and correct violations that might result in the loss of the tax-exempt status of their bonds.

Parties to Conduit Bond Issue

A conduit issuer in a conduit bond financing typically issues the bonds and loans the bond proceeds to a conduit borrower. A conduit borrower is generally responsible for the payment of debt service on the conduit bond issue and is usually contractually obligated to maintain the tax-exempt status of the bonds. The conduit issuer is treated as a “taxpayer” for federal tax purposes and is the party generally responsible for tax compliance. However, the bond documents usually provide for delegation of certain responsibilities to the conduit borrower. The bondholders rely on both the conduit issuer and the conduit borrower to maintain the tax-exempt status of the bonds.

Bonds Supported by Leases

Certain bonds issued by state or local governments are not used to make loans to other entities. Nevertheless, these issues (for example, certain airport bonds) may be used to finance facilities leased to another entity for the entire term of the bonds. While these issues are not conduit bonds, the lessee of the facilities often is primarily responsible for many of the compliance requirements and the bonds may be treated as conduit bonds for many purposes.

Examples of the Tax Compliance Responsibilities of Conduit Issuers

The following are examples of the tax compliance responsibilities of the conduit issuer in the financing of conduit bonds where conduit issuers must take specific actions. The responsibilities are not all inclusive and additional actions may be required for certain types of financings or in certain circumstances.

Information Filing Requirements: Conduit issuers must file certain information returns under IRC Section 149(e). The information return that a conduit issuer must file is determined by the size and type of conduit issuance. However, most conduit issuers are required to file [Form 8038, Information Return for Tax-Exempt Private Activity Bond Issues](#).

Information Return	Due Date	Where to File
<p>Form 8038, Information Return for Tax-Exempt Private Activity Bond Issues.</p>	<p>Generally, this return must be filed by the 15th day of the second month following the quarter in which the bonds were issued. For example, the due date of the return for bonds issued on February 1 is May 15.</p>	<p>File these returns with the IRS: Internal Revenue Service Center Ogden, UT 84201</p>
<p>Form 8038-G, Information Return for Tax-Exempt Governmental Bonds, for governmental bonds with an issue price of \$100,000 or greater.</p> <p>Form 8038-GC, Information Return for Small Tax-Exempt Governmental Bond Issues, Leases, and Installment Sales, for governmental bonds with an issue price of less than \$100,000.</p>	<p>Generally, both these returns must to be filed by the 15th day of the second month following the quarter in which the bonds were issued. For example, the due date of the return for bonds issued on February 15 is May 15.</p> <p>Form 8038-GC may also be filed on a consolidated basis for bond issues of less than \$100,000 each.</p> <p>Consolidated returns are due by February 15 following the calendar year in which the bonds were issued.</p> <p>Example: An issuer issues three governmental bond issues: Issue A on March 1, 2018, for \$50,000; Issue B on June 15, 2018, for \$75,000; and Issue C on October 5, 2018, for \$30,000. The issuer can file one consolidated return by February 15, 2019, for all three bond issues.</p>	<p>File these returns with the IRS: Internal Revenue Service Center Ogden, UT 8420</p>

Late Filing of Information Returns: A conduit issuer may request an extension of time to file Forms 8038, 8038-G, or 8038-GC, so long as the failure to file the return on time was not due to willful neglect. To request an extension, the conduit issuer must follow the procedures outlined in [Revenue Procedure 2002-48, 2002-37 I.R.B. 531](#). These procedures require the conduit issuer to: 1) attach a letter to the return filed (Form 8038, 8038-G, 8038-GC) explaining when the return was due, why it wasn't filed timely, and whether the bond issue is under IRS examination; 2) enter on top of the return "Request for Relief under section 3 of Revenue Procedure 2002-48" and 3) file the letter and return with the IRS at the Ogden Submission Processing Center.

Volume Cap Limit: The volume cap limit for certain qualified private activity bonds, under IRC Section 146, limits an issuer to a maximum amount of tax-exempt bonds that can be issued to finance a particular qualified purpose during a calendar year. If, during a given year, an issuing authority issues qualified private activity bonds in excess of its volume cap limit, the tax-exempt status of those bonds is jeopardized. A conduit issuer must monitor volume cap allocations to properly file information returns and make carryforward elections. Certain types of

qualified private activity bonds do not require volume cap allocations. In addition, certain current refunding bonds do not require volume cap allocations to the extent the amount of refunding bonds does not exceed the outstanding amount of the refunded bonds.

Carryforward of Unused Volume Cap: A conduit issuer may elect to carry any unused volume cap of a calendar year forward for three years. This election can be made for each of the carryforward purposes described IRC Section 146. This generally includes qualified private activity bond purposes subject to volume cap except for the purpose of issuing qualified small issue bonds. This election is made by filing IRS [Form 8328, Carryforward Election of Unused Private Activity Bond Volume Cap](#), by the earlier of February 15 following the year in which the unused amount arises or the date of issue of any bonds pursuant to the carryforward election. Once Form 8328 is filed, the issuer may not revoke the carryforward election or amend the carryforward amounts shown on the form. Errors on this form cannot be corrected through an amended filing. The conduit issuer may file a TEB Voluntary Closing Agreement Program request to correct mathematical, typographical and similar errors. See [Notice 2008-31, 2008-11 I.R.B. 592](#), and [Tax Exempt Bonds Voluntary Compliance](#).

Public Approval Requirement: Generally, prior to issuance, qualified private activity bonds (including qualified 501(c)(3) bonds) must be approved by an elected representative for the governmental entity issuing the bonds and, in some cases, for each governmental entity having jurisdiction over the area in which the bond-financed facility is to be located. The public approval must occur after the holding of a public hearing following reasonable public notice before the public hearing and must be completed within a prescribed period. As such, the conduit issuer is involved in certain aspects of the public approval process. Public approval by a governmental unit may also be by voter referendum. IRC Section 147(f) and Treas. Reg. Section 1.147(f)-1 define the rules for this requirement.

Limitations on Fees Charged by the Conduit Issuer: Conduit issuers may charge fees payable either out of the bond proceeds or by the conduit borrower. The conduit issuer may use these fees to offset all or part of the conduit issuer's costs and may also be used to raise funds for governmental purposes of the conduit issuer. The fees may increase the effective yield of the conduit loan when viewed by the conduit issuer as a purpose investment. IRC Section 148 generally limits the yield on purpose investments to the yield on the bonds plus a spread. This limitation effectively limits the size of the fees that the conduit issuer may charge regardless of whether paid periodically or up front. Conduit issuers generally must ensure that the yield on the conduit loan does not exceed the yield on the bonds by more than the permitted spread to prevent the bonds from becoming arbitrage bonds.

Certification on Expectations for Use and Investment of Proceeds: Treas. Reg. Section 1.148-2(b)(2)(i) provides that an officer of the issuer responsible for issuing the bonds must, in good faith, certify the issuer's reasonable expectations as of the issue date. The certification must state the facts and estimates that form the basis of the issuer's expectations. The certification is evidence of the issuer's expectations, but does not establish any conclusions of law or any presumptions about either the issuer's actual expectations or their reasonableness. This certification is not required if the conduit issuer reasonably expects, as of the issue date, that there will be no unspent gross proceeds after the issue date, other than gross proceeds in a bona fide debt service fund or the issue price of the bond issue does not exceed \$1,000,000.

Reimbursement Declarations of Official Intent: Under Treas. Reg. Section 1.150-2, a conduit issuer or conduit borrower is permitted to use bond proceeds to reimburse certain expenditures paid before the date of issuance subject to certain requirements. One requirement is that the conduit issuer must adopt a declaration of official intent to reimburse expenditures not later than 60 days after the reimbursed expenditure is paid. In the case of qualified 501(c)(3) bonds only, a conduit borrower may also adopt a declaration of official intent. Accordingly, for all other types of qualified private activity bonds the conduit issuer must act to adopt declarations of official intent to permit reimbursement financing.

Qualified Hedge: A conduit issuer pursuant to Treas. Reg. Section 1.148-4(h) must identify a qualified hedge on its books and records maintained for the hedged bonds not later than 15 calendar days after the date on which the conduit issuer (or conduit borrower) and the hedge provider enter into a hedge contract.

Deliberate Actions: Bonds issued by a conduit issuer can lose their tax-exempt status if the conduit issuer or conduit borrower takes a deliberate action, after the issue date, that causes the issue to fail to meet the federal tax requirements for the bonds. A deliberate action is any action taken by the conduit issuer or conduit borrower that is within its control. Intent to violate the requirements of the IRC is not necessary for an action to be deliberate.

Remedial Actions: A conduit issuer, often with the involvement of the conduit borrower, may take a remedial action under Treas. Reg. Section 1.141-12 and [Revenue Procedure 2018-26, 2018-10 I.R.B. 546](#) to cure a deliberate action that would otherwise cause a governmental bond issue or qualified 501(c)(3) bond to become a nonqualified private activity bond issue. If the remedial action requires providing a notice of defeasance to the IRS, the conduit issuer must provide the notice. Remedial actions include redemption or defeasance of bonds, alternative use of disposition proceeds and alternative use of bond-financed facilities. Additionally, if the bonds are treated as “reissued” under the Treas. Reg., the conduit issuer must test the reissued bonds to determine if the interest on the bonds remains exempt from gross income for federal tax purposes (see Bond Modifications section below).

Redemption or defeasance of bonds are remedial actions prescribed in Treas. Reg. Section 1.142-2 for certain failures to properly use the proceeds of exempt facility bonds. The conduit issuer in this case also must provide a notice of defeasance to the IRS. Similar rules apply to qualified small issue bonds and qualified redevelopment bonds.

Bond Modifications: An agreement between a bondholder and a conduit issuer (or conduit borrower) to modify the terms of any bonds, whether direct or indirect, may cause the modified bonds to be treated as new bonds for federal income tax purposes (that is, to be “reissued”). If the conduit bond is considered reissued under IRC Section 1001, then the conduit bond must be tested to determine if the interest on the bonds remains exempt from gross income for federal tax purposes. Revenue Ruling 81-281, 1981-2 C.B. 18, provides that interest on tax-exempt conduit bonds is not excludable from gross income after the terms of the bonds are substantially altered without action by the state or local government issuer. A conduit issuer may generally meet this requirement to approve reissued bonds by adopting a formal resolution of the governing body of the conduit issuer approving the modification of the terms. In addition, the conduit issuer must satisfy all federal tax requirements including timely filing Form 8038, 8038-G or 8038-GC, treating the date of the modification as the date of issuance of the modified bonds.

Elections: The Treas. Reg. on private activity bonds generally require that the conduit issuer make elections in writing and retain them as part of the bond documents. Elections cannot be revoked without permission of the IRS Commissioner. Many elections have to be made on or before the issue date of the bonds.

Examples of Elections Include the Election:

- To waive the right to treat a purpose investment as a program investment;
- To waive the right to invest in higher yielding investments during any temporary period;
- Of the issuer of a pooled financing issue to apply rebate spending exceptions separately to each conduit loan;
- For purposes of the two-year spending exception from rebate to apply certain provisions based on actual facts rather than reasonable expectations;
- For purposes of the two-year spending exception from rebate to exclude from available construction proceeds the earnings on a reasonably required reserve fund;
- For purposes of the two-year spending exception to treat a portion of an issue as a separate construction issue from rebate;
- To pay 1.5% penalty in lieu of arbitrage rebate; and
- To treat portions of a bond issue as separate issues.

Arbitrage Rebate Requirements/Yield Reduction Payments: In certain circumstances, Treas. Reg. Section 1.148-5(c) permits the conduit issuer to make payments to the U.S. Department of the Treasury in lieu of restricting the yield on investments made with bond proceeds at the end of a temporary period.

Conduit issuers of tax-exempt bonds file [Form 8038-T, Arbitrage Rebate, Yield Reduction and Penalty in Lieu of Arbitrage Rebate](#), to make:

1. Yield reduction payments;
2. Arbitrage rebate payments;
3. Penalty in lieu of rebate payments;
4. The termination of the election to pay a penalty in lieu of rebate; and
5. Payments for penalty for failure to pay arbitrage rebate on time.

A yield reduction payment or arbitrage rebate installment payment must be paid by conduit issuers no later than 60 days after the end of every 5th bond year throughout the term of a bond issue. The payment must be equal to at least 90% of the amount due as of the end of that 5th bond year. Upon redemption or final maturity of a bond issue, a payment of 100% of the amount due must be paid no later than 60 days after the discharge date.

A failure to timely pay arbitrage rebate will be treated as not having occurred if the failure is not due to willful neglect and the conduit issuer submits a Form 8038-T with a payment of the rebate amount owed, plus penalty and interest. The penalty may be waived under certain circumstances. For more information, see Treas. Reg. Section 1.148-3(h)(3) and [Revenue Procedure 2005-40, 2005-28 I.R.B. 83](#).

In general, a request for recovery of overpayment of arbitrage rebate can be made when the conduit issuer can establish that an overpayment occurred. An overpayment is the excess of

the amount paid to the U.S. Department of the Treasury for an issue under IRC Section 148 over the sum of the rebate amount for the issue as of the most recent computation date and all amounts that are otherwise required to be paid under Section 148 as of the date the recovery is requested. The request can be made by the conduit issuer completing and filing [Form 8038-R, Request for Recovery of Overpayments Under Arbitrage Rebate Provisions](#), with the IRS.

Record Retention Requirements: IRC Section 6001 and Treas. Reg. Section 1.6001-1(a) generally provide that any person subject to income tax, or any person required to file a return of information with respect to income, must keep books and records sufficient to establish the amount of gross income, deductions, credits or other matters that must be shown on a return. This includes Form 8038 series and other returns filed by the conduit issuer with respect to a bond issue.

IRS Examination of Conduit Issues: The the conduit issuer, and not the conduit borrower, is treated as the “taxpayer” in IRS examinations of tax-exempt bonds, including conduit bonds. This means that the conduit issuer will receive the letter initiating the examination and must be a party to any closing agreement resolving an IRS examination. IRS procedures generally define the “issuer” as “the state or political subdivision or entity that issues bonds on behalf of a state or local government.”

Requesting Voluntary Closing Agreements: The [TEB Voluntary Closing Agreement Program](#) (TEB VCAP) is described in [Notice 2008-31, 2008-11 I.R.B. 592](#). This program provides remedies for issuers, including conduit issuers, who voluntarily come forward to resolve a violation that cannot be self-corrected under programs described in the Treas. Regs. or other published guidance. Closing agreement terms and amounts may vary according to the degree of violation as well as the facts and circumstances surrounding the violation. This notice and [Internal Revenue Manual \(IRM\) Section 7.2.3](#) provide that the conduit issuer must request and execute a voluntary closing agreement.

Requesting Private Letter Rulings: [Revenue Procedure 2019-1](#) (updated annually) and Revenue Procedure 96-16 provide procedures under which an issuer of tax-exempt bonds can request a private letter ruling. Revenue Procedure 96-16 has procedures for “reviewable” private letter ruling requests that under IRC Section 7478 may be reviewed by the U.S. Tax Court and for “nonreviewable” private letter ruling requests that cannot be reviewed by the U.S. Tax Court. Under Section 7478, a conduit issuer may appeal the denial of a reviewable private letter ruling to the U.S. Tax Court. The revenue procedure generally requires that, in the case of a conduit issue, the private letter ruling request must be submitted by the conduit issuer, rather than the conduit borrower.

Certain Procedural Considerations for Conduit Issuers

Conduit issuers may adopt procedures and other options for its conduit bond program to assist them in their tax compliance responsibilities.

A “one size fits all” approach is not workable, due to the various organizational structures of conduit issuers as well as the unique features of different financings. The options below are meant to help conduit issuers develop adequate written procedures to assist them in fulfilling their tax responsibilities for their conduit financings.

Procedures for Closing and Pre-Closing Matters: The chart below identifies certain types of monitoring procedures a conduit issuer may adopt to ensure compliance with the federal tax rules that must be satisfied at or prior to the closing of the bond transaction.

Procedure	Description of Procedures for Closing and Pre-Closing Matters	Responsibilities Described Above
Volume Cap	Procedures to monitor use of volume cap, including carryforward elections	Volume Cap Limit Carryforward of Unused Volume Cap
Public Approval	Procedures on public hearings conducted by the issuer and any approvals by the issuer	Public Approval Requirement
Issuer Fees	Procedures to ensure that issuer fees do not exceed IRC and Treas. Reg. limits	Limitations on Fees Charged by the Conduit Issuer
Closing Certifications	Due diligence procedures to ensure that certifications are reasonable	Certification on Expectations for Use and Investment of Proceeds
Official Intent	Procedures to ensure that reimbursement resolutions meet the Treas. Reg. requirements	Reimbursement Declarations of Official Intent
Qualified Hedge	Procedures to timely identify qualified hedges	Qualified Hedge
Elections	Procedures for federal income tax elections	Elections

Designation of Officials to Assist with Certain Actions: Other than the statutory requirement that an “applicable elected representative” must provide public approval, the provisions of the IRC, Treas. Reg. or other guidance do not specifically provide that particular officials of a conduit issuer have specific tax compliance responsibilities. However, as discussed in the first part of this publication, the Treas. Reg. and other guidance require that a conduit issuer must be involved in a number of different actions including: (1) responding to an IRS examination of the bond issue; (2) submitting a voluntary closing agreement request to the IRS; (3) implementing a “remedial action” upon the change of use of bond-financed property, including, where necessary, filing a Form 8038 and filing a notice of defeasance; and (4) executing a “hedge identification” permitting an interest rate swap or other interest rate hedge to be taken into account in determining bond yield.

A conduit issuer should consider whether to designate one or more officials, to be responsible for assisting in these actions. Conduit issuers may also consider requiring a conduit borrower to identify a particular official or officials to assist the conduit issuer in these actions.

Post-Issuance Compliance Monitoring: A conduit issuer may adopt written post-issuance monitoring procedures to ensure the continuous compliance of its bond issues with federal tax requirements. In formulating its procedures a conduit issuer may consider:

- Designating conduit issuer officials to assist in post-issuance compliance;
- Requiring conduit borrowers to identify officials responsible for assisting the issuer with post-issuance compliance monitoring;
- Providing training or other technical support to designated officials of the conduit issuer and the conduit borrower;
- Requiring the conduit borrower to demonstrate that it has adopted written post-issuance compliance monitoring procedures before the approval of a bond issue;
- Designating time intervals within which the conduit issuer and conduit borrower will complete compliance monitoring activities;
- Timely completing remedial actions to correct (including VCAP requests) or otherwise resolve identified noncompliance; and
- Requiring conduit borrowers to notify the conduit issuer of the completion of post-issuance compliance monitoring activities.

Record Retention: A conduit issuer may adopt written procedures to maintain adequate records to support the tax compliance of its bond issues. In formulating its procedures, a conduit issuer may consider:

- Designating which types of records the conduit issuer must retain and which types of records, if any, the conduit borrower will retain; and
- Designating the manner in which the records will be retained, including back-ups of any electronic records.

Procedures for Post-Closing Matters: The chart below identifies certain types of compliance monitoring and record retention procedures a conduit issuer may adopt to ensure compliance with the federal tax rules required to be satisfied after the issuance of the bonds.

Procedure	Description of Procedures for Closing and Post-Closing Matters	Responsibilities Described Above
Information Return Filing	Procedures to ensure timely filing of information returns, including procedures for amended and late filed returns	Information Filing Requirements Late Filing of Information Returns
Change in Use of Proceeds or Financed Facilities	Procedures to timely identify and remediate deliberate actions	Deliberate Actions Remedial Actions
Reissuance	Procedures to satisfy tax requirements when a modification in terms results in a reissuance for federal income tax purposes	Bond Modifications
Elections	Procedures for timely federal income tax elections	Elections
Arbitrage Compliance	Procedures for the timely computation and payment of arbitrage rebate and yield reduction payments	Arbitrage Rebate Requirements/ Yield Reduction Payments
Record Retention	Procedures for the maintenance of records.	Record Retention Requirements
IRS Contacts	Procedures for compliance check questionnaires, examinations, VCAP and private letter rulings.	IRS Examination of Conduit Issues Requesting Voluntary Closing Agreements Requesting Private Letter Rulings Designation of Officials to Assist with Certain Actions

Certain Tax Credit Bonds

The tax compliance responsibilities discussed above generally apply to conduit issuers of certain other types of tax-advantaged obligations including tax credit bonds issued under IRC Section 54A. The Tax Cuts and Jobs Act (2017) repealed the authority to issue tax-credit bonds. The repeal applies to the authority to issue new clean renewable energy bonds, qualified energy conservation bonds, qualified zone academy bonds and qualified school construction bonds after December 31, 2017. Conduit issuers of tax credit bonds issued prior to January 1, 2018, were required to file [Form 8038-TC, Information Return for Tax Credit Bonds and Specified Tax Credit Bonds](#). As such, given the similarity of applicable tax requirements, conduit issuers of tax credit bonds should also consider adoption of written post-issuance monitoring procedures to assist them in their tax compliance responsibilities.

More Information

You can find information about the tax laws that apply to municipal financing arrangements, including tax forms and instructions, revenue procedures and notices, and publications at www.irs.gov/bonds. If you have account-specific questions, you can call Customer Account Services toll-free at 877-829-5500.