



CREATING AN EFFECTIVE POST- BOND ISSUANCE TAX COMPLIANCE PROGRAM

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Welcome & Introductions



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A PRACTICAL GUIDE TO CONDUCTING AN INTERNAL AUDIT OF TAX- EXEMPT BOND COMPLIANCE

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Overview of Presentation

- Relationship of internal audits to general tax-exempt bond policy and procedures
- Identification of goals and approaches
- Selection of bond issues for internal audit
- Steps for conducting an internal audit
- Managing collateral consequences
- Focus on considerations unique to review of tax-exempt bond compliance, not general standards for conducting internal audits

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Initial Considerations

- Establishing a tax-exempt bond compliance program does not necessarily require conducting internal audits of specific bond issues
- Establishing a tax-exempt bond compliance program provides a good framework for an internal audit
- The approach largely depends on identifying the goals to be achieved

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Why Establishing a Tax-Exempt Bond Policy is Helpful

- Provides framework for assembling information (i.e., a “books and records” system)
- Provides framework for assigning responsibilities
- Provides opportunity to “test drive” a new policy and make changes

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Possible Goals of an Internal Audit

- Provide comfort that outstanding bonds comply with tax rules and will survive an IRS audit
- Identify tax problems for voluntary resolution (may get more favorable treatment than in IRS audit)
- Check on reliability of prior compliance procedures
- “Test drive” newly established compliance procedures
- Provide a more certain basis for future actions (e.g., whether an expected change in use requires remedial action; whether outstanding bonds can be refunded)
- Provide a better basis for compliance certifications (e.g., as required under bond indentures)
- Review particular matters that are suspected to be problem areas
- Review particular matters that are known to be the subject of IRS enforcement focus

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Internal Audit and Upcoming IRS Questionnaires on Tax-Exempt Bond Compliance

- Expected focus of IRS compliance check letters is on whether a nonprofit has compliance procedures
- Top priority, in this context, is establishing compliance procedures
- IRS letters may prompt limited internal audits of specific bond issues

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Selecting Bond Issues for Internal Audit

- Bonds issued on or after May 16, 1997 – higher likelihood of IRS examination
- Bonds still eligible for “project completion review” – opportunity to correct problems
- Bonds suspected to have possible compliance problems
- Bonds expected to be refunded – more rigorous due-diligence review
- Bonds with features known to be subject to IRS examination focus

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Selecting Bond Issues for Internal Audit – Bonds Issued after May 1997

- Final private use regulations apply to bonds issued on or after May 16, 1997
- First phase of IRS current enforcement initiative focused on bonds issued in 1998 and 1999
- New refunding regulations require a special review of such bonds, if refunded
- IRS officials have higher expectations for recordkeeping and private use compliance for such bonds

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Selecting Bonds for Internal Audit – Bonds Eligible for “Project Completion Review”

- General rule: up to 18 months after placed-in-service date to determine how proceeds are spent
- Project completion review for such bond issues is a recommended priority in any event

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Selecting Bonds Issues for Internal Audit – Refunding Candidates

- Due diligence review of compliance will be required in any event when bonds are refunded
- Special review required for bonds issued after May 16, 1997

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Selecting Bond Issues for Internal Audit – Suspected Compliance Problems

- Review of private use resulting from a particular arrangement
- Review of use of proceeds at a facility suspected to have substandard compliance practices
- Others

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Selecting Bond Issues for Internal Audit – IRS Enforcement Targets

- In general, current IRS focus on private use
- New initiative on “float contracts” in advance refundings
- Continued initiative on derivatives contracts
- Qualification as a 501(c)(3) organization

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Selecting an Internal Audit Approach – Scope and Level of Detail

- Comprehensive audit – time-consuming and costly
- Sampling approach (e.g., limited to particular facilities or time periods)
- Targeted review of only limited types of compliance (e.g., private use; rebate; fair market value of investments or derivatives)
- Review of procedures

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Conducting an Internal Audit: Timing

- Schedule and timing should consider “worst case” (that a tax problem is discovered)
- Recommend consideration of
 - Timing of future bond issues
 - Required date for “no-default” certifications
 - Required dates for submission of information to financial auditors

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Conducting an Internal Audit: “Replicating” an IRS Audit?

- IRS audits may be comprehensive, sampling or targeted
- IRS “IDRs” (information document requests) provide a model, but the typical process of numerous IDRs can be compressed
- Whether to replicate typical IRS factual drill-down depends on confidence in recordkeeping procedures
- Replicating a comprehensive IRS audit may be costly and time-consuming
- Replicating an IRS sampling or targeted audit, with some streamlining, may be more practical

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Conducting an Internal Audit: Revisit Bond Counsel Positions?

- Usually, the goal of an internal audit will not be to reconsider legal opinions of bond counsel
- Some exceptions: obvious error; responses to new IRS positions or enforcement focus; internal audit standards or requirements
- Possible problems: tax covenants and certificates often do not provide the complete explanation of bond counsel positions

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Conducting an Internal Audit: Assign Oversight Responsibility

- Treasury
- Legal
- Compliance committee
- Internal audit function
- Outside counsel or accountants

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Advantages of Retaining Outside Counsel to Conduct or Supervise an Internal Audit

- Best basis to claim privilege for work product and analysis developed in the review
- Possible conflict issues for financial auditors
- Legal analysis is often required to identify and state the legal framework positions of bond counsel
- Actual experience in handling IRS tax-exempt bond examinations and voluntary closing agreement requests is helpful

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Conducting an Internal Audit: Initial Steps

- Identify the bond “issue”
- Clearly identify and state the purpose of the review
- Assign responsibilities
- Assemble the “books and records” files
- Identify and understand compliance framework provided by the tax covenants and certificates

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Conducting an Internal Audit: Implementing Steps

- Clearly state and explain specific requirements to be reviewed
- Develop initial “IDRs” (information document requests) to commence review
- Develop follow-up “IDRs” as needed

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Conducting an Internal Audit: Statement of Results

- Need to state results with great care because of possible collateral consequences (e.g., disclosure, bond document default)
- Often best to state final results together with a corrective action plan, if needed

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Discovering a Tax Compliance Problem: Options

- Self-help “remedial action” (private use)
- Late rebate payments or yield restriction payments to IRS
- Submission of voluntary closing agreement to the IRS
- Opinion of counsel

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Discovering a Private Use Tax Compliance Problem: Remedial Action

- In general, must be taken quickly after the deliberate action that results in a problem (usually 90 days)
- Three types:
 - Redemption or defeasance of nonqualified bonds
 - Alternative qualifying use of facility
 - Alternative qualifying use of disposition proceeds

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Discovering a Tax Compliance Problem: Bond Document Defaults and Certifications

- Determining whether a technical default exists may require a close reading of bond documents
- May raise concerns for annual “no default” certifications
- Need to avoid technical default may prompt request to IRS for a voluntary closing agreement

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Discovering a Tax Compliance Problem: Securities Law Disclosure Considerations

- Even if not a Rule 15c2-12 “material tax event”, disclosure might be required or advisable
- Materiality determinations are likely to require a quantification of range of possible exposure
- Possible default and cross-defaults may present most serious disclosure issue
- Different possible considerations if bond counsel positions are being reconsidered

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Discovering a Tax Compliance Problem: Financial Statement Considerations

- Auditors likely to ask for a detailed explanation and quantification of range of exposure

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Seeking an IRS Voluntary Closing Agreement: Procedural Considerations

- Governmental issuer involvement is required – may result in disclosure to the public and additional delay
- Sometimes possible to seek private letter ruling first

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Seeking an IRS Voluntary Closing Agreement

- IRS has goal of consistency of settlement terms for similar violations
- Proportionate settlement terms highly likely, but specific terms at IRS discretion
- IRS has goal of making VCAP settlements more favorable than enforcement settlements, but not always the case
- IRS goal of consistency can leave little room to negotiate based on mitigating facts
- Long delays common because of limited IRS staffing
- Usually no opportunity to argue merits

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Presentation Takeaways

- Need to clearly identify goals and approach at outset
- Best to first put in place overall tax-exempt bond compliance policy and procedure
- Recommend up-front and continuing consideration of collateral consequences

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