Tax Compliance Procedures for Tax-Exempt Bonds

Why Does the IRS Want Them and What Should Issuers Do?

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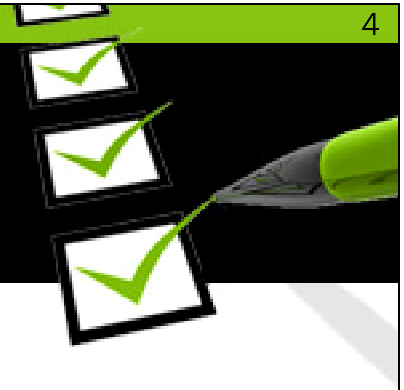

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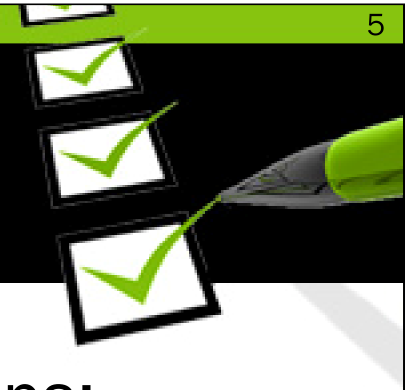
Overview



- Webinar will address the following questions:
  1. What actions is the IRS taking to encourage adoption of tax compliance procedures?
  2. What type of tax compliance procedures are best for a particular issuer?
  3. What are the practical benefits and disadvantages of different approaches to tax compliance procedures?
  4. What policy questions should issuers consider in developing tax compliance procedures?
  5. When are special procedures advisable for certain types of bond issues?
  6. What future IRS actions can be expected?

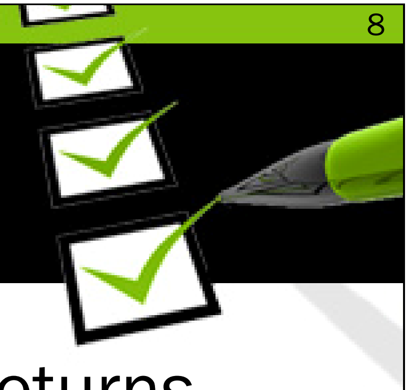
Historical Background: “Snapshot” to “Motion Picture”

- A major theme in the development of tax-exempt bond law in the past several decades has been imposition of requirements that apply over the life of a bond issue (and are not only tested on the date of issuance)
- Examples are the “rebate” requirement (1980s) and the private use rules taking into account post-issuance deliberate actions (1990s)
- Recent IRS administrative actions relating to tax compliance procedures build on this general theme, but generally do not impose new legal requirements

Why Should Issuers Respond?

- The "all-or-nothing" nature of most tax-exempt bond requirements in effect gives the IRS disproportionate negotiating power
- Establishing good faith with the IRS has a number of practical benefits
- The tax rules for tax-exempt bonds are increasingly complex, and the approaches of many issuers have not kept pace with the increased complexity
- Questions and issues not yet raised by the IRS should also be considered

Making Sense of Recent IRS Administrative Actions



- Questions in date of issuance information returns (e.g., Form 8038)
- Form 990 Schedule K
- IRS Internal Revenue Manual procedures
- Compliance check questionnaires
- Statements and questions in IRS examinations
- IRS publication, "Your Responsibilities as an Issuer of Conduit Bonds"
- Postings on the IRS Website relating to tax compliance procedures

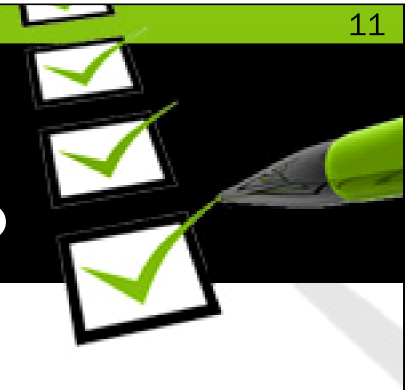
Most Recent IRS Actions Relating to Tax Compliance Procedures are Informational

- Record retention is generally required under the Internal Revenue Code, but application of legal requirements to tax-exempt bond issuers is subject to interpretation
- Information returns (e.g., Forms 8038, Form 990) are required by the Internal Revenue Code, but the IRS has broad discretion over content
- Most IRS actions relating to tax compliance procedures are informational in nature

Best Practices Can Provide Benefits Not Necessarily Raised in IRS Administrative Actions

- Best practices
  - To avoid tax compliance mistakes and oversights
  - To better coordinate date-of-issuance bond documents with ongoing compliance
  - To provide a better, more efficient record for refundings
  - To take advantage of favorable IRS rules
  - To clarify the roles and responsibilities of officers, departments and functions
  - To clarify the roles and responsibilities of outside professionals
  - For 501(c)(3) bonds, to provide better support for information reporting required in Schedule K to Form 990

What Type of Tax Compliance Procedures Should an Issuer Have?



It depends on (1) the goals an issuer identifies for the procedures, (2) the complexity of an issuer's bond issues, (3) whether special legal requirements apply, (4) organizational structure and resources, and (5) cost.

Three Types of Tax Compliance Procedures:

- "Bare Bones" approach
- "Intermediate" approach
- "Best Practices" approach

“Bare Bones” Approach

- Sufficient to allow an issuer or borrower to “check the box” on information return questions
- Components of a “Bare Bones” tax compliance procedure would include procedures:
  - Which meet the requirements of section 148 of the Code
  - Ensure that all nonqualified bonds of an issue are remediated

Section 148 Requirements

- Procedures to monitor the requirements of section 148 (rebate requirement and yield restriction) could reasonably include:
  - FMV
  - Frequency of rebate computations
  - Timing for retention of a rebate consultant
  - Identification of any amounts required to be treated as gross proceeds
  - Identification of any amounts subject to yield restriction
  - Establishing the issue price of bonds
  - Procedures related to swaps, including certifications of professionals
  - Investment of advance refunding escrows and when investments other than SLGS may be used
  - Restrictions/requirements relating to working capital financings

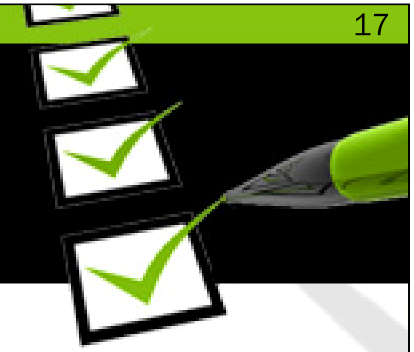
Remediation of Nonqualified Bonds

- Bond-financed property generally may only be used for qualifying purposes and needs to be monitored
- Procedures to ensure that all nonqualified bonds of an issue are remediated may include:
  - A process for identifying the applicable use-of-proceeds limit for the type of bond issue
    - 10 percent for government bonds
    - 5 percent in special circumstances
  - Designation of an official, department or function responsible for monitoring change in use transactions involving bond-financed property
  - Designation of an official, department or function responsible for taking remedial actions if distinct from the responsibility to monitor

Remediation of Nonqualified Bonds (continued)

- Issuers and borrowers should consider, even in the context of a "Bare Bones" approach:
  - Who or what department monitors the requirements of the different types of remedial actions necessary (redemption, defeasance or alternative qualifying use of disposition proceeds)
  - Whether a bond counsel opinion is required
  - Should the issuer or borrower seek VCAP

"Intermediate" Approach

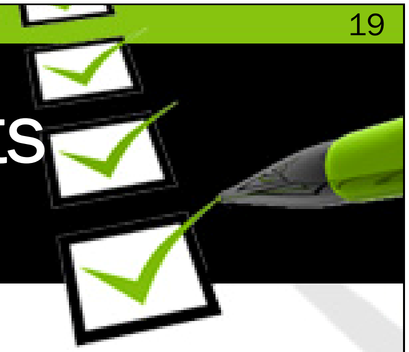


- In order to qualify for favorable treatment under IRS administrative procedures (IRM) tax compliance procedures must:
  - Identify the official(s) responsible for monitoring compliance
  - Describe the training provided to such responsible official(s)
  - Describe the frequency of compliance checks (at least annually)
  - Describe the nature of the compliance activities required to be undertaken
  - Describe the procedures used to timely identify and evaluate the resolution of a violation when it occurs or is expected to occur
  - Contain procedures for the retention of all records material to substantiate compliance with applicable federal tax requirements
  - Evidence an awareness of the availability of VCAP and other remedial actions to resolve violations

Example of Benefit

- In 2005 City issues $100 million of tax-exempt bonds at 4% interest rate at par to finance a building and no other assets
- In 2012 City adopts compliance procedures meeting the IRS Internal Revenue Manual requirements (that is, the "Intermediate" approach)
- On January 1, 2013 City leases 50% of the building to a for-profit corporation for the remaining term
- On January 1, 2014 City discovers the building was bond financed and seeks an IRS voluntary closing agreement
- The settlement will generally be based on "tax exposure" (that is, $1.160 million per year, which is $4 million x 29% for the entire bond issue)
- Tax exposure on the "nonqualified bonds" is about $515,000 per year (that is, $1.160 x 44.4%)
- Adopting "Intermediate" approach compliance procedures would enable the issuer to reduce the settlement amount by at least $515,000

Highlights of the Additional Requirements for the "Intermediate Approach"



- Requirement for compliance checks "at least annually" could be particularly burdensome and costly for some issuers
- Requirement for "training" is not likely as burdensome, but could entail some additional cost
- Record retention procedures may need to be expressly set forth

“Best Practice” Approach

- Accomplishes the goals of both the “Bare Bones” and “Intermediate” approaches
- In addition, allows issuers and borrowers to:
  - Take advantage of favorable IRS rules
  - Better coordinate the roles of participants
  - Provide the best protection against mistakes
  - Less need to revise as IRS takes additional administrative actions (for example, expands the questions asked in information returns)
- Disadvantages:
  - More time-consuming
  - More costly

Comparison of Different Approaches

Procedures	Bare Bones	Intermediate	Best Practice
Identify different "issues" for tax purposes	✓	✓	✓
Arbitrage and rebate	✓	✓	✓
Remedial action/use of financed property	✓	✓	✓
Record retention for the above	✓	✓	✓
Specify responsible officials for the above	✓	✓	✓
Record retention for all requirements		✓	✓
Specify responsible officials for all requirements		✓	✓
At least annual monitoring of use of financed property		✓	✓
Awareness of availability of VCAP		✓	✓
Training		✓	✓
Procedures to track portions of bond-financed projects financed with qualified equity			✓
Bond proceeds spending review/certification			✓
Procedures for reallocation of expenditures			✓
Use of simplifying conventions			✓

- Procedures Covered

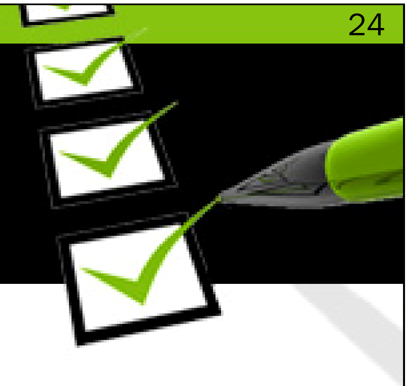
Comparison of Different Approaches

Benefits	Bare Bones — Form 8038, etc.	Intermediate — Favorable voluntary settlements	Best Practice
Respond favorably to Form 8038, etc. — reduce audit risk	✓	✓	✓
Eligible for favorable voluntary resolution settlement terms		✓	✓
Establishing good-faith compliance for possible more favorable treatment in audit	✓	✓	✓
Avoid costly compliance mistakes	✓	✓	✓
Lessen need to complete and update procedures			✓
Clarify roles and responsibilities of bond counsel and other professionals			✓
Take best advantage of favorable rules (e.g., correction of expenditure mistakes)			✓

- Benefits

Policy Considerations Issuers Should Consider in Framing Compliance Procedures

- Policy questions to consider include:
  - At what level should tax compliance procedures be adopted? Board level? By specific officers?
  - Which level of completeness of procedures is best for an organization?
  - Which departments, officers or other functions should be tasked with tax compliance responsibilities?
  - Should tax compliance procedures only apply to future issues or should procedures apply to currently outstanding issues as well?
  - Should tax compliance procedures apply to all types of bond issues or are certain types of issues a more immediate concern?



Procedures that are Particularly Recommended for Consideration

- Project spending review
- Reallocation of bond proceeds
- Documentation of equity contributions to bond-financed projects
- Determination of issue price

Special Procedures for Different Types of Bond Issues

- Special legal requirements for particular types of bond issues may raise the greatest compliance concerns, but are often overlooked
- “Off the rack” compliance procedures may often completely miss covering the key areas that are most likely to raise problems
- Some examples:
  - Long-term working capital financings: commonly contain special covenants to use future surpluses to purchase bonds or take other action
  - Qualified 501(c)(3) Bonds: the requirement of 100 percent qualifying ownership of property is a frequent area of noncompliance
  - Build America Bonds: the 100 percent “capital expenditure” requirement will also likely be a frequent area of noncompliance
  - Tax increment bonds: the requirement that all payments be “taxes of general application” is often the key compliance issue

Seeing Around the Corner: Possible Future Developments

- Extension of the Form 990 Schedule K approach (detailed annual reporting) to other types of bonds, particularly Build America Bonds and other "direct-pay" bonds
- Expansion of tax compliance questions in date of issuance information returns
- IRS actions to provide additional favorable treatment for issuers that adopt compliance procedures (for example, record retention relief)

Takeaways

- How procedures are framed by an issuer will depend on the facts specific to that issuer, including particularly the type of bonds, size and nature of the issuer, and policy decisions about approach
- Issuers generally can choose among three levels of approaches:
  - "Bare Bones"
  - "Intermediate"
  - "Best Practices"

Future Webinars in Our Tax Compliance Series

- Completing the Form 990 Schedule K – this webinar will consider the "nuts and bolts" of responding to particular questions and also consider how Schedule K reporting relates to a borrowers ongoing financings

Questions & Answers

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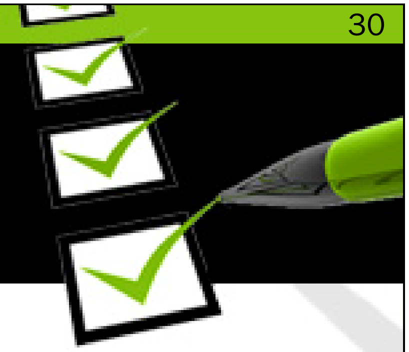
Thank You!



- A copy of the white paper, “Tax Compliance Procedures for Tax-Exempt Bonds: Why Does the IRS Want Them and What Should Issuers Do?” can be found using the following link: http://www.foley.com/tax-compliance-procedures-for-tax-exempt-bonds-why-does-the-irs-want-them-and-what-should-issuers-do-11-21-2012/
  - Bound copies of this white paper are available upon request
- A copy of the PowerPoint presentation and a multimedia recording will be available on the event Website early next week: http://www.foley.com/tax-compliance-procedures-for-tax-exempt-bonds-why-does-the-irs-want-them-and-what-should-issuers-do/
- CLE questions? Contact Ellie Kemmeter at ekemmeter@foley.com
- We welcome your feedback. Please take a few moments before you leave the Web conference today to provide us with your feedback: https://www.surveymonkey.com/s/55DWMRD

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