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# Tax Compliance Procedures for Tax-Exempt Bonds: Why Does the IRS Want Them and What Should Issuers Do?

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# Tax Compliance Procedures for Tax-Exempt Bonds: Why Does the IRS Want Them and What Should Issuers Do?

In recent years, the IRS has taken actions to encourage issuers and borrowers of tax-exempt bonds and tax credit bonds to adopt and implement tax compliance procedures. This article discusses those actions and how issuers and borrowers can respond to them.

The references in this article to “tax-exempt bonds” are generally intended to apply to tax credit bonds (such as Build America Bonds), except as otherwise indicated.

## Summary

The IRS has strongly encouraged issuers and borrowers of tax-exempt bonds to adopt tax compliance procedures by means of questions on information returns, compliance check questionnaires and examinations, statements in its internal manual and its Web site, public speeches by IRS officials, and other means. Although the IRS has not asserted that issuers and borrowers are required to adopt such procedures, there are reasons why issuers and borrowers should do so.

The reasons for adopting compliance procedures include enabling an issuer or borrower to:

- » Report in IRS information returns that it has adopted procedures, thereby reducing the risk of IRS examination
- » Qualify for more favorable settlement terms with the IRS in resolving tax compliance problems, particularly in IRS voluntary resolution programs
- » Possibly receive more favorable settlement terms in IRS examinations
- » Avoid mistakes that lead to failure to comply
- » Best take advantage of favorable IRS rules

Adopting procedures that are based on an “off the rack” model form may be a viable approach for some issuers and borrowers, but for many such an approach will not be useful. The federal income tax requirements for tax-exempt bonds are complicated, and tax-exempt bond issues vary widely in their structure and complexity, so that developing and following procedures that address each technical requirement in detail may be unduly costly and cumbersome. Accordingly, an issuer or borrower is best served by giving careful thought to what objectives it seeks to achieve by adopting procedures and what compliance issues most merit attention. Indeed, often the tax requirements that are most likely to be overlooked are the requirements that uniquely apply to only certain types of bond issues.

The approaches for an issuer or borrower to consider range from “bare bones” procedures that meet only minimal objectives (for example, enabling an issuer or



borrower to respond favorably to questions on information returns) to a “best practice” approach that meets all five objectives described above (including taking best advantage of favorable IRS rules).

Most likely, the IRS will take additional actions relating to tax-exempt bond compliance procedures in the upcoming years. Accordingly, procedures that are narrowly tailored only to respond to current IRS actions are likely to require revision. More complete, “best practice” procedures are less likely to require frequent revision in response to new IRS initiatives.

The following favorable IRS rules merit particular consideration for inclusion in tax-exempt bond compliance procedures:

- » Rules providing flexibility for how bond proceeds are treated as spent (that is, rules permitting reallocation of bond proceeds within certain time periods)
- » Rules providing for favorable treatment for projects that are financed in part with bond proceeds and in part with other cash

### Summary of Key Points

- » How procedures are framed by an issuer or borrower will depend on facts specific to that issuer or borrower, including particularly the type of bonds issued, the size and nature of the issuer or borrower, and the policy decisions made in framing the procedures
- » Even though a “one size fits all” approach is not readily workable, a number of important points apply to all issuers and borrowers
- » Issuers and borrowers generally must choose among three levels of completeness in framing procedures:
  - 1) A “bare bones” approach sufficient to report in IRS information returns, including particularly Form 8038 and Form 8038-G, that procedures have been adopted
  - 2) An “intermediate” approach sufficient to qualify for favorable treatment under current IRS

procedures, including particularly procedures for voluntary resolution of compliance problems

- 3) A “best practices” approach that meets additional goals, including anticipating future IRS actions and taking best advantage of favorable IRS rules.

This article discusses factors to consider in choosing which approach to follow, including the following.

- » Procedures concerning recordkeeping should be considered as an essential part of any procedures, in part because the IRS has particularly emphasized the importance of recordkeeping and in part because recordkeeping is generally the only element of procedures that may be specifically required by law.
- » IRS actions relating to tax compliance procedures have been developing and changing, and it is highly likely that the IRS will continue to take new actions, including further revisions of information return forms and IRS Internal Revenue Manual provisions. Accordingly, issuers and borrowers should contemplate the need for future updating of procedures.
- » Recent IRS actions relating to tax compliance procedures have been particularly informed by reports of the IRS Advisory Committee on Tax Exempt and Government Entities. The committee’s reports are posted on the IRS Web site and provide informative background information.

This article focuses mostly on tax compliance procedures for governmental tax-exempt bonds. Other types of tax-exempt bonds have special eligibility requirements that require corresponding special tax compliance procedures. Most of the general themes discussed in this article, however, apply to all types of tax-exempt bonds.

### IRS Actions to Encourage Tax Compliance Procedures

IRS has taken many different actions to encourage issuers and borrowers to adopt tax compliance procedures. One challenge issuers face is sorting through the different “messages” from the IRS to the



tax-exempt bond community and determining how to respond.

This article first summarizes the various actions that the IRS has taken.

In general, the eligibility rules for tax-exempt bonds take into account not only the reasonable expectations and actions of the issuer or borrower on the date of issuance of bonds, but also actions subsequent to the date of issuance of bonds. Actions that need to be taken after the date of issuance relating to investment of bond proceeds may include an obligation to pay certain investment profits to the IRS (the rebate requirement) and the obligation to restrict the yield on investments in certain cases. Actions that need to be taken after the date of issuance relating to use of bond proceeds include assuring that bond proceeds are used for proper expenditures and that, if there is a change of use of bond-financed property, a proper remedial action is taken.

### QUESTIONS IN INFORMATION RETURNS

This year the IRS has added questions to its tax-exempt bond information returns specifically concerning tax compliance procedures.

In recent years the IRS has revised its information returns in a number of respects to serve purposes other than just information-gathering. The Form 8038-G is the information return that all issuers of governmental bonds are generally required to file with the IRS in connection with the issuance of tax-exempt bonds. The Form 8038-G was revised in April 2012 to add the following two questions:

**Line 43.** If the issuer has adopted written procedures to ensure that all nonqualified bonds of this issue are remediated according to the requirements under the Code and regulations . . . , check box.

**Line 44.** If the issuer has adopted written procedures to monitor the requirements of section 148, check box.

The information return form for Build America Bonds (Form 8038-B) contains almost identical questions

(see Part VII, lines 8 and 9). The form for tax credit bonds (Form 8038-TC) contains substantially similar questions (see Part VII, lines 1d and 4).

The Form 8038, which concerns qualified private activity bonds, contains exactly the same tax compliance questions as the Form 8038-G (see lines 43 and 44). Because the Form 8038 concerns bond issues that are in most (but not all) cases conduit bonds, in which the governmental issuer is the conduit issuer, these same questions have a somewhat different meaning in practice than in the Form 8038-G. In most instances, the conduit borrower of such bond issuers will be in control of the expenditure and investment of proceeds and the use of financed property. The IRS has indicated, however, that the questions in the Form 8038 relating to tax compliance procedures are intended to directly refer to procedures of the governmental conduit issuer, rather than to procedures of the conduit borrower. Accordingly, in the context of Form 8038, the questions relating to tax compliance procedures in most cases in practice refer to whether the conduit issuer has adopted and implemented procedures that in turn require the conduit borrower to adopt and implement procedures.

### IRS INTERNAL REVENUE MANUAL PROCEDURES

In August 2011, the IRS added significant new provisions to the sections of the Internal Revenue Manual relating to standards for settlements for requests for closing agreements by issuers under the IRS voluntary closing agreement program (“VCAP”). One particularly important new provision is set forth below (set forth in Internal Revenue Manual 7.2.3.4.4), which states that an issuer that has adopted written post-issuance compliance procedures can be eligible for more favorable settlement terms.

Qualifying for this more favorable treatment can result in substantially lower settlement amount payments to resolve a violation. In most of the types of violations covered by the settlement standards stated in the Internal Revenue Manual, the IRS uses the tax exposure on nonqualified bonds as the starting point to determine the settlement amount. The “nonqualified bonds” are those in the portion of a bond issue that is



noncompliant. The “tax exposure” is the amount the IRS estimates it could have collected in income tax on the interest on the nonqualified bonds. One key input to the computation is the period of time used to determine tax exposure. Many of the IRS settlement standards provide that this period begins on the date the failure to comply occurred. The new provision in the Internal Revenue Manual, however, permits an issuer to determine the settlement amount based on the period beginning on the date “the issuer discovered the violation or should have discovered the violation,” which in many cases can be many years after the date a violation actually occurred. In many cases, this favorable treatment could result in a settlement payment that could be much less than the settlement payment otherwise required.

*CERTAIN MODIFICATIONS TO RESOLUTION STANDARDS BASED ON TIMING OF DISCOVERY OF VIOLATION*

- » If the requirements of paragraph (2) of this section . . . are satisfied, a [specified] resolution standard . . . that is applied by reference to a period of time after the date of the violation shall be modified so that the resolution standard is applied by reference to a period of time after the earlier of the date the issuer discovered the violation or the date the issuer should have discovered the violation.
- » The requirements of this paragraph are satisfied if the issuer had, prior to the date of the violation, adopted written procedures to ensure that its tax-advantaged bonds remain in compliance with all post-issuance related federal tax requirements that are conditions to the tax-advantaged status of the bonds. The requirements of this paragraph are also satisfied when such post-issuance compliance procedures are implemented after the date of the violation if the issuer both timely identifies the violation following implementation of such procedures and submits its . . . VCAP request no later than 90 days after identification.
- » Such procedures must, at a minimum, specify the official(s) with responsibility for monitoring compliance, a description of the training provided

to such responsible official(s) with regard to monitoring compliance, the frequency of compliance checks (must be at least annually), the nature of the compliance activities required to be undertaken, the procedures used to timely identify and elevate the resolution of a violation when it occurs or is expected to occur, procedures for the retention of all records material to substantiate compliance with the applicable federal tax requirements, and an awareness of the availability of . . . VCAP and other remedial actions to resolve violations. Generally, a reference to reliance on the bond documents, without more, will not qualify as written procedures that satisfy this paragraph.

- » For purposes of applying this paragraph in resolving a violation with respect to a specific bond issue, such procedures only need to ensure compliance with the post-issuance related federal tax requirements applicable to that bond issue.

Notably, this provision does not require that an issuer must have adopted written compliance procedures for all its different types of bond to be eligible for the favorable treatment; rather, the issuer must have adopted only procedures that apply to the particular bond issue that is the subject of the request. For example, if an issuer submits a voluntary closing agreement with respect to a general obligation bond issue, it could be eligible for favorable treatment even if it had established written compliance procedures only for its general obligation bond issues and not for other types of bond issues (such as revenue bonds).

The provisions of the Internal Revenue Manual that set forth procedural requirements for requesting a voluntary closing agreement expressly require that an issuer describe its written compliance procedures in detail, and indicate that appropriate procedures will be a favorable equitable factor in determining settlement terms:

The issuer must include with the request an affirmative or negative statement as to whether it has adopted comprehensive written procedures intended to promote post-issuance compliance with, and to prevent violations of, the provisions of the



Code related to tax-advantaged bonds. The issuer must also include a detailed description of the portion of such comprehensive procedures which relate to the violation which is the subject of the . . . VCAP request. The description of such written procedures should identify the authorized person(s) that adopted the procedures, the officer(s) with responsibility for monitoring compliance, the frequency of compliance check activities, the nature of the compliance check activities undertaken, and the date such procedures were originally adopted and subsequently updated (if applicable). The extent to which an issuer has appropriate written compliance procedures will be an equitable factor that will receive consideration in determining appropriate resolution terms with respect to VCAP requests.

As a formal matter, provisions of the Internal Revenue Manual are not binding on either the IRS or on taxpayers. Nonetheless, these provisions are particularly significant because they are express statements in IRS procedures that issuers that have adopted written compliance procedures will be afforded more favorable treatment than those that do not.

#### **POSTINGS ON THE IRS WEB SITE RELATING TO TAX COMPLIANCE PROCEDURES**

The IRS Web site currently contains a page titled “TEB Post-Issuance Compliance: Some Basic Concepts” that promotes the adoption of post-issuance compliance procedures. See <http://www.irs.gov/taxexemptbond>. The posting generally states that the “on-going nature of post-issuance compliance requirements applicable to tax-advantaged bonds requires issuers to actively monitor compliance throughout the entire period their bonds remain outstanding.” The posting then sets forth the following detailed statement about the content of the post-issuance compliance procedures that issuers should adopt:

Issuers should adopt written procedures, applicable to all bond issues, which go beyond reliance on tax certificates included in bond documents provided at closing. Sole reliance on the closing bond documents may result in procedures insufficiently detailed or not

incorporated into an issuer’s operations. Written procedures should contain certain key characteristics, including making provision for:

- » Due diligence review at regular intervals
- » Identifying the official or employee responsible for review
- » Training of the responsible official/employee
- » Retention of adequate records to substantiate compliance (e.g., records relating to expenditure of proceeds)
- » Procedures reasonably expected to timely identify noncompliance
- » Procedures ensuring that the issuer will take steps to timely correct noncompliance

The goal of establishing and following written procedures is to identify and resolve noncompliance, on a timely basis, to preserve the preferential status of tax-advantaged bonds. Generally, an issuer that has established and followed comprehensive written procedures to promote post-issuance compliance is less likely, than an issuer that does not have such procedures, to violate the federal tax requirements related to its bonds.

The key elements of tax compliance procedures identified by the IRS in this Web site posting are substantially the same as the key elements identified in the Internal Revenue Manual provision discussed above.

#### **COMPLIANCE CHECK QUESTIONNAIRES**

Since 2007, the IRS has sent a number of different compliance check questionnaires to issuers and borrowers of tax-exempt and other tax-advantaged bonds asking questions relating to compliance procedures. It is reasonable to conclude that the purposes of the IRS in these programs included not only gathering information about the practices and procedures of issuer and borrowers, but also sending a message to issuers and borrowers that adoption of written procedures is a good practice.



The following table provides a summary of recent IRS compliance check programs focusing on tax compliance procedures of issuers and borrowers of tax-exempt bonds.

TABLE 1				
Type of Issuer or Borrower	Year	Number of Questionnaires Sent	IRS Form Number	Follow-Up Report
Report Issuers of Qualified School Construction Bonds	2012	111	Online form	Not yet
Issuers of Advance Refunding Bonds	2011	269 (Governmental Issuers) 31 (501(c)(3) Organization Borrowers)	Form 14246	Not yet
Issuers of Direct-Pay Build America Bonds	2010	375	Form 14127	Treasury Inspector General for Tax Administration Report dated June 3, 2011
Issuers of Governmental Bonds	2007	200	Form 14002	Final IRS Report dated July 1, 2011
Section 501(c)(3) Borrowers of Qualified 501(c)(3) Bonds	2007	207	Form 13907	Final IRS Report dated July 1, 2011

In general, each of these compliance check questionnaires has focused mostly on the record retention procedures and practices of issuers and borrowers. The compliance check questionnaires also, however, ask specific questions about the written tax

compliance procedures of issuers and borrowers and, most recently, questions about the date such procedures were adopted.

The questions asked vary in a manner that reflects the different specific eligibility requirements for different types of bond issues. For example, the Advance Refunding Bonds Questionnaire asks specific questions about the types of investments in advance refunding escrows that are not relevant to other types of bond issues.

In part because the questions asked in these compliance check questionnaires have been evolving as the IRS has more experience with them, it is reasonable in developing compliance procedures to consider with particular care the questions asked in the more recent compliance check questionnaires.

One notable theme is that each of the Qualified School Construction Bonds Questionnaire, Advance Refunding Bonds Questionnaire, and Build America Bonds Questionnaire asks detailed questions about whether the issuer has adopted specific procedures to determine the issue price of bonds.

#### STATEMENTS AND QUESTIONS IN IRS EXAMINATIONS

The IRS has increasingly adopted the practice of asking express questions about an issuer's tax compliance policies in the course of IRS examinations of tax-exempt bonds. For example, a form of an information document request for Build America Bonds released in 2009 and posted on the IRS Web site asks for the following information:

Provide a copy of any written procedures that the issuer has in place to ensure the Bonds' compliance with Federal tax requirements and include the date written procedures for such purpose were adopted and the dates of subsequent revisions, if any. If the issuer has no such written procedures, provide a description of any guidelines the issuer uses to ensure the Bonds' compliance with Federal tax requirements including the source from which those guidelines were derived.



## **PUBLICATION ON “YOUR RESPONSIBILITIES AS AN ISSUER OF CONDUIT BONDS”**

In April 2012, the IRS released a publication called “*Your Role as a Conduit Issuer of Tax-Exempt Bonds*” (Publication 5005). This publication, among other things, describes in detail the types of tax compliance procedures that a governmental issuer of tax-exempt conduit bonds may consider adopting. Many of these procedures concern clarifying the tax compliance responsibilities of the conduit issuer and the conduit borrower.

In other publications concerning tax-exempt bonds the IRS makes similar statements about the importance of compliance procedures. For example, the “*Tax Exempt Governmental Bonds Compliance Guide*” says, “The IRS encourages issuers and beneficiaries of tax-exempt bonds to implement procedures that will enable them to adequately safeguard against post-issuance violations that result in loss of tax-exempt status of their bonds.” Future IRS publications on tax-advantaged bonds can be expected to contain more detailed statements regarding tax compliance procedures.

## **FORM 990 SCHEDULE K**

For exempt organization borrowers of qualified 501(c)(3) bonds, the most significant action that the IRS has taken has been the addition of Schedule K to Form 990 beginning in 2009. Schedule K concerns supplemental information on tax-exempt bonds and asks detailed questions in five parts dealing with general descriptive information about bond issues, use of proceeds, private business use, arbitrage, and procedures to undertake corrective action. Particularly notable are questions regarding whether the organization has “adopted management practices and procedures to ensure the post-issuance compliance of its tax-exempt bond liabilities” and “to ensure that violations of federal tax requirements are timely identified and corrected through the voluntary closing agreement program if self-remediation is not available under applicable regulations.”

Certain particularly important tax compliance issues relating to compliance procedures for qualified

501(c)(3) bonds are discussed below. A detailed discussion of Schedule K of the Form 990, however, is beyond the scope of this article.

## **Reasons for Adoption of Tax Compliance Procedures**

One important point is that neither the Internal Revenue Code nor any formal published guidance of the IRS requires issuers or borrowers to adopt and implement tax compliance procedures. The Code does in general require taxpayers to maintain certain records sufficient to establish tax compliance, and certain specific provisions of the federal tax regulations concerning tax-exempt bonds refer to limited record retention practices to qualify for favorable treatment. The IRS has not, however, provided any other formal guidance regarding how recordkeeping requirements apply to issuers and borrowers of tax-exempt bonds, and there is considerable uncertainty regarding the exact extent of any legal obligation imposed by the Code.

Accordingly, it may be emphasized that all IRS actions described above are essentially informational in nature. That is, these actions are not binding on issuers and borrowers and are not formal published guidance of the IRS.

If tax compliance procedures are generally not required by the Code or regulations (other than possibly certain record retention practices), why should issuers and borrowers consider adopting them? The answer is in large part informed by the relative power of the IRS in examinations of tax-exempt bonds.

In general, the Code provides that the rules for qualification of an issue of tax-exempt bonds follow an “all or nothing” approach — under the literal wording of the Code, a bond issue is either 100 percent compliant or 100 percent noncompliant. That is, even a minor violation of the requirements of the Code can cause a bond issue to completely fail to qualify. For example, if the Code requires that no more than five percent of the proceeds of a bond issue may be used for certain “bad” purposes, use of six percent of the proceeds for “bad” purposes can cause 100 percent of the interest



on the bonds to be taxable under the literal wording of the law. As a practical matter, the IRS typically endeavors to resolve cases on a basis at least roughly proportionate to the degree of the violation, but it is not required to do so under current law. This “all or nothing” rule as a practical matter typically means that, in any tax compliance dispute, there is a large imbalance of power between the IRS, on the one hand, and issuers and borrowers, on the other hand. In addition, issuers and borrowers may also have concerns about damaging their reputation in the investing public.

Accordingly, it is often very difficult, as a practical matter, for an issuer or borrower to contest an adverse position taken by the IRS. For these reasons, it is often of great importance for an issuer or borrower to be able to convince the IRS that it has taken good faith steps to comply.

There are a number of reasons for an issuer or borrower to adopt and implement tax compliance procedures beyond becoming eligible for more favorable treatment in administrative dealings with the IRS, however. They include the following:

- » Avoidance of tax compliance mistakes and oversights
- » Better coordinating date-of-issuance bond documents with ongoing compliance
- » Providing a better and more efficient record for refundings
- » Taking best advantage of favorable IRS rules
- » Clarifying the roles and responsibilities of officers, departments, and functions within the issuer or borrower
- » Clarifying the roles and responsibilities of outside professionals, such as issuer’s counsel, bond counsel, and financial advisers

In the case of qualified 501(c)(3) bonds, another important purpose is to provide a better foundation for

the detailed information reporting required by Schedule K of the Form 990.

### Identification of Issues for Federal Tax Purposes

The federal income tax requirements for tax-exempt bonds generally apply separately to each issue of bonds. An “issue” for this purposes is defined in a particular manner under the applicable tax regulations and may not be the same as an issue for State law or other purposes. For example, it is not uncommon for an issuer to issue fixed-rate bonds and variable-rate bonds on the same date that are treated as separate issues for federal tax purposes.

Because the unit of compliance is each separate issue, the starting point for any tax compliance procedures is to identify each issue for this purpose. This basic point is commonly overlooked and not well understood by issuers and borrowers.

In addition, the tax regulations generally permit an issuer to break a single issue into separate pieces for purposes of certain requirements. For example, an issuer may do so by making a separate issue election on or before the date of issuance or by making a multipurpose allocation before or after the date of issuance. Having procedures in place to keep track of any such actions accordingly should be part of the foundation of tax compliance procedures.

### Discussion of Different General Approaches

#### THE “BARE BONES” APPROACH — SUFFICIENT ONLY TO RESPOND TO INFORMATION RETURN QUESTIONS

As is discussed above, the Form 8038-G, Form 8038, and similar information return forms currently ask only certain limited questions regarding tax compliance procedures. The questions in Form 8038-G concern only written procedures (1) “to monitor the requirements of section 148” and (2) “to ensure that all nonqualified bonds of [the] issue are remediated in accordance with the Code and the regulations.”

Accordingly, the “bare bones” approach for issuers and borrowers is to adopt procedures that address only these two requirements.



The IRS does not provide significant helpful guidance regarding the exact scope of procedures to meet these two requirements, although the instructions to the information return forms provide limited further explanation.

The “requirements of section 148,” mentioned in the return form, are the restrictions on investments of gross proceeds of bonds (that is, the rebate and yield restriction requirements). Presumably, procedures adequate to respond favorably to this question should at a minimum (1) refer expressly to both the rebate requirement and the yield restriction requirement and (2) designate an official, department, or function responsible for compliance with these requirements.

It may be noted, however, that procedures to “monitor the requirements of section 148” reasonably could include, among other things, specific procedures relating to (1) establishing that investments are purchased and sold at fair market value; (2) the frequency of rebate computations; (3) the timing for retention of a rebate consultant; (4) the identification of any amounts that may be required to be treated as gross proceeds of the bonds, particularly if not held in the funds and accounts under the bond documents; (5) the identification of any amounts that may be subject to the yield restriction requirement; (6) establishing the issue price of bonds; (7) procedures relating to interest rate swaps, including certifications of professionals; (8) the investment of advance refunding escrows, and the circumstances under which investments other than U.S. Treasury Securities — State and Local Government Series may be used; and (9) special restrictions and requirements relating to working capital financings. Presumably, a “bare bones” approach would not need to include procedures specifically addressing each of these points, although an issuer may wish to consider all these points even in adopting “bare bones” procedures.

The requirement “to ensure that all nonqualified bonds of [the] issue are remediated” generally refers to the restrictions regarding use of bond-financed property for governmental or exempt purposes. In the case of governmental bonds, this requirement generally refers to the rule that a deliberate action taken after the date

of issuance with respect to bond-financed property (for example, a sale, lease, or noncompliant service contract) can result in noncompliance with the use-of-proceeds restrictions. Presumably, procedures to favorably respond to this question should at a minimum (1) identify the applicable use-of-proceeds limit for the type of bond issue (for example, the general 10 percent private business use limit that applies to governmental bonds, and the five percent limits that apply in special circumstances); (2) designate an official, department, or function responsible for monitoring change of use transactions involving bond-financed property; and (3) designate an official, department, or function responsible for evaluating the need for, and taking, remedial actions, if different from the responsibility to monitor changes of use.

It may be noted, however, that procedures “to ensure that all nonqualified bonds of [the] issue are remediated” reasonably could include, among other things, specific procedures relating to (1) the detailed requirements and responsibilities for the different types of remedial action (particularly redemption or defeasance of nonqualified bonds and alternative qualifying use of disposition proceeds); (2) whether a bond counsel opinion or other review is required to take a remedial action; and (3) seeking a voluntary closing agreement with the IRS in the event that a remedial action is not taken on a timely basis. Again, presumably a “bare bones” approach would not need to include procedures specifically addressing each of these points, although an issuer may wish to consider all of these points even in adopting “bare bones” procedures.

#### **THE “INTERMEDIATE” APPROACH — SUFFICIENT TO QUALIFY FOR FAVORABLE TREATMENT UNDER INTERNAL REVENUE MANUAL PROCEDURES**

As is discussed above, the Internal Revenue Manual states that an issuer will be eligible for more favorable treatment in a voluntary compliance resolution request if it has adopted procedures that include at least the following core elements:



- 1) Identification of the official(s) with responsibility for monitoring compliance
- 2) A description of the training provided to such responsible official(s) with regard to monitoring compliance
- 3) A description of the frequency of compliance checks (must be at least annually)
- 4) A description of the nature of the compliance activities required to be undertaken
- 5) A description of the procedures used to timely identify and elevate the resolution of a violation when it occurs or is expected to occur
- 6) Procedures for the retention of all records material to substantiate compliance with the applicable federal tax requirements
- 7) An awareness of the availability of . . . VCAP and other remedial actions to resolve violations

These required elements include procedures not referenced in the questions relating to compliance policies in the Form 8038 and similar information returns. Among other things, these required elements appear to refer to procedures that address all tax-exempt bond rules, and not only the rules relating to investments and use of proceeds. For example, these required elements presumably include procedures relating to restrictions on expenditures and bond maturity limitations (to the extent applicable).

The requirements listed in elements No. 5 (identifying a violation) and perhaps also No. 7 (awareness of VCAP) appear to overlap with the question in the Form 8038-G relating to remedial actions. The requirements listed in elements No. 2 (training) and No. 3 (at least annual compliance monitoring) are not expressly referenced in the Form 8038-G questions.

Of the additional requirements for favorable treatment, the requirement that is likely most potentially burdensome is the requirement for at least annual compliance monitoring. The wording of the provision in the Internal Revenue Manual is not clear whether this annual monitoring requirement applies to all tax-

exempt bond requirements (for example, including expenditure and arbitrage restrictions as well as private business use restrictions) or can be applied only to private business use restrictions. It is possible that procedures requiring at least annual monitoring only with respect to use of bond-financed property would meet the requirement for favorable treatment, at least with respect to noncompliance with the use-of-proceeds resulting from a change of use.

Meeting the requirement of at least annual compliance monitoring could be particularly burdensome for many state and local government issuers. For 501(c)(3) organization borrowers of tax-exempt bonds, the annual monitoring requirement may be less burdensome, because such borrowers are also generally required to provide tax compliance information on an annual basis in Schedule K of Form 990.

TABLE 2			
Comparison of Different Approaches — Procedures Covered			
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		✓	✓



TABLE 2 CONTINUED

Comparison of Different Approaches — Procedures Covered			
Procedures	Bare Bones	Intermediate	Best Practice
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			✓

**THE “BEST PRACTICE” APPROACH**

As is discussed above, IRS statements and actions regarding tax compliance procedures continue to develop and change. A “best practice” approach is to develop comprehensive tax compliance policies that not only cover all matters discussed above, but also accomplish other goals, including taking best advantage of favorable IRS rules, better coordinating the roles of participants, and providing the best protections against mistakes.

One disadvantage of “best practice” tax compliance procedures is that they may be more time-consuming and costly to develop and follow than procedures developed under the more limited approaches discussed above.

One particularly important favorable rule in the regulations permits issuers and borrowers to correct or otherwise change how bond proceeds are spent for a period of time after financed projects are placed in service (generally, 18 months). This rule, which is discussed in more detail below, is often not used to its best advantage by issuers and borrowers. In addition, bond documents often contain completion certificate requirements that do not mesh well with the flexibility afforded by the tax regulations. “Best practice” tax compliance procedures will generally include a “bond proceeds spending review” process that makes best use of this favorable rule.

Another particularly important favorable rule generally permits nonqualified uses to be treated as being associated with portions of a project that are financed with cash (so-called “qualified equity”) that is not derived from tax-exempt bond proceeds. This rule in practice can provide a much greater permitted amount of nonqualified use. In order to take advantage of this favorable treatment, however, an issuer or borrower needs to document and maintain records of equity contributions to bond-financed projects. “Best practice” tax compliance procedures will generally include a process to plan for and document such equity contributions, as well as the use of bond proceeds.



TABLE 3

Comparison of Different Approaches — Benefits

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)			✓

**Discussion of Possible Future IRS Actions**

IRS initiatives relating to tax-exempt bond compliance procedures have been developing and changing in recent years, and there is every reason to believe they will continue to develop and change. Although consideration of future actions of the IRS is of course speculative, the following is a discussion of certain actions the IRS is likely to consider.

**REVISIONS AND ADDITIONAL QUESTIONS REGARDING TAX COMPLIANCE IN INFORMATION RETURN FORMS**

The questions contained in the Form 8038-G (and similar date-of-issue tax-advantaged bond information returns) relating to compliance procedures are limited and do not clearly and completely address all relevant tax requirements. It is possible that, in the future, the questions asked by the IRS in these information return forms will be significantly revised and expanded.

In this regard, it should be noted that the internal process for revising forms within the IRS is much more streamlined than the process for revising regulations or other published guidance. For that reason, the adoption of procedures that slavishly respond to the particular wording of the questions in the current versions of these forms are likely to require updating in the future.

**ADDITION OF QUESTIONS RELATING TO TAX COMPLIANCE PROCEDURES IN TAX CREDIT BOND INFORMATION RETURNS**

The IRS may believe that it lacks clear authority, or decline as a matter of policy, to require issuers of tax-exempt bonds to submit information returns (such as Form 8038-G) periodically after the date of issuance of bonds, other than in connection with a payment of rebate (Form 8038-T). Direct-pay tax credit bonds (such as Build America Bonds), however, generally require the filing of returns in order to receive direct payments relating to interest payments periodically over the life of a bond issue.

The current Form 8038-CP (which relates to Build America Bonds and other direct-pay tax credit bonds) currently contains no express questions relating to tax compliance procedures. The instructions to Form 8038-CP say, however, “This return is to be filed only if, as of the date filed, the issuer of the outstanding obligations for which this return is being submitted has reasonably concluded that the obligations meet all of the applicable requirements for the payment of the requested credit.” The instructions do not elaborate what steps an issuer must take to “reasonably conclude” that a bond issue remains compliant, but



this statement may imply that the IRS generally expects that issuers executing the Form 8038-CP will follow reasonable post-issuance compliance procedures.

It is possible that the IRS views the required periodic filing of Form 8038-CP as an opportunity to emphasize the importance of post-issuance compliance. The IRS may in the future consider significantly expanding the Form 8038-CP to include express questions relating to tax compliance procedures and actual post-information information relating to the bond issue. For example, the IRS may consider adding to the Form 8038-CP express questions relating to the actual expenditures of bond proceeds and actual amount of private business use of financed property in a manner comparable to the questions asked in Schedule K of Form 990.

**REVISIONS TO IRS INTERNAL REVENUE MANUAL PROVISIONS PROVIDING ADDITIONAL FAVORABLE TREATMENT TO ISSUERS AND BORROWERS THAT ADOPT AND IMPLEMENT TAX COMPLIANCE PROCEDURES**

Particularly because the IRS has demonstrated a keen interest in encouraging issuers and borrowers to adopt tax compliance procedures, it is likely that the IRS will consider additional measures to provide incentives to issuers and borrowers to do so. For example, future revisions to the Internal Revenue Manual could provide record retention relief to issuers and borrowers that adopt certain tax compliance policies. The 2009 Report of the Advisory Committee on Tax Exempt and Government Entities set forth a detailed recommendation that the IRS should consider providing such record retention relief, and other favorable treatment, to issuers and borrowers that have adopted such procedures. The senior managers in the IRS Tax Exempt Bond program indicated that these proposals for favorable treatment merit serious consideration.

In addition, it is possible that the IRS will revise the Internal Revenue Manual to provide for additional favorable terms for voluntary resolution of compliance problems for issuers and borrowers that have adopted certain tax compliance procedures.

**Discussion of Policy Questions for Issuer and Borrowers**

The first step in developing a tax compliance policy should be to resolve basic policy questions about the approach that should be taken. The following is a list of important policy questions. This list is not intended to be comprehensive, and in particular does not address many questions that pertain only to particular types of bond issues.

**GENERAL QUESTIONS REGARDING APPROACH**

- » At what level should tax compliance procedures be adopted? Should tax compliance procedures be adopted by the governing board, or only by officers with designated responsibilities?
- » Should the tax compliance procedures follow (1) the “bare bones” approach (sufficient only for information return questions); (2) the “intermediate approach” (also allows for favorable treatment under current IRS procedures); or (3) the “best practice” approach (also provides more protection against mistakes, takes advantage of favorable IRS rules, and anticipates future IRS actions)?
- » If a decision is made to follow the “bare bones” or “intermediate” approach, should the issuer or borrower adopt a plan to further complete the tax compliance procedures in phases?
- » Which departments, officers, or other functions should be assigned tax compliance responsibilities?
- » Should the tax compliance procedures apply only to future bond issues or also to currently outstanding bond issues? If the procedures will apply to currently outstanding bond issues, (1) will bonds issued before particular dates be excluded and (2) will only portions of the procedures apply to outstanding bond issues?
- » Should the tax compliance procedures initially apply only to certain types of bond issues? (For example, should procedures for general obligation bonds be developed before other procedures?)



### **RECORD RETENTION**

- » What general record retention period should be stated in the tax compliance procedures?
- » What departments, officers, or other functions should be assigned record retention responsibilities for different categories of records?

### **INVESTMENT OF BOND PROCEEDS – ARBITRAGE AND REBATE**

- » What departments, officers, or other functions should be assigned responsibilities for rules relating to investment of bond proceeds?
- » Should the tax compliance procedures require retention of a rebate consultant prior to issuance of bonds?
- » Should the tax compliance procedures require rebate determinations to be made more frequently than as required (for example, on an annual basis rather than only for each five-year period)?
- » Should the specific procedures be adopted to ensure that investments are acquired and sold at fair market value? (For example, should the tax compliance procedures require that any guaranteed investment contract meet the “three-bid” safe harbor set forth in the IRS regulations, except in special circumstances?)
- » Should specific procedures be adopted concerning the investments in advance refunding and other defeasance escrows? (For example, should the tax compliance procedures require such investments to be U.S. Treasury Securities – State and Local Series, except in special circumstances?)
- » Should procedures be adopted to specifically identify any amounts deemed to be gross proceeds of a bond issue that are not held in a fund or account established under the bond documents (for example, to identify any amounts treated as pledged funds or sinking funds that are not held in the funds or accounts established under the indenture or resolution for the bond issue)?

### **EXPENDITURE OF BOND PROCEEDS**

- » What departments, officers, or other functions should be assigned responsibilities for rules relating to expenditures of bond proceeds?
- » Should procedures be adopted to screen for any expenditures that are not capital expenditures (that is, to restrict or closely monitor any working capital expenditures)?
- » Should procedures be adopted to provide for a bond proceeds spending review or project completion review for each new money bond issue?
- » Should bond document procedures for completion certificates be revised to better coordinate with the federal tax rules?

### **RESTRICTIONS ON USE OF FINANCED PROPERTY, INCLUDING PROCEDURES FOR CHANGE OF USE AND REMEDIAL ACTIONS**

- » Which department, officer, or function should be assigned responsibility to identify and evaluate possible changes of use of bond-financed property?
- » What is the best approach to identify possible changes of use before they occur (for example, checklists between departments)?
- » Should the tax compliance procedures generally encourage or require the use of simplifying conservative conventions? (For example, should procedures generally require compliance with the private business use restrictions on an annual basis, rather than over the life of a bond-financed asset, absent special review?)
- » Should a remedial action generally require an opinion of counsel?

### **TRAINING**

- » Which officers, departments, or functions should receive training?
- » Should some officers, departments, or functions received only limited training for matters within their responsibility?



- » How frequently should training programs be conducted?
- » Should training programs be presented in-house or by outside professionals?

## Special Procedures to Consider — All Bond Issues

### PROJECT SPENDING REVIEW

The federal tax regulations contain a favorable rule that permits an issuer or borrower to correct or change how bond proceeds are spent if action is taken on a timely basis. Both the federal tax regulations dealing with arbitrage and dealing with use of proceeds of governmental bonds provide that an issuer must account for the allocation of bond proceeds to expenditures not later than the date the expenditure is paid or the date the project, if any, that is financed is placed in service. This allocation must be made by the date the first rebate payment could be due (that is, 60 days after the fifth anniversary of the date of issuance or the date 60 days after the retirement of all bonds of the issue, if earlier).

Procedures making best use of this favorable rule are an important part of best practice tax procedures. Under this rule, an issuer or borrower is not necessarily bound by initial requisitions of bond proceeds but rather has an opportunity to correct any mistaken expenditures and to choose the best expenditures to finance. A project completion review or bond proceeds spending review is useful to provide the best framework for the ongoing compliance of a bond issue.

This rule is referenced in a question in Part II of Schedule K of the Form 990 (“Has the final allocation of bond proceeds been made?”), but the importance and usefulness of the rule is not explained by the IRS.

To make best use of this rule, consideration should be given to how it meshes with state law requirements and completion certificate requirements that are often set forth in bond indentures. A “best practice” approach is to frame any bond indenture completion certificate requirements in a manner that accommodates the flexibility afforded by the federal tax rule. If bond document provisions are not framed in

this manner, a “best practice” tax compliance procedure will generally set forth how a change in how bond proceeds are spent for tax purposes meshes with bond document and state law requirements.

In addition, to make best use of this favorable rule, a “best practice” procedure will set forth exactly how a change in how bond proceeds are spent (that is, a “reallocation of bond proceeds”) works as a practical matter, as is set forth below.

### PROCEDURES FOR REALLOCATION OF BOND PROCEEDS

Although the idea of reallocating bond proceeds is straightforward, in practice the process of changing how bond proceeds are spent may require steps that may not be obvious. In particular, it is important that bond proceeds be accounted for from the date of issuance until the date of expenditure. Accordingly, a “best practice” procedure will set forth the accounting framework for how a reallocation of bond proceeds works.

A simple example can illustrate the point. Suppose an issuer spends \$1 million of bond proceeds on Project A on July 1, 2012. On February 1, 2013, the issuer reviews its expenditures and determines that the expenditure on Project A was not proper and desires instead to spend the bond proceeds on Project B. The issuer used “qualified equity” (meaning cash other than bond proceeds) to pay for Project B on December 1, 2012. Provided that the expenditure on Project B is permitted under the bond documents and the new allocation is timely, the reallocation should be permitted under the tax regulations. The issuer should also account, however, for how the bond proceeds were deemed to be held and invested from the period of July 1, 2012 to December 1, 2012. A reasonable approach is to identify the fund or account of the issuer that would in the ordinary course hold funds pending use for such a capital expenditure (for example, a general revenue fund). A “best practice” approach for tax compliance procedures is to specifically identify the fund or account of the issuer that will be deemed to hold bond proceeds in the event that a reallocation results in delay in expenditures.



### **PROCEDURES FOR DOCUMENTING EQUITY CONTRIBUTIONS TO BOND-FINANCED PROJECTS**

Proposed regulations published by the IRS permit an issuer or borrower to associate the portion of a project used for a private business use with the portion that is financed with “qualified equity” (that is, cash not derived from tax-exempt financing), provided that certain conditions are met. The prevailing view of bond counsel is that qualified equity may be allocated to noncompliant use, although different bond counsel may have different positions on the details of how this rule works in practice, particularly because final regulations have not yet been published.

As a general example, suppose an issuer desires to bond-finance a \$10 million, 10-story building, and eight of the stories will be used for its governmental purposes, but the issuer expects that two stories will be leased to private corporations. In most cases the issuer may finance \$8 million of the cost of the building with bond proceeds and \$2 million with qualified equity. The bond issue may be treated as having no private business use.

The proposed IRS regulations generally would permit such an approach but strongly emphasize that the benefit of an equity contribution is only available to an issuer if the issuer carefully documents the equity contribution and how the allocation of the equity to private business use is intended to work.

A detailed discussion of the proposed regulations is beyond the scope of this article. In light of the general approach of the proposed regulations, however, “best practice” tax compliance procedures relating to equity contributions will address the following:

- » Record retention procedures for equity contributions
- » Procedures to identify the project or projects that are in part financed with tax-exempt bond proceeds and in part financed with qualified equity
- » Procedures to identify how the equity contribution is allocated to a project (that is, whether to a discrete portion of a project or to an undivided portion of a project)

Tax compliance procedures that address how equity contributions are to be documented and used may need to be revised when the IRS publishes final “allocation and accounting” regulations addressing this question.

### **PROCEDURES FOR DETERMINING ISSUE PRICE**

In recent years, IRS officials have repeatedly indicated that it is important for issuers and borrowers to carefully determine the issue price of their bonds. For example, the recent Qualified School Construction Bonds Questionnaire, discussed above, asks whether an issuer has procedures for determining issue price and the following specific questions:

- » Are records of trading activity for your [bonds] available through the Municipal Securities Rulemaking Board’s Electronic Municipal Market Access System (EMMA)?
- » Did you or a consultant to the issuer (NOT the underwriter or initial purchaser) review the records of the trading activity for your [bonds]?
- » Did you receive a written analysis of trading activity for your [bonds]?
- » Did the written analysis of trading activity for your [bonds] include an analysis of the pricing?

Similar questions are asked in the IRS Direct Pay Bonds Compliance Check Questionnaire and Advance Refunding Bonds Compliance Check Questionnaire.

The apparent message of these questions is that the IRS believes that it is at least a best practice for issuers and borrowers to review actual pricing information, or to retain a professional that is not a principal in the bond transaction to review actual pricing information, to determine the issue price of bonds.

A detailed technical discussion and explanation of the issue price rules is beyond the scope of this article. By way of general background, however, the issue price of a bond is the amount the issuer is deemed to receive from the sale of the bond, including any compensation that the issuer is deemed to pay an underwriter or placement agent. Thus, one way of looking at the issue



price of bonds is that it is a way to determine the amount an underwriter or a placement agent is deemed to be paid.

The tax rules for publicly offered bonds are somewhat more favorable to tax-exempt bond issuers than the rules for bonds that are not publicly offered. In the case of publicly offered bonds, the issue price is determined based on reasonable expectations as of the date the bonds are sold (rather than the date the bonds are actually issued). Historically, issuers have relied largely on certifications provided by underwriters, placement agents, and purchasers that match the technical requirements of the tax regulations to determine issue price. The IRS has increasingly questioned whether relying solely on such certifications is a reasonable practice.

IRS officials have indicated that new guidance on determining issue price may be published soon. When such guidance is published, it may provide safe harbors or other rules that will serve to frame tax compliance procedures. Until such guidance is published, however, the options available to an issuer for procedures to determine issue price including the following:

- » Procedures relating to the wording of issue price certifications provided by underwriters, placement agents, and purchasers
- » Procedures requiring comparison, by the issuer or a fiduciary professional (such as a financial advisor), of actual pricing information available on EMMA to issue price certifications
- » Procedures requiring a financial advisor to review issue price certifications and provide certifications that it is reasonable for the issuer to rely on those issue price certifications
- » Procedures requiring an issuer to follow all, or certain of, the best practices to determine issue price released by the Government Finance Officers Association
- » Whether certain types of bonds should be identified for the most rigorous issue price procedures

The determination of issue price may be of critical importance for certain bond issues. For example, an advance refunding bond may depend on a precise determination of issue price if the advance refunding escrow is invested near the bond yield; a precise issue price determination may be particularly important for a tax credit bond (such as a Build America Bond) that is not permitted under the Internal Revenue Code sold at a substantial premium. In some other types of bond issues, issue price will be relevant to tax compliance but not as critically important.

### Special Procedures to Consider — Specific Types of Bond Issues

Different eligibility requirements and rules apply to the many different types of tax-exempt bonds and tax credit bonds. Accordingly, tax compliance procedures generally need to be tailored to address the specific different rules that apply to different types of bond issues. As is discussed above, this article focuses on general rules and approaches that span all types of tax-exempt bonds and tax credit bonds and also focuses on the rules that generally apply to governmental bonds. The following is not intended to be a comprehensive discussion of all the special rules for different types of bond issues that are relevant to tax compliance procedures but rather is intended to highlight particularly important considerations. One approach for issuers to consider is to adopt additional special “modules” to a general tax compliance policy if the issuer will issue, or has issued, certain special types of bond issues.

#### **SPECIAL PROCEDURES FOR GOVERNMENTAL BONDS**

Even within the broad category of governmental bonds, different types of bond issues are subject to significantly different specific rules that merit consideration in tax compliance policies. The following is a list of certain different types of governmental bonds and certain of the special rules that apply to them that in particular may merit consideration in developing tax compliance procedures:



TABLE 4

Type of Governmental Bond Issue	Special Rules to Consider
Public Power	Output contract private business use rules Special \$15 million limitation on "nonqualified bonds"
Water and Sewer	Output contract private business use
Tax Increment Bonds	Rules restricting "impermissible agreements" relating to taxes of general application Monitoring payments from private persons receiving bond proceeds
Special Assessment Bonds and Other "Dirt Bonds" Secured by Real Estate Special Taxes	Essential governmental purpose requirement for financed projects Equal basis requirement for assessments
Long-Term Working Capital Bonds	Special bond document covenants to use surplus amounts to redeem bonds or for other designated purposes
Build America Bonds	100% capital expenditure requirement Prohibitions on substantial bond premium Procedures intended to avoid purchase of bonds by the issuer or an entity that could be treated as part of the issuer
Pooled Financing Bonds	Special origination requirements Special arbitrage requirements

**SPECIAL PROCEDURES FOR BUILD AMERICA BONDS**

A number of special eligibility requirements apply to Build America Bonds and other special tax credit bonds, and in particular to direct-pay Build America

Bonds (with respect to which the issuer receives direct cash payments from the United States). Although the authority to issue new Build America Bonds expired at the end of 2010, tax compliance procedures are of course appropriate for the period Build America Bonds will remain outstanding. In addition, the need to make periodic filings to the IRS in order to receive direct payments increases the value of procedures that provide support of tax compliance that when each filing is made.

One special rule for direct-pay Build America Bonds is the requirement that 100 percent of the bond proceeds (other than amounts used to pay costs of issuance and to fund a reasonably required reserve fund) be used for capital expenditures. For certain types of expenditures, determining whether to properly classify the expenditure as a capital expenditure for federal tax purposes can be difficult. The absence of any IRS guidance providing relief for *de minimis* failure to comply as a practical matter increases the need for careful monitoring of expenditure of proceeds. An express procedure for this capital expenditure requirement is accordingly a best practice.

Another special rule for direct-pay Build America Bonds prohibits issuing Build America Bonds at a substantial premium. Accordingly, procedures relating to the determination of issue price, discussed above, may be a particular best practice for direct-pay Build America Bonds.

Perhaps the most important consideration for special tax compliance procedures for Build America Bonds, however, concerns the possibility that the purchase of a Build America Bond by the issuer, or an entity that is treated as part of the issuer, could cause the Build America Bond to be extinguished for federal tax purposes. In such a case, the result could be that the issuer could lose its right to receive cash payments from the United States with respect to that Build America Bond. The IRS has released voluntary dispute resolution standards in its Internal Revenue Manual that permit an issuer in a possible extinguishment situation to enter into a voluntary closing agreement to preserve the right to receive at least future direct payments. The IRS has not, however, provided



interpretive guidance addressing the particular circumstances of when such an extinguishment or merger could occur. IRS officials have informally suggested that, at least under certain circumstances, the purchase of Build America Bonds by a State pension fund might result in extinguishment if those bonds were issued by the same State. In light of the many and varied ways state and local governments are organized and constituted, developing such guidance could be a difficult task for the IRS. In any event, a best practice approach is to consider procedures that are intended to avoid, as much as reasonably possible, purchases that could result in disqualification to receive direct payments.

It should be emphasized that tax compliance procedures about extinguishment are qualitatively different than other types of tax compliance procedures for tax-exempt and tax credit bonds, because such procedures would need to apply not only to the department or office of a State or local government actually responsible for the issuance of the Build America Bonds but also to all other departments or other entities that could be treated as part of the issuer.

### **SPECIAL PROCEDURES FOR LONG-TERM WORKING CAPITAL FINANCINGS**

In recent years, a large number of state and local governments have issued long-term tax-exempt bonds to finance working capital deficits, either directly or indirectly. The federal income tax regulations concerning investments generally indicate that long-term working capital financings raise potential compliance issues but do not indicate with specificity how these financings need to be structured. To respond to these regulations, the prevailing practice of bond counsel is to require the issuer to enter into special tax covenants that are generally not seen in other types of financings. For example, one common approach is that the bond documents require the issuer to annually identify whether a surplus amount exists (for example, at the beginning of the fiscal year) and to apply those surplus amounts to particular permitted purposes (for example, redemption or purchase of bonds of that issue, redemption or

purchase of other working capital tax-exempt bonds of the issuer, or investment in other tax-exempt bonds).

One important point is that, because there is no specific IRS authority on how to properly structure tax-compliant long-term working capital bonds, different bond counsel frame the special tax covenants in a variety of different ways.

### **SPECIAL PROCEDURES FOR QUALIFIED PRIVATE ACTIVITY BONDS**

The Code permits a number of different categories of tax-exempt bonds to be issued for the benefit of entities other than State or local governments. In general, these so-called “qualified private activity bonds” include qualified 501(c)(3) bonds, exempt facility bonds (such as bonds to finance airports, docks and wharves, facilities for furnishing water, sewerage facilities, solid waste disposal facilities, and other designated facilities), qualified mortgage bonds to finance single-family housing (including veterans housing), student loan bonds, and small issue bonds for manufacturing facilities. These categories of bonds are each subject to special requirements. In general, most types of qualified private activity bonds are subject to special requirements that do not generally apply to governmental bonds. These special rules include but are not limited to the following:

- » The bonds must receive special public approval after noticed public hearing
- » In most cases, the weighted average maturity of the bonds must not exceed 120 percent of the reasonably expected economic life of the financed property
- » Not more than two percent of proceeds may be used to pay issuance costs
- » Proceeds not used for a reasonably required reserve fund or issuance costs must be used for specified purposes, subject to small *de minimis* exception
- » In many cases, use of bond proceeds to acquire existing property is not permitted



» In many cases, use of bond proceeds to acquire land is restricted

A complete discussion of all specific tax compliance procedures that may be appropriate for different categories of qualified 501(c)(3) bonds is beyond the scope of this article. In general, however, best practice tax compliance procedures will address all special requirements set forth above.

### **SPECIAL PROCEDURES FOR BONDS ISSUED FOR THE BENEFIT OF 501(C)(3) ORGANIZATIONS (QUALIFIED 501(C)(3) BONDS)**

The IRS has emphasized the need for tax compliance procedures for bonds that benefit 501(c)(3) organizations than for any other category of tax-exempt bonds. In part, this emphasis is reflected in Schedule K to Form 990, which requires detailed tax compliance reporting for bonds issued after the year 2002. Also, the first IRS compliance check initiative dealing with tax compliance procedures was targeted at 501(c)(3) organization borrowers, and it appears that a disproportionately high number of IRS tax-exempt bond examinations and voluntary closing agreements have concerned qualified 501(c)(3) bonds.

Because 501(c)(3) organization borrowers, such as health care organizations, educational organizations, and cultural institutions, are often large and sophisticated, the tax issues relating to their tax-exempt financings often tend to be complex. Also, many 501(c)(3) organizations, particularly health care organizations, finance facilities that involve extensive use by private business. In addition, large 501(c)(3) organizations are often in the vanguard of using new and sophisticated financing structures and techniques.

The federal tax requirements that apply to qualified 501(c)(3) bonds are unique, because they are a blend of the rules that apply to governmental bonds and to other types of qualified private activity bonds.

For all the foregoing reasons, tax compliance procedures for qualified 501(c)(3) bonds merit special discussion. A complete discussion of all of the considerations for such tax compliance procedures is

beyond the scope of this article, but a number of particularly important points are highlighted below.

The additional tax requirements that apply to qualified 501(c)(3) bonds that do not apply to governmental bonds include the following:

- » 100 percent of the bond-financed property must be owned by a 501(c)(3) organization or a State or local government
- » Unrelated trade or business use is treated as noncompliant use
- » The bonds must receive special public approval after noticed public hearing
- » In most cases, the weighted average maturity of the bonds must not exceed 120 percent of the reasonably expected economic life of the financed property
- » Not more than two percent of proceeds may be used to pay issuance costs
- » The amount of certain nonhospital bonds may not exceed \$150 million

The requirement that 100 percent of the property financed with a bond issue must be owned by a 501(c)(3) organization or a state or local government is, as a practical matter, a compliance issue that merits close attention in developing tax compliance procedures for 501(c)(3) organizations. This requirement is particularly difficult to monitor, because the IRS permits no *de minimis* exception (that is, the five percent nonqualified use that is permitted for other types of private business use does not apply).

The rule that unrelated trade or business use is treated as nonqualified use also merits close attention in developing tax compliance procedures. This requirement is difficult to monitor in part because noncompliant use can result from the nature of an activity and not only from the terms of a contract.

The \$150 million limitation on nonhospital bonds treated as allocated to any 501(c)(3) organization (and



its related parties) was partially repealed in 1997 but still remains a consideration for certain large 501(c)(3) organizations.

Another requirement that is often a particular compliance focus for certain qualified 501(c)(3) bond issues is the rule that certain donations specifically pledged to the financed project, and other pledged amounts, may need to be taken into account in sizing a bond issue and may need to be treated as gross proceeds subject to investment restrictions. This issue is not uncommonly the most important tax compliance issue for certain bonds for cultural institutions that receive a considerable amount of pledged donations. For those types of borrowers, tax compliance procedures relating to the treatment of pledged donations may be particularly important.

Tax compliance procedures developed for 501(c)(3) organizations should take into account the detailed annual tax compliance reporting required by Schedule K to Form 990. As is indicated above, however, there appears to be a significant possibility that the questions asked by Schedule K will continue to change in future years. Accordingly, there is probably more reason for 501(c)(3) organizations to consider adopting and implementing “best practice” tax compliance procedures than other types of issuers and borrowers of tax-exempt bonds.

Although the questions asked in the Schedule K are extremely detailed, and include a number of questions that have questionable purpose, it may be noted that they do not address many of the substantive requirements that are most difficult to monitor, as is set forth in the following table:

TABLE 5			
Tax Rule	Covered by Schedule K	Not Covered by Schedule K	Comments
100 percent ownership requirement for financed property		✓	Part III, line 1 refers only to ownership by a partnership or LLC, but not by other entities
Private business use by contracts	✓		
Unrelated trade or business use treated as private use	✓		Schedule K requires separate reporting of private use that results from unrelated trade or business use
Bond maturity limitation (120 percent of weighted average economic life of financed property)		✓	Not addressed in any manner, but bond issues are not uncommonly near the limit
\$150 million limit on nonhospital bonds		✓	A possible concern mostly for large 501(c)(3) organization borrowers
All financed property described in public approval		✓	Not addressed in any manner, but sometimes difficult to monitor for system financings
Existence of pledged funds and sinking funds		✓	Certain aggregate gross proceeds are required to be reported, but not pledged funds separately

