A Taxing DILEMMA

A new IRS compliance initiative may affect nearly 50,000 issuers with $3 trillion in tax-exempt bonds

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Casually sorting through your business mail, you stop and stare at the "Official Business" white envelope. It is addressed to you as the executive and official representative for your employer and is from The United States Treasury, Department of Internal Revenue Service, Tax Exempt and Government Entities Division.

Opening it, the cover letter reads:

"Re: Examination of 200x Revenue Bonds. Dear Sir or Madam: We have selected the debt issuance named above for examination. The Internal Revenue Service (IRS) routinely examines municipal debt issuance to determine compliance with Federal tax requirements."

In short, one or more series of your organization's tax advantaged bond portfolio is being audited.

Attached to the cover letter is a multiple-page IRS Form 4564, Information Document Request (IDR) which lists 35 different items to be provided as part of the examination and is due to the IRS examining agent within 30 days. The letter goes on to say that your organization has the right to designate a representative to act on your behalf by completing IRS Form 2848, Power of Attorney and Declaration of Representative, if you so desire. Additionally, the IRS, as part of this examination, may need to contact third parties, including but not limited to bond and special tax counsels, trustees, GIC providers, underwriters and employees.

As you set the letter down, one thing is for sure: Your calendar just changed—dramatically.

False sense of security

For a little history, tax-exempt bonds (TEBs) have, for decades, been a source of low cost financing for road and bridge infrastructure across our nation, hospitals, as well as schools or universities, public utilities, stadiums, and a whole host of other projects which provided a public benefit. You may have heard them called: Governmental, 501(c)(3) Bonds, Environmental Enhancement, other Qualified Private Activity, Recovery Zone, as well as newer Tax Credit, BABs, CREBs or similar names.

The bond issuer provides detailed information about its organization and the purpose of the bond offering through the official statement; the tax exempt bonds are typically sold through a public market transaction whereby the bond purchasers receive interest on these bonds, which is not subject to taxation by the IRS, the transaction is finalized and the proceeds are disbursed to the issuer, usually repaid over a period lasting up to 30 years or longer, if refinanced. As long as the bonds retain their qualifying tax-exempt status, interest income earned by the bondholders is not subject to federal, and in many cases, state and/or local income taxation.

Many issuers have been lulled into a false sense of security and simply relied on their tax certificates within their transcripts or believed that records retention policies will cover them in the event of an IRS audit. This, unfortunately, is simply not the case.

Since 2001, the IRS has focused extensive time and effort auditing governmental and qualifying non-profit bonds.

In 2010 alone, the following bonds were issued:

and ultimately the bondholders of those bonds. The IRS collected over $200 million between FY2009 and FY2011 as a result of its TEB examination process.

Why were these findings and penalties assessed? Perhaps because a well-organized post-issuance compliance program is not in place.

Record-Keeping Obligations. When tax-advantaged bonds are issued, as part of the official statement and bond transcripts, the issuer attests that they, or their designee, will maintain, for the life of the subject bonds outstanding (including any refinancing), plus three years, the following:

- Transcripts of the proceedings
- Trustee statements for construction, reserve and debt service funds
- Records of how proceeds were used to demonstrate adequate "good use" of the bonds
  - Invoices and checks showing the qualifying expenditures
  - Costs of issuance detail
  - Contracts
  - Debt service schedule, including interest income and interest expense activity during the construction period
  - Sale or change of use of bond financed assets while bonds are outstanding.
- Arbitrage rebate calculations, yield restriction or exception reports
- GICs, credit enhancements or other such agreements related to the bonds

Total Tax Exempt, Taxable Direct Payments and Tax Credit Bonds, 2010
(Value in millions of dollars)

	Number	Value	Percent
Total	29,315	$556,890	100%
Tax Exempt	25,660	$420,679	75.5%
Taxable Direct Payment	3,456	$135,127	24.3%
Tax Credit Bonds	199	$1,084	0.2%

Source: IRS, Statistics of Income Division, November 2012

In 2010, the IRS scheduled 700 audits of various Issuers but ended up with over 1,500 audits closing during that period. It was estimated that 40 percent of audits had reportable problems that could result in a voluntary closing agreement (VCAP) or a "change in status" determination which could affect the tax exempt status of the bonds,

- Private business use (PBU) analysis – on an ongoing basis
  - Management or service contracts (cafeteria, bookstore, parking, etc.)
  - Retail or unrelated business use (Solar panels, renting gym or classrooms, etc. if not related to exempt mission of the issuer or if with a non-qualified party)

- Research or sponsored projects contracts or agreements
- Other contracts or agreements with non-related parties which could give rise to PBU
- Cumulative PBU calculations

- Written post-issuance compliance program and procedures, describing recordkeeping, frequency of review, compliance training and individual(s) responsible for managing the program
- Filing of Schedule K with Form 990, if applicable
- Continuing disclosure reporting requirements are met (SEC Rule 15c2-12)
- Possibly other items as determined by specific agreements within your transcripts.

Conduit Bonds—An Added Layer of Complexity. Say you are a state, health facility or a special utility district issuing on behalf of other entities which will ultimately use the proceeds. The conduit issuer issues the bonds, then distributes the proceeds to the conduit borrower(s) in accordance with the transcripts. The conduit borrower repays the loan to the issuer who, in turn, pays the bondholders. This can get really interesting for older bonds or for conduit offerings where the proceeds were disbursed to distinctly separate recipients within the same bond series under audit. Ultimately, the IRS will send the IDR to the issuer of the bonds, but the issuer will likely look to each conduit borrower for the details to support their portion of the tax exempt bonds. The IRS looks at compliance of the bonds in totality, so it is crucial that each borrower proactively monitors use so that one significant problem does not taint the entire series of bonds.

Be Proactive in our Downsized, Post-Recession Environment. Companies must do more with less and adding the review and documentation of sometimes complicated (and older) bond deals where detailed records could be scattered or missing, accounting systems have changed or the bonds have been refinanced one or more times may not rise above other fires currently burning.

As a practitioner who has "been there, done that" but also been unlucky enough to open four IDR Letters (one conduit issuer, one conduit borrower and two issuer bonds) since 2007, I have the following insights:

- As part of their new PIC internal controls review initiative, TEB agents in an August webinar stated that issuers are "checking the box" on their Form 8038s and Schedule K's, attesting they have written compliance procedures in place. Agents believe there may be significant gaps in following those procedures.
- If you don't have adequate records compiled when you get an IDR, can you demonstrate compliance in 30 days?
- The IRS rotates audits by sectors—501(c)(3)s, hospitals, utilities and is focusing on hot spots like research and PBU.
- For bonds issued before 2002, the IRS may be more understanding of certain missing records such as original invoices, bank statements, etc. For newer bonds, you need records.
- If it is a refunding audit, your records need to address the original use of proceeds (i.e. originally issued 2002 bonds, refunded by 2012 bonds).
- The IRS has between 300 and 400 audits open at any time.
- The time to discover a potential problem with your bonds is before you receive an IDR. Then you can remediate via the IRS voluntary compliance assistance program (VCAP) and/or do a partial bond defeasance.
  - Expert help is available, starting with your bond counsel or finance team.
- Under audit, if a problem jeopardizes the tax exempt status of the bonds, you, as the issuer, could find yourself facing further litigation:
  - You, your counsel, the underwriters, or others—who is liable?
  - Ultimately, if you cannot reach a settlement with the IRS, it is the bondholders who will be subject to audit on their personal tax returns. They, in turn, may sue you.
  - This could result in increased cost of capital, damage to your corporate reputation and financial loss to your bondholders.

If you have a policy and effective, detailed procedures in place, it will provide the best protection against post issuance compliance problems, plus the IRS has been known to provide more favorable treatment to issuers who have them.

I successfully resolved all four audits, but not without considerable time, legal cost and stress to my team. Whether your TEB portfolio is $10 million or several billion, you (or your predecessors) promised to maintain records in compliance with the federal tax requirements for the life of the TEB bonds, plus three years. The IRS is ratcheting up its audit efforts to make sure you are doing just that.

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