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Work Session IV: Liability for Municipal Bond Issues – The New Paradigm. How to Protect Your Local Government; How to Protect Yourself and What to Disclose

Post-Issuance Tax Compliance

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Post-Issuance Tax Compliance

1. Introduction

Issuers[1] of tax-exempt bonds are required to monitor for compliance with federal tax laws throughout the life of their bonds, including refunding bonds, and such issuers have the burden of proof of establishing compliance with such laws. In some cases, failure to comply with federal tax laws after issuance can result in the Internal Revenue Service (IRS) declaring interest on the bonds to be taxable retroactively. In other cases, the IRS may require the issuer to enter into a closing agreement with the IRS that protects the tax-exempt status of the bonds, usually in exchange for a significant payment from the issuer.

Issuers may help protect themselves against an adverse audit by adopting, and following, written post-issuance compliance procedures. This paper discusses the history of IRS enforcement with respect to tax-exempt bonds and the obligations of an issuer with respect to monitoring for compliance with federal tax laws after issuance.

2. IRS Enforcement with Respect to Tax-Exempt Bonds

For many years, the IRS did not actively audit or review tax-exempt bond transactions. However, beginning in the 1990s, the IRS began to train enforcement personnel in tax-exempt bonds, and quickly established a dedicated audit team for tax-exempt bonds. Since then, IRS enforcement of tax-exempt bonds has changed dramatically. As many as 100 IRS employees are dedicated to enforcement tax-exempt bonds, and the IRS audits or reviews approximately 1,000 tax-exempt bond issues each year.

[1] Note that in conduit financings, issuers typically delegate the responsibility for post-issuance tax compliance to the conduit borrowers in the conduit loan documents.

The increase in enforcement activity with respect to tax-exempt bonds likely reflects a shift in thinking by the IRS. For many decades, the IRS did not seem concerned about tax-exempt bonds, likely because it had little interest in interfering with the activities of State and local governments. However, Congress considers tax-exempt bonds to be a form of federal subsidy to State and local governments that is inefficient, because some of the benefit of the subsidy goes to the bondholder who receives the tax-exempt interest. As the tax-exempt bond market grew (in 2012, almost $500 billion of tax-exempt bonds were issued), Congress became concerned that in addition to the inherent inefficiency of the subsidy associated with tax exempt bonds, issuers were abusing tax laws to either inappropriately increase the subsidy received or to transfer inappropriately the benefit of the subsidy to private businesses. Accordingly, the IRS tax-exempt audit program was born.

During the course of an IRS audit examination, the IRS will request an extensive list of records and information to determine if (1) the bond issue was eligible to be issued on a tax-exempt basis, and (2) the bond issue has continued to comply with all federal tax requirements since its issuance. These audits are expensive, time-consuming and nerve-wracking for issuers, but the IRS claims issuers that have adopted and that follow written procedures and policies for monitoring compliance with federal tax requirements after issuance have fewer problems during audits. In fact, the IRS provides significant incentives for issuers to adopt and follow post-issuance compliance policies by providing materially better terms for closing agreements entered into with respect to bonds whose noncompliance was discovered by the issuer as a result of following its post-issuance compliance procedures and voluntary reported to the IRS. Moreover, strong procedures and internal controls help issuers increase the likelihood that an issuer will discover and cure problems before the problems impact the tax-exempt status of the bonds.

3. Summary of Post-Issuance Tax Compliance Obligations

The federal tax rules applicable to governmental purpose tax-exempt bonds after issuance generally fall into three basic categories: restrictions on use of the proceeds (the private business tests and the private loan financing test), arbitrage restrictions (yield restriction and rebate), and record-keeping requirements. These rules apply to tax-exempt bonds both when the bonds are issued and throughout the entire term of the bonds.

3.1. Restrictions on Use of Proceeds

3.1.1. Private Business Tests

The private business tests are designed to identify situations in which too much of the federal tax subsidy associated with an issue of tax-exempt bonds is received by nongovernmental entities. In general, the private business use test require that in order for municipal bonds to be issued on a tax-exempt basis, the amount of "private business use" of the bond-financed property must be limited.

Section 141(b) of the Internal Revenue Code of 1986, as amended, (the "Code") sets forth two private business tests which, if met, will result in bonds being <u>ineligible</u> for tax-exempt status. Ineligibility results from meeting <u>both</u> tests. The tests are commonly referred to as the "private business use test" and "private security or payment test." For governmental purpose bonds, each test has a 10% threshold, assuming that the private business use is *related* to the governmental use of the proceeds of the bonds. The tests described below drop to 5% if the use by a private business is *unrelated* to the governmental use of the proceeds of the bonds.

The <u>private business use test</u> will be met if more than 10% of the proceeds of the bonds (or of the property financed by proceeds of the bonds) are used for private business use. Private business use includes use by nongovernmental persons engaged in a trade or business. Nonprofit entities and federal governmental agencies are considered "nongovernmental" persons for purposes of these tests.

The <u>private security or payment test</u> will be met if more than 10% of the debt service on the bonds is paid or secured by money derived, directly or indirectly, from payments received from a private party in respect of private business use of bond-financed property.

Again, it is important to note that ineligibility for tax-exempt status results only if <u>both</u> the private business use test <u>and</u> the private security or payment test are met.

3.1.2. Private Loan Financing Test

Making or financing a loan to a nongovernmental person is also considered a type of private use and is restricted under Section 141(c) of the Code. Private loans may arise even if there is no private *business* use, such as in the case of loans to individuals in a non-business capacity. Any transaction that is generally characterized as a loan for federal income tax purposes is a loan for the purposes of the private loan financing test. This analysis depends upon all of the facts and circumstances. A loan may arise from the direct lending of bond proceeds, and also includes any transaction in which the indirect benefits are the economic equivalent of a loan.

The <u>private loan financing test</u> is met if more than the lesser of 5% or $5 million of the issue is used, either directly or indirectly, to make or finance loans to persons other than governmental persons.

3.1.3. Remedial Actions Available to Cure Violations of Federal Tax Law After Issuance of Tax-Exempt Bonds

The initial determination of tax-exempt status of municipal bonds is made at the time of issuance of the bonds, based upon the reasonable expectations of the issuer and users of the bond-financed property at that time. However, subsequent actions can cause bonds to lose their eligibility for tax-exempt status. Treas. Reg. § 1.141-2(d)(1) provides that a governmental purpose bond issue is in jeopardy of losing its tax-exempt status if the issuer of the bonds takes a *deliberate action* after the issue date of the bonds that causes the bonds to meet either (1) the private business tests or (2) the private loan financing test. Treas. Reg. § 1.141-2(d)(3) defines a *deliberate action* as any action taken by an issuer that is within the issuer's control.

3.2. Arbitrage Restrictions

Arbitrage restrictions are designed to identify situations in which the federal tax subsidy received with respect to an issue of tax-exempt bonds is in excess of permissible limits. In general, arbitrage restrictions require that an issuer receive only limited benefit from investing the proceeds of tax-exempt bonds prior to spending such proceeds.

Section 148(a) of the Code requires that proceeds of tax-exempt bonds must not be invested at rates that are materially higher ($1/1000^{th}$ of a percent unless an exception applies) than the yield on the bonds (i.e., the bonds must be yield-restricted), unless a specific exception applies. For most new money bonds issued to finance capital expenditures, the proceeds of the tax-exempt bonds will qualify to be invested at an unlimited yield for a 3-year period beginning on the issue date of the bonds. Other exceptions to yield restriction exist, including exceptions for proceeds of current refunding bonds and investments held in a reasonably required reserve or replacement fund.

Section 148(a) of the Code also requires that the interest earned by an issuer from the investment of bond proceeds at rates in excess of the bond yield be paid (i.e., rebated) back to the federal government in certain instances. Similar to the yield restriction rules, several exceptions apply to the rebate requirements including the spending exceptions (Treas. Reg. § 1.148-7) and the small issuer exception (Treas. Reg. § 1.148-8). Payments of arbitrage rebate are due within 60 days of the computation date dependent upon whether the bond issue is a fixed rate issue or a variable rate issue.

Failure to yield restrict investments of tax-exempt bond proceeds or failure to timely pay an amount of arbitrage rebate when due may result in either the assessment of a penalty and interest or a determination that the bonds are taxable arbitrage bonds.

3.3. Record-Keeping Requirements

Section 6001 of the Code and § 1.6001-1(a) of the Treasury Regulations generally provide that "taxpayers" must maintain sufficient books and records to establish the amounts required to be shown in any return required to be filed. In the case of a tax-exempt bond issue, the only "taxpayers" are the beneficial holders of the bonds. However, in most cases, the beneficial holders of tax-exempt bonds will not have any records to support their exclusion of the interest paid on those bonds. Instead, these records will generally be found in the bond transcript and the books and records of the issuer, the conduit borrower, and other participants to the transaction. Therefore, IRS Notice 2006-63 clarifies that Section 6001 imposes record retention requirements on issuers and other parties to tax-exempt bond transactions.

In the case of many private activity bonds, the conduit borrowers are also taxpayers. For instance, the conduit borrower generally will deduct the interest paid on its loan or will claim depreciation deductions for bond-financed property. Accordingly, conduit borrowers should maintain sufficient records to support their interest deductions, depreciation deductions or other tax deductions, exclusions or credits related to the tax-exempt bond issue.

3.3.1. IRS Recommendations for Post-Issuance Compliance Procedures

The IRS recommends that issuers should adopt written procedures, applicable to all bond issues, which go beyond reliance on tax certificates included in bond documents provided at closing. The IRS believes that relying solely on the closing bond documents may result in procedures insufficiently detailed or not incorporated into an issuer's operations. The IRS recommends that 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; and
- Procedures ensuring that the issuer will take steps to timely correct noncompliance.

3.3.2. IRS Document Retention Recommendations

The documents that must be retained by an issuer will be different for each bond issue. However, at a minimum, the IRS recommends that issuers and borrowers maintain documentation—

- Evidencing the total proceeds of the bond issue;
- Evidencing how and when proceeds were spent;
- Relating to any investment of bond proceeds (e.g., purchase and investment of securities, guaranteed investment contracts and rebate calculations);
- Relating to the allocation of proceeds to expenditures which indicate the date of expenditure, date of official intent (for reimbursement of expenditures made prior to the date of issue), and date allocation of proceeds was made to each expenditure;

- Evidencing the issuer's expectations for use of proceeds to establish reasonable expectations that bonds are not hedge bonds;
- For multi-purpose issues, evidencing the amount of proceeds allocated to each purpose;
- Identifying all non-qualifying use of bond-financed facilities;
- Describing excess bond proceeds and their disposition;
- Identifying bond transaction funds and moneys to be deposited therein as well as funds from transferred proceeds, disposition proceeds, or replacement proceeds, if any, that will also become bond transaction funds;
- Identifying applicable temporary periods, rebate, rebate exceptions and yield parameters;
- Documenting elections, including establishment of first computational period;
- For governmental and qualified 501(c)(3) bonds, regarding any private use and all sources of payment and security with respect to the bonds;
- For single family mortgage bonds, evidencing that at least 20% of the proceeds were available for owner financing of targeted area residences and satisfaction of other program requirements;
- For multi-family housing bonds, evidencing that the facility is not used on a transient basis, satisfaction of the low-income set aside requirements and satisfaction of other program requirements; and
- For student loan bonds, evidencing that the student-borrower is a resident of the State entity issuing the bonds or that the student-borrower is attending an educational institution enrolled in such State and other program requirements.

The IRS recommends that tax records listed above and other material tax records be retained for the term of the bonds, plus the term of any bond refunding or re-refunding the bonds, plus three years. These time periods can be longer than the document retention schedule recommended by a state's auditor's office.

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.

4. Other Resources

Below are other useful links to various resources on the topic of post-issuance compliance.

- Internal Revenue Service's site for the tax-exempt bond community.
  http://www.irs.gov/taxexemptbond/index.html
- After The Bonds Are Issued: Then What? – Here's an article provided on the IRS website discussing the post-issuance compliance responsibilities of borrowers.
  http://www.irs.gov/pub/irs-tege/bonds_act_0607.pdf
- Post-Issuance Compliance checklist provided by the Government Finance Officers Association ("GFOA") and the National Association of Bond Lawyers ("NABL").
  http://www.gfoa.org/downloads/PostIssuanceCompliance.pdf

Appendix A
Identifying Private Business Use

Treas. Reg. § 1.141-3(b)(1) states that private business use may result both from actual and beneficial use of bond-financed property by a nongovernmental person engaged in a trade or business activity. Accordingly, private business use can result from the use of tax-exempt bond financed property by, among others, (1) a for-profit business, (2) a natural person engaged in a trade or business, (3) a nonprofit organization (501(c)(3) or otherwise), and (4) an agency or instrumentality of the federal government (collectively, "private users"). Private users do not include state or local governmental units, natural persons not engaged in a trade or business and members of the general public.

Private business use includes direct or indirect use by one or more private users of any portion of a bond-financed facility. Examples of arrangements that may give rise to private use include

- Ownership by private users;
- Nonqualified management and service contracts (e.g. management contracts for parking garages);
- Leases, including cell tower leases;
- Naming rights;
- Preferential rates for certain customers;
- Rights of first refusal;
- Research contracts;
- Use by federal government and nonprofits on a preferential basis;
- Professional service contracts;
- Food service contracts;
- Contracts with independent contractors;

- Privatization of facilities; and
- Sales or dispositions of bond financed property.

Issuers are encouraged to consult with their bond counsel and to obtain training to help them identify private business use with respect to their own bond issues.