

HAWKINS ADVISORY

THE NEED FOR POST-ISSUANCE WRITTEN TAX COMPLIANCE PROCEDURES

Introduction

Pronouncements by the IRS in recent years have made it clear that issuers and borrowers of tax-exempt bonds and other tax-advantaged bonds should adopt effective post-issuance written tax compliance procedures.

On July 1, 2011, the Internal Revenue Service (the "IRS" or the "Service") released its Final Report on Governmental and Charitable Financings (the "Report") summarizing data collected from two compliance questionnaire projects (collectively, the "Project") which commenced in 2007.

This Report represents the latest communication from the Service identifying the need for issuers and conduit borrowers of tax-exempt bonds and other tax advantaged state and local bonds to adopt written procedures ensuring the requisite post-issuance compliance in connection with such bonds and underscores the importance of this objective to the entire municipal finance industry.

Recent attention focusing on the benefit of written procedures for purposes of assisting issuers, conduit borrowers and the Service in complying with the various requirements of the Internal Revenue Code of 1986, as amended (the "Code"), in respect of tax advantaged bonds should persuade issuers and conduit borrowers to examine their current practices and memorialize such practices to assure continuity of record collection and retention. Tax-exempt bonds and tax credit or interest subsidy bonds are typically of long duration (30 years or more), and the continued tax advantaged status of such bonds depends on the continued compliance with arbitrage and use of proceeds requirements over the life of the issue. Unlike most recordkeeping obligations imposed by the Code, the longevity of bond issuances necessarily results in decades of changing personnel, all engaged in the same endeavor. Written procedures are intended to ensure that the requisite information is collected and maintained in an orderly, consistent and seamless fashion, allowing for the effective administration of the requirements of the Code by the beneficiaries of these tax advantaged bonds.

While it is generally acknowledged that issuers, conduit borrowers and bond issues are not all the same, and, consequently, there is no "one-size-fits-all" approach to the task, written post-issuance compliance procedures will greatly assist all parties involved in demonstrating compliance with arbitrage and use of bond-financed facility reviews in the context of new issues, refundings, filings of 8038-CPs for certain tax advantaged taxable bonds, and IRS audits of these issues.

What follows is a brief summary of the Report findings and some highlights of the history of post-issuance compliance.

Summary of Report Findings

Tax-Exempt Bond Financings Compliance Check Questionnaire – Form 13907 ("Form 13907") was directed to charitable organizations benefitting from the issuance of tax-exempt bonds and Governmental Compliance Check Questionnaire – Form 14002 ("Form 14002") was directed to state and local governmental issuers of tax-exempt bonds. The purpose of these questionnaires, as stated in the Report, was to "identify the overall knowledge of section 501(c)(3) organizations and governmental issuers of tax-exempt bonds relating to applicable post-issuance compliance and record retention requirements". The main focus of the questionnaires was to elicit information regarding policies, practices and recordkeeping procedures in respect of use of proceeds, use of bond-financed property, arbitrage, and other fundamental requirements applying to tax-exempt bond issues.

Form 13907 was sent to 207 organizations described in section 501(c)(3) of the Code that had reported being the "ultimate obligor" of tax-exempt bonds outstanding as of the end of 2005. Form 14002 was sent to 200 governmental issuers of tax-exempt bonds in 2005. Not all recipients of the questionnaire responded, and not all recipients had benefitted from tax-exempt bonds that were still outstanding.

The majority of the organizations that did respond generally acknowledged that the continued tax-exemption of interest on the bonds of which they are the beneficiaries is dependent on the retention documentation regarding the investment of bond proceeds in anticipation of such proceeds being applied to project costs and the use of the bond-financed projects for the period the bonds are outstanding, including refunding bonds. Many described the practices directed to complying with such requirements, yet few were actually able to produce written post-issuance compliance procedures and retention policies.

The Service concluded that it will "actively continue to promote post-issuance compliance while exploring opportunities to reduce overall taxpayer burden in the tax-exempt bond industry". The Report also reminds issuers of direct pay interest subsidy bonds issued pursuant to the applicable provisions of the American Reinvestment and Recovery Act of 2009 ("ARRA"), as supplemented by the Hiring Incentives to Restore Employment Act of 2010 ("HIRE") that the Form 8038-CP, Return for Credit Payments to Issuers of Qualified Bonds, which must be filed in order to claim the

interest subsidy payments is filed under penalties of perjury and “constitutes a certification by the issuer that the obligation meets all applicable requirements as of the date that it files Form 8038-CP”.

Historical Highlights

The Project stems from a long-standing concern regarding post-issuance compliance in the context of tax-exempt bonds.

The issuance of a tax-exempt bond opinion is predicated upon future compliance with both arbitrage requirements and restrictions relative to the use of the facilities financed with the proceeds of the tax-exempt bond issue. Generally, the opinion of bond counsel that interest on the bonds is tax-exempt relies on a substantial due diligence process which documents how the issuer/conduit borrower reasonably expects to invest and apply the proceeds received from the sale of the bonds. These reasonable expectations generally take account of relevant facts and circumstances in existence at the time the bonds are issued. A tax certificate memorializes the information gathered during the due diligence process, affirms the issuer/conduit borrower’s reasonable expectations in connection therewith, and certifies that the issuer/conduit borrower will not act or fail to act in a manner that would result in interest on the bonds losing their tax-exempt status. The bond counsel opinion is rendered “assuming continuing compliance” with such certifications, affirmations and undertakings.

In 2003, the Service posted “Tax Exempt FAQs regarding Record Retention Requirements” (the “FAQs”) on its webpage. The FAQs note, in relevant part, that during the course of an examination, the IRS agent will request all material records and information to support an issue’s compliance with section 103 of the Code. The FAQs state that the recordkeeping requirements of the Code, established under section 6001, apply to issuers, conduit borrowers, and bondholders, and may apply to other parties to a tax-exempt bond transaction. Material records should be retained for as long as the bonds are outstanding (including refunding bonds), plus three years after the final redemption date of the issue. While the state and local governmental persons and organizations designated under section 501(c)(3) of the Code that are the beneficiaries of tax-exempt bond issues may not be taxpayers per se, section 1.6001-1(a) of the Treasury Regulations generally provides that books and records must be maintained that are sufficient to establish the amounts required to be shown in any return required to be filed.

The Advisory Committee on Tax Exempt and Government Entities (“ACT”) Report of Recommendations dated June 13, 2007 and entitled “After the Bonds are Issued: Then What?” (the “2007 ACT Report”), described the practical concern as follows: “[b]ecause most tax-exempt bonds will remain outstanding for many years, it is important to have

procedures, which can be understood and implemented over time, even as the responsible officials may change. The particular procedures which are appropriate vary substantially, depending upon the size and complexity of the issuer/borrower being monitored and the type of bond issue involved, . . . Most important is to assign responsibility for post-issuance tax law compliance and to be sure that sufficient information is routinely identified and maintained to allow those who later inherit that responsibility to successfully continue the job. . .”

ACT urged the IRS to encourage improved compliance procedures on a forward looking basis without drawing negative inferences with respect to prior procedures in the inherently backwards looking context of the audit process. Recognizing that issuers and conduit borrowers vary substantially with respect to their size, their resources, and the number and complexity of their bond transactions, the 2007 ACT Report observed that “[t]here can be no one-size-fits-all set of procedures. However, each issuer or borrower should identify and establish appropriate procedures to ensure that its bonds remain in compliance with this complex body of federal law.”

For qualified 501(c)(3) organizations, the need for post-issuance compliance has culminated in Schedule K of the revised Return of Organizations Exempt from Income Tax - Form 990. Part III of Schedule K requests information relative to private business use and unrelated trade or business use in connection with tax-exempt bond financed facilities for all issues of tax-exempt bonds issued after December 31, 2002, which had an outstanding principal amount in excess of \$100,000 as of the last day of the tax year. Bonds issued to refund bonds issued prior to December 31, 2002 are exempt from the private use information requirement. Part IV elicits information about arbitrage.

Direct Pay Bonds

It should be noted that in connection with the ongoing filings associated with direct pay bonds issued under the applicable provisions of ARRA and HIRE, the representative signing Form 8038-CP, which is the form submitted to request the refund of the tax credit, is required to declare (under penalties of perjury) that he or she has examined the return and any accompanying schedules and statements and to the best of his or her knowledge and belief, they are true, correct and complete.

To quote Carl Scott, a group manager in the Compliance & Program Management Function of the IRS Office of Tax Exempt Bonds (the “TEB”) during the TEB’s June 20, 2011 Webinar “Getting it Right: Form Filing and Compliance Issues for Direct Pay Bonds”:

One thing of particular note for issuers filing the Form 8038-CP is that filing is a certification that the issue is eligible for the amount of the refundable credit claimed in the form as of the date it is filed. The first page of the instructions described important criteria in connection with the filing. The instructions contain a cautionary instruction, note with a large exclamation point and the work "caution." This warning states that **'This return is to be filed only if, as of the date the form is filed, the issuer of the outstanding obligation(s) with respect to which this return is submitted has reasonably concluded that the obligation(s) meet all applicable requirements for the payment of the requested credit.** (Emphasis added)

Conclusion

The Service continues to request and collect information regarding the existence of written procedures. Form 8038-B, Form 8038-TC, as well as the recently revised Form 8038 and Form 8038-G, all inquire as to whether, among other things, the issuer has established written procedures to ensure that all nonqualified bonds of the issue are remediated in accordance with the requirements under Regulations section 1.141-12. Similar questions are included in the Direct Pay Bonds Compliance Questionnaire - Form 14127, which was sent out 375 issuers of Build America Bonds. More recently, the Service initiated another questionnaire project: Advance Refunding Bonds Compliance Check Questionnaire – Form 14256, which questionnaire also inquires as to whether the issuer has adopted

written procedures to ensure that record collection and retention requirements are complied.

In light of the need to evidence compliance with applicable information gathering and retention mandates throughout the life of a tax-exempt bond in order to safeguard the tax-exemption of interest, or, in the case of a direct pay tax credit bond, entitlement to interest subsidy payments, we strongly recommend that issuers and conduit borrowers adopt meaningful policies and procedures with the aim of ensuring compliance in a rational and concise manner.

Hawkins Delafield & Wood LLP is highly experienced in all matters involving the issuance of tax-exempt bonds and interest subsidy bonds. Please contact a member of the Tax Department for assistance in developing written post-issuance compliance procedures or any other matter. Our website address is Hawkins.com

James R. Eustis, Jr.

Email: jeustis@hawkins.com

Tel: (212) 820-9450

Kam Wong

Email: kwong@hawkins.com

Tel: (212) 820-9410

Kathleen J. Orlandi

Email: korlandi@hawkins.com

Tel: (212) 820-9454

Michela Daliana

Email: mdaliana@hawkins.com

Tel: (212) 820-9631

Russell A. Miller

Email: rmiller@hawkins.com

Tel: (415) 486-4202

Faust Bowerman

Email: fbowerman@hawkins.com

Tel: (212) 820-9429

About Hawkins Advisory

The Hawkins Advisory is intended to provide occasional general comments on new developments in Federal and State law and regulations that we believe might be of interest to our clients. Articles in the Hawkins Advisory should not be considered opinions of Hawkins Delafield & Wood LLP. The Hawkins Advisory is not intended to provide legal advice as a substitute for seeking professional counsel; readers should not under any circumstance act upon the information in this publication without seeking specific professional counsel. Hawkins Delafield & Wood LLP will be pleased to provide additional details regarding any article upon request.

This Hawkins Advisory is not intended or written to be used, and cannot be used, by a taxpayer for the purpose of avoiding penalties that the Internal Revenue Service may impose on the taxpayer.

Additional copies of this edition of the Hawkins Advisory may be obtained by contacting any attorney in the Firm.

New York

One Chase Manhattan Plaza
New York, NY 10005
Tel: (212) 820-9300

San Francisco

One Embarcadero Center
San Francisco, CA 94111
Tel: (415) 486-4200

Newark

One Gateway Center
Newark, NJ 07102
Tel: (973) 642-8584

Hartford

20 Church Street
Hartford, CT 06103
Tel: (860) 275-6260

Los Angeles

333 South Grand Avenue
Los Angeles, CA 90071
Tel: (213) 236-9050

Sacramento

1415 L Street
Sacramento, CA 95814
Tel: (916) 326-5200

Washington, D.C.

601 Thirteenth Street, N.W.
Washington, D.C. 20005
Tel: (202) 682-1480

