Client Alert

November 2011

IRS Warning to Tax-Exempt Issuers and Borrowers: Implement Compliance Procedures Now

In its strongest warnings to date, the Internal Revenue Service (the "IRS") has advised issuers and private beneficiaries of tax-exempt bonds that the failure to develop and implement a detailed post-issuance compliance program can have serious financial consequences whenever (1) such an entity seeks to avail itself of the IRS's Voluntary Closing Agreement Program ("VCAP") or (2) the IRS audits such an entity's bonds. In the current environment, audits are a real possibility for any issuer or private beneficiary, because the IRS now has a substantial program of random and targeted audits. In recent years, the IRS has expressed particular concern that private nonprofit hospitals, retirement facilities and educational entities have not adequately monitored their use of bond-financed facilities, and, most recently, it has expressed concern that traditional governmental issuers, such as cities and counties, have failed to establish appropriate post-issuance compliance mechanisms.

In both its July 2011 report relating to its survey of post-issuance compliance in tax-exempt financings and its August 2011 revised administrative procedures relating to VCAP, the IRS has delivered a clear warning: in enforcement and settlement, the IRS will come down hard on issuers and conduit borrowers that have not adopted or do not abide by thorough, detailed post-issuance compliance policies and procedures in conformity with the IRS's guidance on the matter. In contrast, the IRS has indicated, issuers and borrowers with sound post-issuance monitoring and tax compliance programs will be treated more favorably, with potentially significant differences in terms of the payments and penalties that the IRS may require in return for protecting the tax-exempt status of the subject bonds.[1] **The message is not subtle: in an audit or other IRS proceeding, the failure to have a tax compliance program that meets the IRS standards may cost you real money.**

Goals of a Compliance Program. Bonds can lose their tax-exempt status if issuers and/or conduit borrowers do not take steps to ensure both that (1) the original proceeds are spent in compliance with the requirements of the Internal Revenue Code (the "Code") and (2) the bond-financed facilities are used in accordance with the Code's requirements over the entire life of the bonds. Most commonly, problems arise when bond-financed space is subject to "bad use." This can occur, for example, if a governmental issuer leases space to a private entity (e.g., for a restaurant) or if a nonprofit hospital permits bond-financed space to be used in connection with a joint venture between such hospital and a for-profit entity. Additionally, issuers and beneficiaries are subject to ongoing arbitrage requirements, including requirements to make yield reduction or rebate payments if there are excess earnings realized on the investment of bond proceeds. It has always been true that the failure of an issuer or beneficiary to monitor compliance with such requirements can jeopardize tax-exempt status. Now the IRS has gone further by asserting that the absence of satisfactory compliance procedures will likely increase the penalties that the IRS will impose if it finds any violations.

[1] This Client Alert refers to tax-exempt bonds, but the same principles apply to other tax-advantaged bonds, such as tax-credit and direct-pay bonds, where post-issuance noncompliance can undermine the bonds' tax-advantaged status.

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The VCAP program allows an issuer or conduit borrower to disclose voluntarily to the IRS the existence of a federal tax law violation relating to its tax-advantaged bonds and to negotiate a settlement or other resolution that generally will be on more favorable terms than if the IRS discovered the violation during an audit. The August 2011 VCAP guidance emphasizes that a party that has adopted and implemented written procedures for post-issuance monitoring and compliance, and that identifies and discloses a Code violation in accordance with such procedures, may receive more favorable treatment than if the party had not adopted such written procedures.

All issuers of tax-exempt bonds are required to file IRS Form 8038 upon issuance, and all such forms now contain a question as to whether the issuer has established the appropriate written procedures to monitor post-issuance compliance. Any answer may create risk. Disclosing the absence of such procedures may encourage an audit. Asserting that procedures are in place may create problems if the IRS subsequently determines that the procedures were inadequate.

New Minimum Requirements. In recent years, issuers sometimes have been advised that they can evidence the existence of appropriate post-issuance compliance simply by stating in the tax certificate delivered at closing that they have designated the appropriate person or persons to review compliance periodically, to maintain and review records, and to take such other steps as needed to ensure ongoing post-issuance compliance. In the latest guidance, however, the IRS has made it clear that such a reference is no substitute for creating and implementing specific detailed procedures. The IRS expects that, at minimum, the procedures of an issuer or beneficiary will address with particularity each of the following items:

- the officials with responsibility for monitoring compliance;
- a description of the training provided to such responsible officials with regard to monitoring compliance;
- the frequency of compliance checks, which 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;
- the procedures for retention of all records that are material for substantiating compliance with the applicable federal tax requirements; and
- a demonstration of the awareness of the availability of VCAP and other remedial actions to resolve violations.

Conduit Issuers. Conduit issuers, such as economic development authorities and other special authorities, face a particular lack of clarity about what constitutes adequate procedures for issuer and borrower, respectively, since the bond documents customarily place all responsibility for post-issuance compliance with the borrower, and the borrower often is obligated to indemnify the issuer for the results of any failure to so comply.

Schedule K for 501(c)(3)s. Schedule K to the IRS Form 990, which 501(c)(3) organizations with tax-exempt bonds are required to fill out on an annual basis, also requires a 501(c)(3) conduit borrower to address its bond-related compliance procedures. With increased IRS scrutiny of the accuracy and sufficiency of annual Form 990 disclosures, 501(c)(3) entities should be especially cautious that their procedures in this area conform to IRS standards and are being properly followed, and that their actual behavior is consistent with any claim to have procedures in place. Schedule K asks specifically whether the organization routinely engages bond counsel to review its management or service contracts and research agreements relating to its bond-financed property.

Practical Problems in Creating and Documenting a Compliance Program. The recent IRS pronouncements suggest that every issuer or beneficiary needs to implement a compliance program before it either issues new bonds or, in the case of a 501(c)(3) organization, files a Form 990. The requirements for such a program will vary depending on the type of issuer or beneficiary and the typical use of bond proceeds, but, as described above, all such programs must meet certain minimum standards.

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Many issuers and beneficiaries of tax-exempt bonds are already subject to extensive reporting requirements and may look to their existing programs for examples of procedures that have been successful. Hospitals and colleges, for example, are likely to have compliance and reporting mechanisms in place. There are also various IRS pronouncements that suggest that "spot checking" of the use of bond proceeds may be acceptable.[2]

The fact that Schedule K to Form 990 specifically asks 501(c)(3) organizations whether they engage bond counsel to review management contracts and research agreements strongly suggests the prudence of such legal assistance.

Finally, it is always important to avoid a situation where policies are created that, as a practical matter, cannot be carried out.

Helping You Help Yourself. While any post-issuance compliance program must reflect the special circumstances of the entity, there are (1) certain basics for all such programs and (2) common issues for particular types of issuers and beneficiaries. These include traditional local governments, special authorities, airports, public and private institutions of higher education, hospital systems and nonprofit retirement communities.

The public finance and tax attorneys at Hunton & Williams stand ready to assist any issuer or beneficiary in meeting these new requirements in a practical and efficient manner. After an initial consultation, we can offer starting points for such a program and then assist individual issuers or borrowers to tailor the program to fit their own circumstances, with policies that meet legal requirements with the least burden on senior personnel.

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[2] *See*, e.g., Treasury Regulations § 1.141-2(d)(5)(iii).