DEVELOPMENTS FOR POST-ISSUANCE COMPLIANCE IN TAX-EXEMPT BONDS AND TAX CREDIT BONDS

New material from the Internal Revenue Service ("Service") provides a more clear and notable view of the importance the Service attaches to "post-issuance compliance" ("PIC") related to tax-exempt bond matters or tax credit bonds. These materials include a summary checklist for PIC procedures, new standards for settlement under the Voluntary Closing Agreement Program, many with tight deadlines that issuers are more likely to meet if they have regular internal review under a PIC procedure, and new reporting procedures for Form 8038 and Form 990.

Post-Issuance Compliance Procedures

On the Service's website for the "Tax Exempt Bond Community," it has now published the following summary bullet points of certain characteristics that "should" be contained in written PIC procedures:

- 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.

Service representatives have said repeatedly that "one size does not fit all" and that issuers' and borrowers' procedures should be tailored to the specific facts of their bond issues. Thus, this list is merely a starting point for implementing comprehensive written procedures to promote PIC.

Voluntary Closing Agreement Program updates

On August 5, 2011, the Service added a number of provisions to the Internal Revenue Manual ("IRM") concerning the Voluntary Closing Agreement Program ("VCAP") administered by the Service's Tax Exempt Bond Division ("TEB"). VCAP allows bond issuers to request an agreement that a compliance violation will be disregarded, normally in exchange for a cash payment by the issuer. One of the more important new provisions, concerning what must go into a formal VCAP request, is as follows:

> "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 TEB 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." (IRM 7.2.3.2.1)

In other words, having "comprehensive written procedures" for post-issuance compliance justify a more favorable settlement (for example, having to pay a smaller amount) for the same violation.

The IRM is an internal publication of the Service without the formal force of a revenue ruling or the regulations. It is, however, generally regarded as "authoritative" on the points that it covers.

In addition to the general statement quoted above about compliance procedures, the recent IRM revisions covered a number of other points relevant to VCAP. These can be outlined as follows and by reference to specific sections of the manual:

- ***Anonymous Requests*** - As in the past, representatives of issuers can contact the Service on behalf of an unnamed ("anonymous") issuer in an effort to determine an appropriate resolution method. Anonymous requests may only pertain to a general matter, question, or factual scenario, and responses to detailed factual scenarios will not be provided. If the request is in satisfactory form, CPM will provide a general response in writing. In order to have a binding resolution of the matter, the issuer must follow up with a regular VCAP request (indentifying the issuer and the bond issue). IRM 7.2.3.1.5.

- ***Required Information*** - The Service's office on Compliance & Program Management ("CPM") requires that all VCAP requests include the following information: (1) the identity of the issuer; (2) identifying information of the bond issue; (3) an explanation of the violation, including, the specific federal tax requirement that is the basis for the violation and how the violation was discovered; (4) the issuer's proposed settlement terms for resolving the violation; (5) a statement of good faith; (6) a statement describing any explanation that the representatives have made to the issuer regarding conflicts of interest under Circular 230; and (7) whether or not the violation has been disclosed to the public or any state taxing jurisdiction. Additionally, the issuer must identify any previous or contemporaneous requests submitted by the issuer dealing with the same bond issue or violation, including any anonymous requests or private letter ruling requests. IRM 7.2.3.2.1.

- ***Case Development*** - Generally, upon receipt of the assigned VCAP case, an IRS specialist will review the VCAP request and provide written notification if additional information is required or if information is missing. While the case is under review, the IRS specialist will provide the issuer with telephone updates regarding the status of the request. The IRS specialist may confer with the CPM group manager to discuss the appropriateness of issuing a "final demand letter," if he or she determines, at anytime while the case is under review, that the issuer or authorized representative is not proceeding toward resolution in good faith and with due diligence. IRM 7.2.3.3.2.

- ***Minimum Settlement Payment*** - A minimum settlement payment of $1,000 will be required in most cases if the penalty payments discussed below are determined to be less than $1,000.

The Service also added "resolution standards" (i.e., the formula for the determining the penalty payment associated with VCAP and statements of specific remedied actions) for a number of identified violations. The Service anticipates expanding the list of resolution standards for various additional violations over time. The new standards, for Tax-Exempt, Direct Pay, and Tax Credit bonds, are described below.

- ***New Resolution Standards for Tax-Exempt Bonds*** -

  <u>Nonqualified Ownership of 501(c)(3) Bond-Financed Property</u> - Ownership of bond-financed property by a nonqualified person is a violation of the rules for qualified 501(c)(3) bonds. The violation may be resolved if the issuer redeems the nonqualified bonds and pays 100% of the taxpayer exposure on the nonqualified bonds within 6 months of the violation. Taxpayer exposure represents the estimated amount of tax liability the United States would collect from the bondholders if the income realized from the bonds was treated as taxable income and included in gross income during the calendar year(s) covered under the closing agreement.

  <u>Extinguishment/Merger</u> – Generally, if an issuer or a related person acquires its own tax-exempt bonds, the bonds are treated as "extinguished" on the ground that the property right to them has "merged" back into the issuer. A number of exceptions to this rule, published in 2008 in response to issuer purchases attributable to the 2008 financial crisis, expired on December 31, 2010. A violation occurs if the issuer (or a related party to the issuer) acquires its own bonds, holds them beyond the permitted holding periods, and then remarkets them to purchasers who treat them as continuing tax-exempt bonds. Issuers may resolve this violation by paying a fee amount equal to the par value of the outstanding bonds held by the issuer multiplied by 0.029% for each month during the extinguished period, which began on January 1, 2011, or the later date the issuer purchased the bonds. Such a request must be submitted no later than December 31, 2012 and is conditioned on the issuer reselling or refunding the extinguished bonds. The IRM cross-reference to announcement 2011-19 for more details. IRM 7.2.3.4.2.

These resolution standards are in addition to the existing standards for excessive nonqualified use of proceeds, failure to provide notice of defeasance in a remedial action, alternative minimum tax adjustments, excess capital expenditures in a $10,000,000 "small issue" of private activity bonds, bond maturity exceeding 120% of facility economic life, impermissible advance refundings, and failures to make timely reinvestments in 0% "SLGS" in advance refunding escrows.

- **New Resolution Standards for "Direct Pay" Bonds –**

<u>Bonds Become Private Activity Bonds</u> – The new IRM provision creates a resolution standard for "direct payment" Build America Bonds or Recovery Zone Economic Development Bonds ("RZEDBs") if the proceeds are used in a manner causing them to be private activity bonds. An issuer may resolve this violation by making a settlement payment based on a "credit maintenance amount" equal to the present value of the direct payment tax credit allocable to the private use portion of the issue, taking into account both the past payments and the scheduled future payments.

If the VCAP request is submitted within six months of the date of the violation, the settlement payment will be equal to the credit maintenance amount. If the request is submitted after six months from the violation but within one year of it, the settlement payment must be 110% of the credit maintenance account.

Unlike the resolution standards applicable to tax-exempt bonds, this standard and the others for direct payment or tax credit bonds do not depend on redeeming the nonqualified bonds. On the other hand, a reduced ("shortened") calculation of the credit maintenance amount will be permitted if credits or payments are not claimed in the future.

<u>Final Allocation of Proceeds to an Impermissible Use</u> - A violation occurs when an issuer of direct-payment Build America Bonds, RZEDBs, or "specified tax credit bonds" (Qualified Zone Academy Bonds, Qualified School Construction Bonds, Qualified Energy Conservation Bonds, or New Clean Renewable Energy Bonds, i.e., QZABS, QSCBs, QECBs, or New CREBS) makes a final allocation of proceeds to an impermissible use, such as costs later determined to be costs of issuance exceeding the 2% limit. To resolve the violation, the issuer must make a settlement payment equal to the credit maintenance amount on the nonqualified bonds. This resolution standard is similar to the resolution standard for direct payment bonds that become private activity bond standard mentioned above, except that the nonqualified bonds must be treated as nonqualified from date of issuance. The settlement payment increases to 110% of the credit maintenance amount if the request is submitted more than six months but within the later of August 1, 2012 or one calendar year after the date of the "deliberate action," presumably the expenditure for an impermissible use.

<u>Issue Price Premium Above De Minimis Amount</u> - A violation occurs when the issue price of Build America Bonds, Recovery Zone Economic Development Bonds and certain tax credit bonds is greater than the principal amount of each bond maturity plus a premium in a "de minimis" amount calculated by a statutory formula. To correct the violation, the issuer must determine an adjusted rate equal to the yield on the bonds assuming an issue price of the maximum permitted amount (including a de minimis premium) as compared to the scheduled payments of principal and interest on the bonds. The issuer must then calculate a credit maintenance amount equal to the present value of the direct payment credits that would be allowable on the principal amount of the bonds if they bore interest at a rate equal to the difference between the stated interest rate and the adjusted interest rate. The formula driving this calculation is counter-intuitive in that the adjusted rate will be higher than the stated rate rather than lower as one might have assumed, given that the abuse to be remedied is presumably that the stated rate exceeds a

> market rate as a result of the premium. The VCAP calculation introduces a time-weighting into the process and therefore is arguably more "correct" than simply requiring the issuer to pay over the excess premium.
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> As with the other direct pay VCAP resolution standards, the settlement payment is increased to 110% of the credit maintenance amount if the request is made between six months and the later of August 1, 2012, or one year after the date of issuance. A shortened calculation period is permissible if the issuer will agree to stop claiming the credits on the "nonqualified bonds," presumably the amount of bonds corresponding to the excess issue price.
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> *Extinguishment/Merger* – Direct pay and tax credit bonds will also be treated as extinguished if purchased and held by the issuer or a related party. A violation occurs when an issuer claims a direct pay credit on an extinguished bond or remarkets it as a tax-credit bond. To resolve the violation, the issuer must pay penalty equal to the credit maintenance amount on the bonds acquired by the issuer or a related party from the date of the initial acquisition until the first interest payment dated after the date of the closing agreement. The issuer must sell the acquired bonds to an unrelated party and include, as a penalty, any profits from the subsequent sale of the bonds. This resolution standard is available if the issuer submits the request by the later of February 1, 2012, or six months after the acquisition. Fthe request is submitted after this period but within the later of August 1, 2012, or one year after the initial acquisition, the payment amount must be 110% of the credit maintenance amount.

As can be seen, the VCAP resolution standards for direct payment bonds require the issuer to submit the request generally by August 1, 2012. Shorter deadlines apply for lower settlement payments.

<u>Defeasance of Build America Bonds is not a remedial action at this time</u>

In general, a "deliberate action" causing a non-qualified use of a tax-exempt bond can, and in some instances must, be "remedied" outside of the VCAP program by "defeasing" the tax-exempt bonds (i.e., providing securities, not derived from the proceeds of tax-exempt bonds, to pay principal and interest on the nonqualified bonds until their first optional redemption date). However, the new IRM provisions contain the following discussion concerning Build America Bond:

> "Until specific remedial action provisions are provided in regulations or other published guidance, an issuer may remediate deliberate actions impacting Build America Bonds by taking remedial actions, other than defeasance of nonqualified bonds, under section 1.141-12 of the Regulations. Build America Bonds, as taxable bonds, are not included in the exception from the significant modification rule for defeasance of tax-exempt bonds under ITR section 1.1001-3(e)(5)(ii)(B). Therefore, defeasance of a Build America Bond may cause a reissuance and a bond reissued after December 31, 2010 is not a Build America Bond pursuant to IRC section 54AA(d)(1)(B)." (IRM 7.2.3.1.2)

This analysis means that a Build America Bond cannot be advance refunded, without the defeased bond losing its eligibility for the Build America Bond subsidy or direct payments. Under normal market conditions, this loss will, in almost every instance, make the advance refundings of such bonds financially unworkable or at tremendous cost to the issuer.

Schedule K of Form 990 and Post-Issuance Compliance

A revised Schedule K (of Form 990) will apparently ask a more forceful variation of the past question about whether a tax-exempt organization has PIC procedures in place. Last year, the 2010 form asked simply whether the tax-exempt organization had adopted management practices and procedures to ensure PIC. This year, the “draft” 2011 form breaks this into two questions, both of which are far more pointed. First, Part III, Private Business Use, will now ask whether the tax-exempt organization has established written procedures to ensure that all nonqualified bonds of the issue are remediated in accordance with the requirements of the regulations. Second, a new Part V, Procedures to Undertake Corrective Action, will ask whether the tax-exempt organization has established written procedures 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 the regulations. Form 990 is the annual information return required of all tax-exempt organizations with receipts over threshold floors. Schedule K, added during the 2008 program of revisions to the “core form” and schedules, asks various questions about outstanding tax incentive and tax-exempt bonds for the benefit of the tax-exempt organization.

Form 8038

The April 2011 revision of Form 8038, reporting the issuance of private activity bonds, asks for the first time, whether the issuer has written procedures to ensure that nonqualified bonds will be remediated and to monitor the requirement of section 148 (arbitrage). Similar questions are asked on Form 8038-TC (June, 2010), the form for reporting the issuance of tax credit bonds. There is no comparable question on the current version of Form 8038-G, reporting the issuance of tax-exempt bonds that are not private activity bonds, which was released in May of 2010, eleven months earlier than the current Form 8038.

Requirements for Post Issuance Compliance Procedures are here to stay

For issuers and borrowers availing themselves to tax-exempt financing, the IRS’s message is clear: the requirements for post issuance compliance procedures must be an integral component of any bond program, and the requirements are here to stay. Issuers and borrowers should adopt and implement PIC procedures that indentify violations in a timely manner and provide for a quick resolution once the violation is identified. Contact a Ballard Spahr LLP public finance lawyer to discuss how your organization can adopt and implement successful post issuance compliance procedures.

For more information about these subjects, contact any member of Ballard Spahr’s public finance department. This e-alert was prepared by Frederic L. Ballard, Jr., ChristopherJ. Dodd, and Garland Gantt, III.