2013 Tax Forum

Bond Tax Compliance and IRS Initiatives

8:15 a.m. to 9:15 a.m.
Hyatt Regency St. Louis at the Arch
Monday, October 21, 2013

Edward Jennings,
Tax Director
University of Michigan

Excerpts of this presentation have been taken from recent co-presentations with Chapman & Cutler and University of Notre Dame
AGENDA

• Scrutiny on Tax-Exempt and Tax-Advantaged Bonds
• Impact to You and Your Institution
• Steps to Take to Manage these Risks and Ensure Compliance
• Results and Resources

U-M Tax Department
Tax professionals aren’t boring people, they just get excited about boring stuff.
Scrutiny on Tax-Exempt and Tax-Advantaged Bonds

**Tax Reform Hearings**

- **House Ways & Means (HW&M)** – This past March, the HW&M Committee held a hearing to consider whether the federal tax provisions that affect state and local governments should be viewed in the context of comprehensive tax reform.
  - Witness Scott Hodge, President of the Tax Foundation said, “the availability of this source of cheap financing does create a moral hazard that can only be cured by eliminating the exemption.”

- **Senate Finance Committee (SFC)** – This past April, the SFC Committee held its own hearing on tax reform of bonds.
  - Committee Chairman Max Baucus (D-MT) said “[c]urrently, the value of this subsidy varies based on taxpayers’ marginal income tax rates. For every dollar we spend on infrastructure through a tax-exempt bond, 20 cents goes to tax breaks for higher-income taxpayers.”
  - The Build America Bonds program provides a uniform subsidy, meaning each taxpayer receives the same subsidy regardless of tax bracket.
Sequestration

- **Reduction** – This past March, as part of the Federal budget sequestration, the IRS announced that credit payments claimed on Form 8038-CP by issuers of certain tax credit bonds may be subject to a reduction of 8.7%.
- **Type of Bonds** – Bonds include Build America Bonds (BABs), New Clean Renewable Energy Bonds and Qualified Energy Conservation Bonds.
- **Timeline** - Without further Congressional action, this reduction will remain in effect for all credit payments made from March 1, 2013 through September 30, 2013, inclusive, after which date a different rate will apply.
- **Process** - Continue preparing and filing Form 8038-CP. The IRS will notified the issuer if and to what extent these credit payments are reduced.
Private Business Use Re: Research

- **Private Business Use (PBU)** - Permit more flexible research arrangements for purposes of private business use (PBU)
  - President Obama's FY14 budget request; in the “Green Book," (page 130) provides the following:
    - Exception for Research - The budget calls for an exception to the private business limits on tax-exempt bonds for arrangements relating to basic research at tax-exempt bond-financed research facilities which meet certain requirements.

- **Public-Private Partnerships (P3s)** – Last October, the Assistant Treasury, Mark J. Mazur, responded in writing to a request made by Rep. Harold Rogers (R-Ky.).
  - Rogers asked Treasury to liberalize the treatment of PBU for P3s.
  - Mazur agreed to consider his request.
IRS Scrutiny

• Revised Audit Approach
  – Market Segment Examinations - Last October, it was reported that the IRS plans to begin annual market segment examinations of tax-exempt bonds.
    • The intent is to move away from a project-focused workload towards recurring annual market segment examinations of tax-exempt bonds and tax credit bonds.
    • Segments include healthcare, education, transportation and utilities.
    • The IRS expects to cycle through market segments about once every three years.
  – First year - The IRS examinations will focus on:
    • Governmental bonds, qualified 501(c)(3) bonds, qualified small issue bonds, various exempt facility bonds including airports, solid waste and sewage, various disaster relief bonds, build America bonds, and qualified school construction bonds.
TEB FY 2013 Work Plan

• **Purpose** - Identifies the operating priorities for the office of Tax Exempt Bonds (TEB) and provides program guidance and direction to all TEB employees.

• **Primary Areas of Focus (per the Work Plan)**
  
  – **Arbitrage** - Remain TEB’s highest compliance risk and enforcement focus.
  
  – **Post-Issuance Compliance** - Promote the use of post-issuance compliance monitoring practices (including the implementation of written procedures) to ensure the continued compliance of their obligations.
  
  – **Governmental and Charitable Financings** – Maintain a high priority on examination, voluntary compliance, education and outreach programs focused on governmental bonds and qualified 501(c)(3) bonds reflecting their relative prominence in the municipal bond market.
• **Use of the Form 990, Schedule K**
  
  – TEB is working with the EO division.
  
  – EO Agents will complete TEB checklist on all examinations and make referrals to TEB.

• “[W]e’re going to be dedicating more staff resources to Schedule Ks than in past years. [W]e’ll look at [it] and see if we want to go out and get more information, which may result in targeted audits.” – Steven A. Chamberlin, CPM Manager, October 2011.
Series of Compliance Checks

- **CC #1** - In 2007, TEB sent its “Tax-Exempt Bond Financings Compliance Check Questionnaire” (Form 13907) to 207 Section 501(c)(3) organizations that are borrowers of tax-exempt bond proceeds.

- **CC #2** - In 2009, TEB sent its “Governmental Bond Financings Compliance Check Questionnaire” (Form 14002) to 200 government issuers of tax-exempt bonds.

- **CC #3** - In 2010, TEB sent its “Direct Pay Bonds Compliance Check Questionnaire” (Form 14127) to 375 issuers of Direct Pay Bonds.

- **CC #4** – In 2011, TEB sent its “Advance Refunding Bonds Compliance Check Questionnaire” to 300 entities (31 exempt organizations and 269 governmental entities) that have issued advanced refunding bonds between July 1, 2009, and June 30, 2010.

- **Final Report** – In 2011, TEB released its “Tax Exempt Bonds Questionnaire Project: Final Report on Government and Charitable Financings” on its compliance check questionnaires sent to both Section 501(c)(3) organizations that are borrowers and governmental issuers [CCs #1 and #2].
Outreach Programs

The IRS hosted several teleconferences Recently.

• This past summer the IRS held phone forums on the following:
  – Primer On Monitoring Post-Issuance Compliance
  – What’s Special about Schedule K (Form 990)?
• Last spring and summer the IRS sponsored the following:
  – “Arbitrage Yield Restriction & Rebate Compliance”.
  – “The TEB Examination Process”.
• Coming this year the IRS will provide a session on the new types of tax credit bonds including Build America Bonds (BABs).

The IRS recently revised its Internal Revenue Manual (IRM).
Recent Publications

- **Form 14429** – Tax-Exempt Bonds Voluntary Closing Agreement Program Request
- **Publication 5005** – Your Responsibilities as a Conduit Issuer of Tax-Exempt Bonds
- **Publication 4077** - Tax-Exempt Bonds for 501(c)(3) Charitable Organizations / Compliance Guide
- **Publication 4078** - Tax-Exempt Private Activity Bonds / Compliance Guide
- **Publication 4079** – Tax-Exempt Governmental Bonds / Compliance Guide
- **Publication 5091** - Voluntary Compliance for Tax-Exempt & Tax Credit Bonds
Impact to You and Your Institution

- Arbitrage Computations
- Private Business Use Computations
- Record Keeping Requirements
Arbitrage and Yield Restriction

- **General Rule** – An issuer cannot invest gross proceeds in higher yielding investments.
  
  - **Exceptions:**
    - Temporary periods
    - *Bona fide* debt service fund
    - Debt service reserve fund (up to certain limit)
    - *De minimis* amounts
    - Investing in non-AMT tax-exempt bonds

- **Rebate** - If allowed to invest in higher yielding investments, still need to rebate arbitrage profits to the Treasury.
  
  - **Spending exceptions**
    - 6 month, 18 month, 2 year
    - If met, generally no rebate due
Arbitrage Calculations

- **Steps to take to ensure completeness and accuracy.**
  - **Yield** - Obtain computation of yield of bonds and establish procedure to track investment returns.
  - **Accounting Method** - Choose accounting method with respect to bond proceeds and interest earnings, investment and expenditures.
  - **Allocation** - Establish procedure for allocation of bond proceeds and interest earnings to expenditures, including reimbursement of pre-issuance expenditures.
  - **Funds** - Avoid formal or informal creation of funds reasonably expected to be used to pay debt service on bonds without determining in advance whether such funds must be yield restricted.
  - **Monitor the following:**
    - Situations in which compliance with applicable yield restrictions depend upon later investments and monitor implementation
    - Compliance with 6-month, 18-month or 2-year spending exceptions to rebate requirement, to the extent relevant.
  - **Rebate** - Arrange for timely computation of rebate liability and, if rebate is payable, and timely filing of Form 8038-T and rebate payment.
Private Activity Bonds

- **General Rule** - Interest on a State or local government bond is not included in the gross income of the bondholder for federal income tax purposes.

- **Exception to General Rule** - Tax exemption does not apply to a “private activity bond,” with certain limited exceptions.

- **A Private Activity Bond is a Bond that:**
  - Has excessive private business use (PBU), *i.e.* meets the private business use test,
  - *AND*
  - Has excessive private payments and/or security, *i.e.* meets the private security or payment test;
  - *OR*
  - Is a bond, the proceeds of which are used to make excessive loans to persons other than governmental units, *i.e.* meets the private loan test.
Private Business Use Computations

- **Definition** - When all or a portion of a financed facility is used in a private, nongovernmental trade or business.

- **Thresholds** - This test is met when more than 5% of the proceeds of a bond issue are used in a private business use (10% in some circumstances for governmental obligations).

- **Examples of Private Business Use (PBU):**
  - Sale or transfer of property to private business user,
  - Lease of property to private business user,
  - Management of property by private business user under a management or service contract (unless safe harbor is met),
  - Naming rights,
  - Research, including sponsored research contracts.
PBU Exceptions

- **Short-Term Rental Arrangements**
  - 50 days, negotiated arms length agreement.
  - 100 days, according to a rate schedule, not reasonably available \((i.e.\) may be too expensive) for use by individuals.
  - 200 days, according to a rate schedule, primary use by individuals (rather than corporations) not engaged in trade or business.
    - Number of days of use:
      - 11 days a year \(* 5\) years = 55 days
      - Includes all renewal options

- **Use by the General Public**
- **Qualified Improvements**
- **Incidental Use**
# Governmental v. 501(c)(3) Distinctions

<table>
<thead>
<tr>
<th>Topic</th>
<th>Government Public Institution</th>
<th>501(c)(3) Private Institution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Threshold for Private Business Use (PBU)</td>
<td>10% (unless unrelated or disproportionate use, then 5%) or $15 million, whichever is less.</td>
<td>5% of bond issuance or $15 million, whichever is less, including issuance costs of up to 2%.</td>
</tr>
<tr>
<td>Unrelated Trade or Business (UTB)</td>
<td>N/A</td>
<td>UTB, as defined by IRC Section 513(a), counts as PBU (exceptions, such as, rents and other passive income, which is excluded from UTB is not excluded from PBU).</td>
</tr>
<tr>
<td>Schedule K of Form 990</td>
<td>N/A</td>
<td>Annual Filing, (and inquiries about arbitrage &amp; PBU computations.</td>
</tr>
</tbody>
</table>
PBU Computations

- **Internal Process** - Steps to take to establish a functional approach to managing PBU.
  - **Maps** - Establish procedure for mapping what outstanding bond issue financed which facilities and in what amounts.
  - **Allocation** - Establish procedure for allocation of bond proceeds to expenditures, including pre-issuance reimbursement expenditures.
  - **Use** - Establish procedure for allocation of bond proceeds and funds within a bond-financed project to ensure that bond proceeds are used for qualifying costs.
  - **Thresholds** - Monitor private use of bond-financed facilities to ensure compliance with applicable percentage limitations.
PBU Attributes

- **Measurement Factors**
  - Measured on an issue by issue basis - Rental space is measured by square foot allocations.
    - Allocations generally needed for common areas.
  - Life of the Bond – PBU is measured over the life of the bond.
  - Dual-Use of Facilities - For facilities used at certain times by private business users and other times by U-M.
    - For example, a private business user uses a meeting room in the university hall every Wed. and Sat. for 2 hours at a time. That same meeting room is used by the university for 8 hours on Mon., Tue., Thurs., Fri. and Sun. and 6 hours on Wed. and Sat.
    - University use = 52 hours; private business use = 4 hours.
    - **Private business use calculation** (assuming 100% of bond proceeds used for meeting room = 4/56) is **7.15%**.
    - Not permissible since private business use is more than 5% for the issue of bonds.
Record Retention Requirements

- **General Rule** – “Material records should *generally* be kept for as long as the bonds are outstanding” (including refundings), “plus 3 years after the final redemption date of the bonds.”
  - This rule is consistent with the specific record retention requirements under section 1.148-5(d)(6)(iii)(E) of the arbitrage regulations.

- **FAQs on Keeping Records**
  - Why keep records with respect to tax-exempt bond transactions?
  - Who may maintain records?
  - What are the basic records that should be retained?
  - Are these the only records that need to be maintained?
  - How long should records be kept?
  - What happens if records aren't maintained?
  - Can a failure to properly maintain records be corrected?
  - Are there exceptions to the general rule regarding record retention for certain types of records?

What Needs To Be Retained?

- Basis records relating to the bond transaction.
  - Indenture, resolution, and ordinance.
  - Bond counsel opinion.
  - Transcript.
- Documentation that evidences expenditure of proceeds.
- Documentation that evidences use of bond-financed property, including private sources (e.g., cafeteria management contracts).
- Documentation that evidences all sources of payment or security for the bonds.
- Documentation that pertains to any investment of bond proceeds (e.g., Purchase and sale of securities, SLGS subscriptions, yield calculations for each class of investments, rebate calculations).
Additional Documents

- Investment records regarding Swaps, Hedge Funds or SLGS.
- A complete copy, including amendments, modifications, and extensions, of any and all partnerships, joint ventures, or other shared agreement arrangements entered into with regard to the facilities financed, if applicable.
- A depreciation schedule, or schedule of all assets, financed with the bond proceeds, from issue date to the present.
- Trade confirmation tickets indicating the issuer’s cost to purchase the securities for the refunding escrow account.
### Documents Regarding Investments and Arbitrage

**Governmental Bond Financings Compliance Check Questionnaire – Form 14002**

9. Do you maintain records documenting the allocations and earnings and investments related to your bond financings?  
   - Yes [ ]  
   - No [ ]

10. Do you maintain records for investments of your bond financing proceeds related to:
   - a. Investment contracts (e.g., guaranteed investment contracts)?
     - Yes [ ]
     - N/A [ ]
     - No [ ]
   - b. Credit enhancement transactions (e.g., bond insurance contracts)?
     - Yes [ ]
     - N/A [ ]
     - No [ ]
   - c. Financial derivatives (swaps, caps, etc.)?
     - Yes [ ]
     - N/A [ ]
     - No [ ]
   - d. Bidding of financial products?
     - Yes [ ]
     - N/A [ ]
     - No [ ]

11. Do you maintain records of the following arbitrage documents related to your bond financings:
   - a. Computations of bond yield?
     - Yes [ ]
     - No [ ]
   - b. Computation of rebate and yield reduction payments?
     - Yes [ ]
     - No [ ]
   - c. Form 8038-T, Arbitrage Rebate, Yield Reduction and Penalty in Lieu of Arbitrage Rebate?
     - Yes [ ]
     - No [ ]
     - Yes [ ]
     - N/A [ ]
     - No [ ]

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U-M Tax Department

*We mean business in higher education*
‘Gaps’ in Retention

- Various Consequences If Adequate Records are Not Maintained.
  - Issuer or Borrower may have difficulty demonstrating compliance with federal tax law applicable to the bond transaction in the event of an IRS examination.
  - Noncompliance can have various outcomes.
    - Interest treated as taxable.
    - Additional arbitrage rebate may be owed.
    - Penalties.

- IRS - TEB Voluntary Closing Agreement (VCAP) program may provide a way to correct a failure to properly maintain records.
Consequences of Non-Compliance

- SEC investigation for failure to promptly disclose tax risks.
- SEC lawsuits from bond holders.
- Credit ratings risks.
- Difficulty selling bonds in the future.
- Reputational risk to your institution.
Stakeholders

- Bond trustees/underwriters
- Bond legal counsel
- Bond rating agencies
- Bondholders
- Officers & trustees of issuers/borrowers
- Donors, creditors and vendors of issuers/borrowers
- Media & general public
Steps to Take to Manage these Risks and Ensure Compliance

• Plan A -

Dear IRS,

I would like to cancel my subscription. Please remove my name from your mailing list.

• Plan B – Continue with the Power Point
## Comparison and Contrasts Between EO and TEB IRS Audits

<table>
<thead>
<tr>
<th>Exempt Organizations (EO) Examinations</th>
<th>Tax Exempt Bonds (TEB) Examinations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>The length of time</strong></td>
<td><strong>Length of time</strong></td>
</tr>
<tr>
<td>Typically, the audit covers the past 3 Fiscal Years of the taxpayer.</td>
<td>The audit may cover the life of the bond plus 3 years.</td>
</tr>
<tr>
<td><strong>The EO is the taxpayer</strong></td>
<td><strong>The issuer/borrower is not the taxpayer</strong></td>
</tr>
<tr>
<td>The EO has standing to take the IRS to court.</td>
<td>The college or university is not the taxpayer but maintains the records.</td>
</tr>
</tbody>
</table>
Cross-Functional Participation

• Compliance Check question asked of 501(c)(3) conduit issuers – Form 13907

Who is primarily responsible for monitoring post-issuance compliance of bond financings?

☐ Board Member (e.g., Director, Trustee)

☐ Management Official (e.g., Chief Financial Officer, Comptroller, Treasurer)

☐ Staff Person What is the person's title? 

☐ Other Person What is the person's title? 

☐ None
### Assign Departments to At-Risk Issues

<table>
<thead>
<tr>
<th>Issues</th>
<th>Impacted Departments</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Proof of filing</strong></td>
<td>Designated party – Tax/Counsel Support and resources - Treasury</td>
</tr>
<tr>
<td>Forms 8038/G/GC/CP/TC/T with IRS and state (if applicable)</td>
<td></td>
</tr>
<tr>
<td><strong>Private business use (PBU)</strong></td>
<td>Designated parties – Treasury and Tax Support and resources - Purchasing, Research, Facilities &amp; Operations, Accounting.</td>
</tr>
<tr>
<td>Sale of facility, Lease, Nonqualified management contract (Rev. Proc. 97-13), Nonqualified research contract (Rev. Proc. 2007-47), Special Legal Entitlement</td>
<td></td>
</tr>
<tr>
<td>Issues</td>
<td>Assignments</td>
</tr>
<tr>
<td>------------------------------------------</td>
<td>-----------------------------------------------------------------------------</td>
</tr>
</tbody>
</table>
| Arbitrage yield restrictions and rebate procedures | Designated parties – Treasury and Tax/Counsel  
Support and resources - Accounting, and Facilities & Operations. |
| Allocation of proceeds to expenditures   | Designated party – Accounting  
Support and resources - Treasury, Tax/Counsel, Facilities & Operations. |
| Record Retention – general records for life of issue plus any refunding plus three years | Designated party – Accounting and Treasury  
Support and resources  
Tax/Counsel, Accounting, Purchasing, Research, Facilities & Operations. |
Written Tax Procedures

• **Due Diligence** – Written procedures will significantly improve the ability to identify noncompliance and prevent violations from occurring, or timely correct identified violations, to ensure the exemption of the bonds.
  - **Issuers and borrowers should adopt written procedures that reflect the process, procedures and practices to monitor these bonds during their life cycles.**

• **IRS Forms** – Form 8038-G (Information Return for Tax-Exempt Governmental Obligations), and Schedule K of the Form 990 have been recently revised.
  - **They ask whether the filer has written procedures to monitor private business use and arbitrage restrictions as well as correct any resulting violations.**
Critical Elements of Post-Issuance Written Procedures

• **Requirements of a Written Tax Policy** - Such procedures must, at a minimum, specify the following:
  - Identify **official(s)** responsible for monitoring compliance.
  - Describe the **training** provided to these officials.
  - Address the **frequency** of compliance checks (must be at least annually) and the nature of the compliance **activities** required to be undertaken,
  - Include the procedures used to timely **identify** and elevate the resolution of a violation when it occurs or is expected to occur,
  - Provide the procedures for the retention of all **records** material to substantiate compliance, and
  - Discuss the availability of TEB VCAP and other remedial actions to resolve violations. (IRM Section 7.2.3.4.4.2.A)
Implementing This Policy – One Size Does Not Fit All

• Challenges
  – Institutional cooperation?

• Process SNAFU’s
  – Unit turnover?

• Lessons Learned
  – Enter into written agreements with certain delinquent departments?

• Insights
  – How much emphasis does one give to the Private Business Use (PBU) computation or arbitrage calculation as part of the policy?

• Resources – Other polices found on the Internet
Results and Resources

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“SCHWAD,”

“’M WORTH MORE THAN $3,000 AS A FEDERAL INCOME TAX EXEMPTION, SO HOW ABOUT A RAISE IN MY ALLOWANCE?”
Results

- **Executive Reports** – The benefit of reporting to executive management regularly may help to bring cross-functional efforts together and work across ‘silos’.

- **Assurances** – This report should make executives aware of the scrutiny on tax exempt bonds and provide them with comfort that the risks are being managed.
  - This team may include Regents, Trustees, Vice President of Finance, Vice President of General Counsel and/or outside counsel, Director of Internal Audits.

- **Appreciation** - Management may provide additional resources (e.g. access to bond counsel, CPE, software, FTE’s) to ensure that these ‘at-risks’ concerns and related tax matters are handled appropriately.
Information for the Tax Exempt Bond Community

Published Volume Cap Limit for Tribal Economic Development Bonds
IRS announces the Published Volume Cap Limit for applications for allocations of national bond volume limitation authority to issuers of tribal economic development bonds for the period beginning August 1, 2013.

Effect of Sequestration on Certain State & Local Government Filers of Form 8038-CP
Pursuant to the requirements of the Balanced Budget and Emergency Deficit Control Act of 1985, as amended, certain automatic reductions will take place as of March 1, 2013. These required reductions include a reduction to refundable credits under section 942 of the Internal Revenue Code applicable to certain qualified bonds.

Extra Time Granted for Tax-Exempt Bond Issuers Affected by Severe Storms and Tornadoes in Oklahoma
Government entity issuers of tax-exempt bonds affected by the severe storms and tornadoes occurring in parts of Oklahoma may qualify for additional time to file certain returns related to tax-exempt bonds, qualified tax credit bonds, and specified tax credit bonds.

New Voluntary Closing Agreement Program Request Form
The Internal Revenue Service released the new Form 14429, Tax Exempt Bonds Voluntary Closing Agreement Program Request, which must be submitted with a Tax Exempt Bonds Voluntary Closing Agreement Program submission request.

IRS Report on Avoiding Troubled Tax-Advantaged Bonds
This report produced by the TEB Compliance Practice Research Team seeks to provide aid to issuers of tax-advantaged municipal bonds. It identifies some considerations for issuers of such bonds and in TEB’s initial step toward producing public resource products that assist issuers in avoiding troubled transactions.

Sale of Assets Financed with Tax-Exempt Bonds by State and Local Governments and 501(c)(0) Organizations
Often, in need to raise funds, state and local governments and 501(c)(0) organizations may sell property financed with tax-exempt bonds. These sales could cause the bond issue to become
Benchmarks

• Develop relationships and share notes with similar institutions.
  – Ascertain their approach to post issuance compliance, e.g. exchange written tax procedures.
  – Learn how they manage debt compliance responsibilities on their campuses.
  – Understand how they address different situations and contracts related to PBU.

• How they compute PBU?

• What process do they use to review research contracts?

  – Share information on the completion of the Schedule K.
Other Resources

- Subscribe to the Bond Buyer.
- Attend National Association of Bond Lawyers (NABL) tax conferences and webcasts.
- Meet more frequently with outside counsel.
- Subscribe to mailing lists from professional firms that specialize in TEB compliance.
- Surf websites for written tax policies on post-issuance compliance of TEB’s.
- Treasury Institute Tax-Exempt Bond Compliance Workshop.
Questions?