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2018 Outlook: IRS Implementing Data Driven Muni Bond Audits.

WASHINGTON – In 2018 the Internal Revenue Service will rely on a new data driven approach for auditing municipal bonds, while focusing on several regulatory issues.

That's the prediction from bond attorneys, muni market groups and and the director of the recently consolidated IRS enforcement office that handles audits of both tax exempt bonds and Indian tribal governments.

The municipal bond market went through a roller coaster in 2017 that culminated in a new tax overhaul law that terminates advance refundings and tax credit bonds as of Dec. 31 without any transition rules to delay the effective date that had been sought by market participants.

"If you look at advance refundings all they have to do is strike through the code. It's done," said Emily Brock, director of the Federal Liaison Center of the Government Finance Officers Association. "Unfortunately I think there are a lot of technical points that weren't addressed in the final tax legislation that may need greater focus."

From an enforcement standpoint, terminating advance refundings and tax credit bonds means "there will be less for the IRS to look at" in 2018, Ed Oswald, a tax partner at Orrick Herrington & Sutcliffe in Washington, dryly observed.

On the regulatory front, the latest IRS priority guidance targets an update on regulations for bond reissuance, guidance on remedial actions and finalization of the long-awaited updated rules that the IRS and Treasury issued Sept. 28 on the notice and approval requirements for private activity bonds under the Tax Equity and Fiscal Responsibility Act.

Bond reissuance is a timely topic because reissuances will rise with the termination of advance refundings, several lawyers said.

"I suspect that we're going to need clarifications on what is needed or not needed to cause a reissuance," said Perry Israel, a bond attorney based in Sacramento, Calif. who is on the board of the National Association of Bond Lawyers. He foresees "a number of "Cinderella bond" structures in which taxable bonds are changed into tax-exempt bonds as a method of replacing advance refundings.

"Also, there will be a lot of intentional reissuances as banks try to keep their customers. Many direct placements with banks have been written with 'gross up' language that would increase the rate on the bonds if the after tax value is reduced to the bank," Israel said. "This means that if the bank's tax rate reduces, the rate on the bonds would go up — with the reduction in corporate tax rates that could be very costly and banks are going to want to change those adjustments to keep those customers."

Rich Moore, a partner at Orrick Herrington & Sutcliffe in San Francisco who is also a NABL board member, said it isn't clear whether the IRS will break new ground on reissuance rules.

"I don't know whether this new guidance would go in a regulation or be in a notice that would supercede the others," Moore said. "At a minimum, what it is going to do is just take the existing guidance on reissuance rules for tax exempt bonds and put them in one place."

Bond attorneys also are uncertain whether the new TEFRA rules will remain in "proposed" status for the indefinite future or be finalized this year.

IRS spokesman Dean Patterson said his agency "generally does not discuss the timing of future guidance or regulations."

Moore said he's "optimistic they can be finalized because they got the proposed regulations under the Trump administration and they are user friendly."

The proposed rules take into account tax law changes that have expanded the kinds of private activity bonds that can be issued and technological changes that have occurred since 1983 such as the Internet and electronic communications.

TEFRA established the public notice and approval requirements for PABs in 1982 before the PAB categories were expanded. The tax reform legislation recently approved by Congress left PABs untouched so the need for the updated TEFRA rules remains.

The remedial action rules need an update, Oswald said. These are rules on actions that issuers can take to remediate certain tax law or rule violations for tax-advantaged bonds, which include tax-exempt, taxable direct-pay, and taxable tax-credit bonds.

"It's still difficult economically to get either privatizations or P3 transactions done under the current remedial action rules," Oswald said.

On the enforcement side, the IRS expects to close 577 audits in the tax exempt bond office in fiscal 2018, which began on Oct. 1, 2017 and ends on Sept. 30, 2018. That's significantly down from the 717 closed in fiscal 2017 but slightly higher than the 570 concluded in fiscal 2016 and the 569 in fiscal 2015.

The IRS does not offer projections for how many voluntary agreement program cases it will close in fiscal 2018, but the trend has been a decline from 122 in fiscal 2015 to 67 in 2016 and 44 in 2017.

The IRS 2018 work plan for Tax Exempt and Government Entities publicly released Sept. 28 lists "hedge terminations; economic life and weighted average maturity (WAM); safe harbors for guaranteed investment contracts; and rules for qualified hedges" as areas for examination for its new data-driven Knowledge Management unit.

The 2018 work plan lists five areas to focus on as part of its compliance strategy: arbitrage of tax-advantaged bonds with guaranteed investment contracts and/or qualified hedges as well as bonds with investments beyond a temporary period; acquisition financing involving private activity bonds to determine whether the rehabilitation requirement was satisfied; non-qualified use in the disposition of financed facilities and/or excessive private business use; bonds issued with a deep discount; and private activity bonds with excessive weighted average maturities.

Christie J. Jacobs, who took over the consolidated offices of Tax Exempt Bonds and Indian Tribal Affairs in May, told The Bond Buyer in a mid-December interview that she doesn't have any new compliance concerns for 2018.

Jacobs, who has worked for the IRS for more than 28 years, headed the ITG office since its creation in 2000. She started working at the IRS as an intern while attending the Columbus School of Law at Catholic University.

She received her undergraduate degree from Vassar College and is a Maine native who now lives in Colorado.

The reorganization to a combined ITG/TEB office came as an efficiency move against the backdrop of a continuing wave of retirements that has reduced the workforce and reduced funding from Congress.

The TEB operation is expected to have only 19 agents conducting exams by June of 2018, down from 23 at the Oct. 1 start of the fiscal year. In 2009 the office had 60 agents, six managers, five support staff, and technical adviser.

“Because there are fewer people, they will spend less time figuring out where to focus their work and they will be given cases electronically,” Jacobs said. “There’s going to be compliance strategies developed based on data and we will go take those compliance strategies and do audits on those.”

Jacobs said the ITG/TEB office is using a data driven, centralized approach to deciding when to conduct examinations. “This is for all of our divisions, just to be clear, but it’s also for the tax exempt bond work as well,” she said.

One area not tracked by the IRS is states’ compliance with their private activity bond volume caps. “I don’t think that’s generally our function,” Jacobs said. “I know there have been industry concerns about keeping track of those volume caps and I know we’ve looked some at what the states do to keep track of their own volume caps and I don’t think we found those approaches lacking.”

Carol Lew, past president of NABL and a shareholder at Stradling Yocca Carlson & Rauth in Newport Beach, Calif., thinks the new muni audit process, which encourages communication between issuers, their lawyers and auditors as soon as possible after the IRS notifies the issuer of an audit, is “making headway.”

The net effect the new approach, Lew said, is that if a municipal issuer is audited “it doesn’t necessarily mean there’s a problem with their deal.” Instead, the transaction might come under an area the IRS has targeted for examinations.

One example is that the 2018 work plan is focusing on multifamily housing projects that involve existing housing to determine if deals complied with the rehabilitation restriction.

“The issuers may see be a more indepth audit instead of a summary,” Lew said.

By Brian Tumulty

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