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Memo Provides Interim Guidance on Audits of Direct-Pay Bonds.

WASHINGTON – A memorandum recently issued by Rebecca Harrigal, director of the Internal Revenue Service tax-exempt bond office, provides examiners and managers in the office with interim guidance on conducting audits of Build America Bonds and other direct-pay bonds.

The guidance became effective July 20 and will be incorporated into the Internal Revenue Manual, which provides instructions to employees, within the next 12 months.

Direct-pay bonds are taxable bonds for which issuers receive subsidy payments from the federal government equal to some or all of their interest costs. In addition to BABs, direct-pay bonds include new clean renewable energy bonds, qualified energy conservation bonds, qualified zone academy bonds and qualified school construction bonds.

"The examination and processing of resolutions of these bonds present unique situations that require procedures specifically tailored to these bonds," Harrigal said in the memo.

In audits of tax-exempt bonds, the bondholders are relevant because if bonds are determined to be taxable, the bondholders will then have to pay taxes on the interest. However, in audits of direct-pay bonds, the bondholders are not relevant because the bonds are already taxable.

Instead, the eligibility for and the amount of the subsidy payments to the issuers is at stake. Issuers file Form 8038-CP tax returns to request subsidy payments.

Under the interim guidance, examinations of direct-pay bonds will follow the procedures generally applicable to audits of tax-exempt bonds, but with the modifications and additional procedures described in the 39-page memo.

The examination of bonds' qualification as direct-pay bonds and the examination of the 8038-CP forms will generally be handled under the guidance in coordinated but separate ways, said Tom Vander Molen, a partner at Dorsey & Whitney in Minneapolis.

An audit of direct-pay bonds will generally be initiated on the issuer's information return to the IRS that reported the bond transaction. Audits of the 8038-CP forms will generally be opened as related cases when the IRS issues a notice suggesting a problem with the bonds, according to the interim guidance.

Additionally, the memo said that the IRS can choose to audit an individual form 8033-CP to look at matters relating to the amount of the subsidy payment that do not relate to the bonds' status as qualified direct-pay bonds, such has if the issuer filed duplicate returns or did not request a subsidy payment in a timely manner.

The interim guidance addresses the statute of limitations for assessing a penalty on subsidy payments in audits. "For purposes of calculating assessment statute expiration dates, the examiner will treat the period for assessment of tax on Form 8038-CP returns as three years from the date the return is filed," the memo said.

This is similar to the statute of limitations on taxing tax-exempt bond interest as a result of an audit. Generally, if the IRS thinks a bondholder needs to pay tax on bond interest in a certain year, the service needs to take action within three years of when the taxpayer filed his or her return for that year.

The interim guidance states that the procedures for settling an audit of direct-pay bonds will generally follow existing procedures that apply to tax-advantaged bonds.

The guidance also describes what should be done if an issuer agrees that its bonds don't qualify for subsidy payments, enters into a closing agreement where future payments are reduced, or receives a final adverse determination letter. It provides procedures for examiners about the collection of payments from issuers.

Bond lawyers viewed the interim guidance positively.

Vander Molen said that for the most part, the procedures seem to be "appropriate."Carol Lew, a shareholder at Stradling Yocca Carlson & Rauth in Newport Beach, Calif, said she was happy to see the memo come out because it standardizes procedures.

Matthias Edrich, of counsel at Kutak Rock in Denver, said that the future publication of this guidance in the IRM "suggests that the Internal Revenue Service is continuing to look at its procedures proactively to make sure its processes are current and tailored to the characteristics of individual categories of bonds."

The Bond Buyer

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