Bond Case Briefs

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Tax-Exempt Bonds: Post-Issuance Compliance Issues.

Why Borrowers Using Tax-Exempt Bonds Need a Post-Issuance Compliance Policy

For borrowers using tax-exempt bonds, particularly 501(c)(3) organizations, it is tempting to treat the issuance of tax-exempt bonds as the end of a financing process that can be unfamiliar and somewhat complicated. However, it would be unwise for a borrower to place its bond documents on a shelf and ignore them.

There are a number of issues that can arise post-closing that could affect the taxability of the bonds, many of which are addressed in a tax exemption agreement that the borrower likely entered into at closing. These issues include (1) use of the bond proceeds of the bonds, including arbitrage issues relating to investment of the bond proceeds, (2) restrictions on use of the bond-financed property including, in the case of 501(c)(3) bonds, restrictions on the borrower's ability to enter into leases and other contracts related to the bond-financed property with for-profit entities, (3) in the case of 501(c)(3)bonds, maintenance of the borrower's 501(c)(3) status, and (4) disposal of all or part of the bond-financed property. As the borrower has gone to some effort to obtain the advantages of a tax-exempt bond, it should ensure that its post-closing actions and inactions do not jeopardize the tax treatment of those bonds by establishing a post-issuance compliance policy.

The specifics of a post-issuance compliance policy will vary depending on the borrower, the relevant Internal Revenue Code provisions authorizing the bonds and the type of project financed with bond proceeds. For example, post-issuance compliance policies related to 501(c)(3) bonds should focus significant attention on contracts with any private businesses for the use or management of any part of the bond-financed property. Post-issuance compliance policies related to low-income housing bonds should contain detailed provisions related to the requirements for verification of tenants' income limits, and methods of ensuring that the tenant income requirements are adequately monitored and maintained.

As a practical matter, having a comprehensive post-issuance compliance policy that identifies potentially problematic actions related to the bond-financed property and the use of the proceeds is likely to reduce or eliminate violations of federal tax law and the relevant regulations. Employees of the borrower dealing with the bond-financed property and bond proceeds should receive training on the post-issuance compliance policy and, in particular, should understand which types of actions (including third-party contracts, investment of bond proceeds and disposal of bond-financed property, among other actions) need to be flagged, and the compliance officer or outside counsel with whom those actions should be vetted. As Internal Revenue Service ("IRS") Publication5091 notes, reliance on the Tax Exemption Certificate and Agreement alone regarding future compliance obligations is not recommended, as this agreement and the related financing documents may not be known to the relevant employees or may not contain sufficient detail. Further, the language used in the Tax Exemption Certificate and Agreement is legal and technical in nature, and may not be properly understood by employees responsible for the day-to-day functions of the organization, who may not have been involved in the financing transaction at all.

There is another important potential benefit to borrowers involved in tax-exempt financing of having a written post-issuance compliance policy. Tax Exempt Bonds ("TEB"), a division of the IRS, administers federal tax laws applicable to tax-exempt bonds.1 As part of its oversight of tax-advantaged bonds, TEB administers a Voluntary Compliance Agreement Program ("VCAP"), which is a procedure for resolving violations of the federal tax laws applicable to tax-exempt bonds. Parties to a tax-exempt bond issuance that participate in the VCAP generally receive more favorable outcomes than in instances where the IRS's examination of the bonds reveals an issue.2 As part of the information submitted by a borrower to participate in the VCAP, the borrower needs to identify how the violation was discovered and whether it has post-issuance procedures in place to monitor federal tax law compliance.

Using the VCAP following identification of an issue pursuant to a borrower's written post-closing compliance procedures could have several advantages for the borrower. In many cases, the amount that must be paid to resolve an issue under the VCAP will increase the longer the period between the violation and the submission of the VCAP request, so having policies and procedures in place that will promptly identify violations after they occur is important in minimizing the borrower's exposure to additional costs.3 A closing agreement entered into under the VCAP is final and conclusive as to the matters addressed, and may not be reopened or modified by the IRS.4 Further, IRS procedures state that, absent extraordinary circumstances, a bond issuance will not be selected for examination while it is under the VCAP review. A borrower with a comprehensive post-issuance compliance policy is therefore better positioned to take advantage of the VCAP if tax issues arise.

Therefore, while the specifics of the post-issuance compliance policy will vary depending on the type of bonds and the specifics of the borrower's industry and situation, we recommend that all borrowers involved in tax-exempt financing adopt and follow written policies related to post-issuance compliance with federal tax laws and regulations.

Footnotes

1 Note that the TEB VCAP program also applies to other types of tax advantaged bonds, such as tax credit bonds that provide a tax credit to the bond holder, and direct pay bonds, where the issuer receives a refund of part of the interest it pays on the bonds.

2 See https://www.irs.gov/Tax-Exempt-Bonds/New-Voluntary-Closing-Agreement-Program--equest-Form.

3 See Internal Revenue Manual 7.2.3.4.2 and 7.2.3.4.4.

4 See IRC 7121 and the corresponding Regulations.

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

Last Updated: March 16 2016

Article by Mindy F. Rice

Reinhart Boerner Van Deuren S.C.