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New IRS Priorities Include Student Loan Bonds, Form 8038-G.

The Internal Revenue Service on Monday announced new compliance priorities for tax-exempt bonds involving student loan bonds and yield restrictions on Form 8038-G for government-issued municipal bonds.

Monday's announcement came at the halfway mark of fiscal 2021 after only one other priority — arbitrage violations — had been announced since the Oct. 1 start of the federal fiscal year.

The strategy for focusing on student loan bonds will determine if the Internal Revenue Code Section 144(b) requirements are met, the IRS said.

"Failure to satisfy these requirements could result in the interest on the bonds being taxable to the bondholders," the service said. "The treatment stream for this strategy is examinations."

The decision by the IRS to return to auditing student loans after focusing on that area years ago was described as an "interesting" by Christie Martin of Mintz Levin in Boston, chair of the National Association of Bond Lawyers tax law committee.

Matthias M. Edrich, a partner at Kutak Rock in Denver and another member of the NABL tax law committee, also said he was surprised "since this segment already went through an audit focus not too many years ago."

"Yield restriction and arbitrage rebate matters that might relate to student loans would presumably already be incorporated in the yield restriction and arbitrage rebate focus points," Edrich said. "Is the IRS intending to examine other student loan aspects now, beyond the arbitrage bond rules?"

The IRS said its audits of Form 8038-G will "review bond proceeds yield restrictions after the statutory temporary period to determine whether proceeds are restricted to the yield of the issue."

"If the issuer fails to yield-restrict the investments after the temporary period, the bonds will be deemed arbitrage bonds and taxable," the service said. "Additionally, the interest paid to the bondholders will be taxable."

Late last year the IRS said its initial fiscal 2021 focus involved potential arbitrage violations of Internal Revenue Code Section 148 by the investment of bond proceeds in higher-yielding investments beyond the allowable temporary period under Treasury Regulation (Treas. Reg.)1.148-2(e).

At that time, the IRS said other priorities for tax compliance and enforcement involving municipal bonds would be released in quarterly updates on the webpage of the Tax Exempt and Government Entities Division-Compliance Programs and Priorities.

Edrich recalled that he was disappointed last November when the IRS released its fiscal year 2021 program letter with the only reference to tax-exempt bonds contained in the accompanying TE/GE strategic goals publication.

“At the time I remember being disappointed with the lack of details concerning tax-exempt bonds, compared to program letters from prior years,” he said. “I think it is useful that the IRS has now published additional information about its bond-related examination focus.”

The IRS also said Monday that it would continue its fiscal 2020 IRS enforcement and compliance priorities, which were public safety and jail bonds, sinking fund overfunding, and variable rate bonds.

In regard to public safety bonds, the IRS is determining whether federal government use and management contracts cause excessive private business use that adversely affects the tax-exempt status of public safety bonds.

Last last month the Santa Cruz County Jail District in Arizona filed a public notice that the IRS has made a preliminary determination that its 2017 tax-exempt refunding bonds should be treated as retroactively taxable.

The March 10 IRS letter said the jail refunding bonds meet the private business use and private payments test because part of the facility is under contract to house federal prisoners.

In regard to sinking fund over-funding, the IRS is focusing on whether over-funding caused the bonds to be arbitrage bonds, which negatively impacts their qualification as Tax Credit Bonds.

And for variable-rate bonds, the IRS is determining whether the issuances complied with the rebate and yield restriction rules under IRC Section 148, the bond and investment yields were properly computed and rebate or yield reduction liability (if any) was correctly determined.

The IRS audits involving the fair market value of open market securities are determining arbitrage violations under IRC Section 148, specifically as to the fair market value requirements for yield restricted defeasance escrows under Treasury Regulation 1.148-5(d)(6).

The Internal Revenue Service Tax-Exempt Bonds unit closed around 200 fewer examinations in fiscal 2020 than had been expected because of the interruption caused by the pandemic.

New examinations were suspended between March 2020 and last July because of COVID-19.

As a result, the TEB unit closed nearly 300 cases instead of attaining its earlier goal of around 500 cases.

The earlier goal had been cited in a presentation to the National Association of Bond Lawyers more than in 2019 but was not mentioned when the IRS announced its 2020 achievements earlier this year.

The exams that TEB did close involved a combination of “compliance strategies and referrals, claims and other casework,” the IRS said in the February summary published by Edward Killen, the acting commissioner for Tax Exempt & Government Entities group.

The majority of those cases — 170 — involved compliance strategies that “resulted in a written advisory to the bond issuer, including issues such as private business use and issuance costs,” the February statement said.

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