



IRS TEB PUBLISHES FINAL REPORT ON POST-ISSUANCE COMPLIANCE SURVEY

On July 13, 2011, the Tax Exempt Bonds (“TEB”) function of the IRS Tax Exempt and Government Entities Division released its final report (the “Report”) related to TEB’s soft-contact post-issuance compliance check program initiated in 2007. The intent of the program was to evaluate the post-issuance compliance and record retention practices within the tax-exempt bond industry. The Report summarizes the information received in response to the Tax-Exempt Bond Financings Compliance Check Questionnaire (Form 13907) (the “questionnaire”) distributed by TEB. The questionnaire went to 207 exempt organizations described in Section 501(c)(3) of the Internal Revenue Code that had reported outstanding tax-exempt liabilities at the end of the 2005 calendar year.¹

The purpose of the questionnaire was to evaluate whether Section 501(c)(3) organizations have “a sufficient level of knowledge of the post-issuance tax compliance requirements applicable to their

tax-exempt debt obligations.”² According to the Report, “the main focus of the questionnaire was to ascertain the degree of written procedures or guidelines maintained by the Section 501(c)(3) organizations and bond issuers to monitor use of proceeds of their bond issues with respect to expenditures, asset acquisitions, private business use of bond-financed property, and the investment of bond proceeds. In addition, the questionnaire attempted to ascertain the amount of specialized education provided to individuals identified as responsible for monitoring tax-exempt bond post-issuance compliance.”³

This *Commentary* will provide a short description of post-issuance compliance, summarize the results of TEB’s post-issuance compliance check program for Section 501(c)(3) organizations, and describe some suggested best practices for Section 501(c)(3) organizations regarding post-issuance compliance.

¹ The soft-contact compliance check program initiated by TEB in 2007 also evaluated compliance by governmental issuers with post-issuance requirements. This *Commentary* does not discuss the results of that questionnaire.
² Tax Exempt Bonds Questionnaire Project: Final Report on Governmental and Charitable Financings.
³ *Id.*

WHAT IS POST-ISSUANCE COMPLIANCE AND WHY IS IT IMPORTANT?

Section 501(c)(3) organizations that borrow tax-exempt bond proceeds are responsible for ensuring that their financings satisfy all applicable federal tax requirements relating to tax-exempt bonds at the time of issuance *and* for as long as such bonds remain outstanding. The post-issuance federal tax rules applicable to qualified 501(c)(3) bonds generally fall into two basic categories: (1) qualified use of proceeds and financed property requirements and (2) arbitrage yield restriction and rebate requirements.⁴

According to the Advisory Committee on Tax-Exempt and Governmental Entities⁵ (“ACT”) in a report issued on June 13, 2007 and quoted in the Report, “post-issuance tax compliance begins with the debt issuance process itself and provides for a continuing focus on investments of bond proceeds and use of bond-financed property. It will require identifying existing policies, the responsible people, the applicable procedures, and the affected population.”⁶

The consequences of a failure to comply with the federal tax rules applicable to qualified 501(c)(3) bonds can be significant and include the loss of the tax-exempt status of such bonds. According to the IRS, Section 501(c)(3) borrowers should “implement procedures that will enable them to adequately safeguard against post-issuance violations that result in loss of the tax-exempt status of their bonds.”⁷ A Section 501(c)(3) organization with an effective post-issuance compliance policy will be able to determine quickly and efficiently whether its private use is within the prescribed limits at the time of entering into new arrangements, will be able to accurately track the sale of bond-financed property, and will otherwise be able to manage its day-to-day activities in a manner that will ensure the continued tax-exempt status of its bonds. In addition, the implementation of effective post-issuance compliance procedures will make it easier for a Section 501(c)(3) organization to

complete Schedule K of Form 990 and to respond to the IRS in the event of an inquiry related to its bonds. Finally, effective record retention will assist an organization in providing the necessary documentation in the event of a refunding of a tax-exempt bond issue. Such original documentation is essential since the tax-exempt status of the refunding bonds will be determined, in part, based on the assets financed by the initial series of “new money” bonds, including the use of such assets.

THE RESULTS OF IRS FORM 13907, TAX-EXEMPT BOND FINANCINGS COMPLIANCE CHECK QUESTIONNAIRE

The five-page questionnaire, consisting of 27 questions, is divided into five parts. Part I of the questionnaire asks general questions about post-issuance compliance, including whether an organization maintains written procedures or guidelines relating to proper and timely use of bond proceeds and bond-financed property, arbitrage yield restriction and rebate, and timely return filings and other general requirements. In addition, Part I requests information regarding who is primarily responsible for monitoring post-issuance compliance of bond financings at the organization and what training such person or persons receive. Finally, Part I asks general questions regarding the tax-exempt status of the organization and inquires whether the organization is aware of the options available to correct failures to comply with post-issuance requirements. Part II of the questionnaire relates to the general recordkeeping practices of the organization. Part III of the questionnaire inquires whether the organization maintains the necessary documentation relating to the investment of proceeds of tax-exempt bonds and arbitrage and rebate requirements. Part IV of the questionnaire focuses on records relating to the expenditure of bond proceeds. Finally, Part V of the questionnaire relates to the maintenance of records detailing the private business use of assets financed with tax-exempt bond proceeds.

4 I.R.S. Publication 4077 (Rev. 9-2005), *Tax Exempt Bonds for 501(c)(3) Charitable Organizations Compliance Guide*.

5 The Advisory Committee on Tax Exempt and Governmental Entities is an organized public forum for the IRS to receive regular input on administrative policy and procedures of the Tax Exempt and Governmental Entities Division. The advisory committee consists of external stakeholders who are appointed by the Secretary of the Treasury.

6 I.R.S. Publication 4344 (Rev. 6-2007), *Advisory Committee on Tax Exempt and Governmental Entities Report of Recommendations*, dated June 13, 2007. See section entitled “After the Bonds are Issued: Then What?”

7 I.R.S. Publication 4077 (Rev. 9-2005), *Tax Exempt Bonds for 501(c)(3) Charitable Organizations Compliance Guide*.

TEB sent the questionnaire to 207 organizations and received 203 responses.⁸ Of the 203 responses, 11 respondents indicated that they either did not have bonds or that their bonds were not qualified 501(c)(3) bonds. The final report summarizes the data received from the remaining 192 respondents.

In response to the questions regarding the implementation of formal, written procedures or guidelines relating to post-issuance compliance, approximately 95 percent of the respondents represented that they had written procedures or guidelines in place relating to the use of proceeds and property, arbitrage, and other filings and general requirements. However, the respondents were also asked to provide narrative responses describing such written procedures. Based on these narrative responses, TEB determined that, in actuality, only 15 percent of the respondents maintain true *written* procedures relating to post-issuance compliance, 33 percent of the respondents perform the necessary post-issuance compliance procedures on an “ad hoc” basis without formal written guidelines, 28 percent rely on the requirements set forth in the tax certificate or other bond documents, and 2 percent of the respondents engage specialists to monitor post-issuance compliance. According to TEB, another 19 percent of the respondents either failed to provide a narrative response or provided a nonresponsive or inadequate description of their procedures. In the Report, TEB stated “these conclusions are consistent with previous TEB examination experience, which has noted significant pockets of industry inattention to post-issuance compliance, particularly with respect to maintenance of records throughout the life of the bonds.”⁹

In addition, the responses to the questionnaire indicated that organizations are predominantly delegating the responsibility for post-issuance compliance to a high-level person within the organization.

The TEB concluded that the responses to questions relating to record retention policies and procedures indicated that almost all of the organizations adequately maintain the necessary bond-related records to ensure post-issuance compliance. However, some of the organizations responded that they did not keep certain tax-exempt records, such as their Form 1023.

Based on the responses provided to the questionnaire, TEB concluded that “overall, our analysis indicated a high level of awareness of compliance requirements in each of the aforementioned areas. However, there still appear to be significant misconceptions and inadequacies concerning the responsibilities of governmental issuers and conduit borrowers in post-issuance compliance.”¹⁰ TEB further concluded that, “the responses to the questionnaire indicated that there is a high recognition of the importance of post-issuance compliance and recordkeeping; however, the overall effectiveness of the implementation of such programs is questionable.”¹¹

WHAT DO THE RESULTS MEAN TO YOUR ORGANIZATION?

Establishment of post-issuance compliance procedures is not strictly required by any current statutes or regulations. The IRS also acknowledged in the Report that, due to the phrasing of some of the questions in the questionnaire, “the data may not fully disclose the actual level of compliance with applicable post-issuance requirements.”¹² Finally, the IRS noted that the questionnaire did not require respondents to indicate the dates of implementation of various procedures referenced in the questionnaire and that “identifying such dates would improve the [IRS’s] ability to assess both historical compliance practices and, possibly, the effectiveness of the ‘soft contact’ approach in encouraging respondents to adopt such procedures *voluntarily* (emphasis added).”¹³

8 According to the Report, the four nonrespondents were referred for classification to determine the appropriateness of opening an examination of a specific bond issuance for which they are the beneficiary or for other follow-up.

9 Tax Exempt Bonds Questionnaire Project: Final Report on Governmental and Charitable Financings.

10 *Id.*

11 *Id.*

12 *Id.*

13 *Id.*

At the risk of doubting the veracity of the respondents, one might wonder whether respondents felt the only “safe” response was “yes,” with such a response to be immediately followed up by the establishment of post-issuance compliance procedures. (Note that the IRS commented that “about half of the respondents failed to describe their written procedures and guidelines, despite being asked to do so.”)¹⁴

Nevertheless, at this point, the IRS has a survey that indicates that “between 93% and 95% of the respondents reported they had post-issuance written procedures or guidelines to ensure that their tax-exempt bonds remained in compliance with the federal tax requirements...”¹⁵ Based on the questionnaire, it would seem that the IRS could argue that any organization that does not have such procedures is not acting in a manner consistent with the vast majority of other Section 501(c)(3) organizations.

In the Report, TEB acknowledged the taxpayer burden relative to record retention and other tax-exempt bond requirements, quoting ACT’s 2007 report that noted that post-issuance compliance procedures “may require *on-going* (emphasis added) consultation with bond counsel”¹⁶ and that “such consultation may go beyond the scope of bond counsel’s initial engagement.”¹⁷ Despite “acknowledging” that burden, TEB noted that it will actively continue to monitor post-issuance compliance and record retention practices of issuers and borrowers of tax-exempt bonds.¹⁸

TEB concluded in the Report that “information gathering projects, such as these compliance questionnaires, should be an integral component to the IRS’s tax-exempt bond compliance program.”¹⁹ Therefore, despite the lack of any true regulatory requirement for post-issuance compliance procedures and the acknowledged cost of implementing and maintaining such a program, it would seem that a

Section 501(c)(3) organization puts itself and its bonds at risk if it does not establish written procedures and actively monitor its post-issuance compliance.

SOME POST-ISSUANCE COMPLIANCE BEST PRACTICES

First and foremost, Section 501(c)(3) organizations should adopt formal, written policies and procedures governing post-issuance compliance. Organizations should not simply rely on “ad hoc” procedures. According to the Report, the IRS’s “examination experience suggests that the adoption and consistent utilization of *formal* (emphasis added) procedures and practices generally improves the likelihood of post-issuance compliance.”²⁰ “The IRS believes that it is important for Section 501(c)(3) and governmental organizations to have clearly defined procedures and to implement and review those procedures over time to insure the current person(s) responsible for post-issuance compliance will be able to fulfill their duties.”²¹ Bond counsel can be engaged to assist in the development of a procedural framework.²²

Second, organizations should assign responsibility for post-issuance compliance to a specific individual or group of individuals within the organization. In the Report, TEB referenced ACT’s 2007 report, which states, “most important is to assign responsibility for post-issuance tax law compliance and to be sure that sufficient information is routinely identified and maintained to allow those who later inherit that responsibility to successfully continue the job.”²³

Third, Section 501(c)(3) organizations should retain bond-related books and records for the life of the bond issue and for the life of any refunding bond issue. Such books and records should include both the bond transcript and

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ I.R.S. Publication 4344 (Rev. 6-2007), *Advisory Committee on Tax Exempt and Government Entities Report of Recommendations*, dated June 13, 2007. See section entitled “After the Bonds are Issued: Then What?”

¹⁷ *Id.*

¹⁸ See Tax Exempt Bonds Questionnaire Project: Final Report on Governmental and Charitable Financings.

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.*

²² See I.R.S. Publication 4344 (Rev. 6-2007), *Advisory Committee on Tax Exempt and Government Entities Report of Recommendations*, dated June 13, 2007. See section entitled “After the Bonds are Issued: Then What?”

²³ *Id.*

documents relating to the use of the bond-financed assets and the investment of bond proceeds. In addition, Section 501(c)(3) organizations should maintain records that track all expenditures financed with bond proceeds and documents relating to the sale or other disposal of bond-financed assets. For specific guidance on what bond-related books and records should be retained, Section 501(c)(3) organizations can review several publications, including the Post Issuance Compliance Checklist developed by the National Association of Bond Lawyers and the Government Finance Officers Association, which is available at <http://www.nabl.org/library/documents/107>. In addition, Section 501(c)(3) organizations should maintain records related to their tax-exempt status, such as Form 1023. “Sufficient records should be maintained to allow newly installed officials or new personnel to successfully continue compliance monitoring.”²⁴

Fourth, organizations should consider integrating their post-issuance compliance programs with their accounting systems. “Whenever possible, monitoring of tax law compliance should be integrated with existing accounting systems so that those who directly manage bond-financed assets will be prompted to identify relevant facts at the time any changes are contemplated and to communicate such plans to the appropriate finance officials. For example, bond-financed property could be specially coded on an existing plant ledger in order to require *advance* (emphasis added) review of contemplated sales, leases, or other contractual arrangements involving bond-financed property.”²⁵

CONCLUSION

The summary of the questionnaire and the IRS’s conclusions drawn from the Report seem to indicate that a prudent Section 501(c)(3) organization that does not currently have in place written post-issuance compliance procedures should immediately begin to establish such procedures. Ongoing compliance with the federal tax rules applicable to qualified 501(c)(3) bonds is critical to maintaining the tax-exempt status of such bonds. The establishment of written, post-issuance compliance procedures should help to ensure that Section 501(c)(3) organizations do not inadvertently fail to comply with such federal tax rules. Such procedures will also have the added benefit of assisting Section 501(c)(3) organizations in responding to certain questions on Form 990.

²⁴ Tax Exempt Bonds Questionnaire Project: Final Report on Governmental and Charitable Financings.

²⁵ I.R.S. Publication 4344 (Rev. 6-2007), *Advisory Committee on Tax Exempt and Government Entities Report of Recommendations*, dated June 13, 2007. See section entitled “After the Bonds are Issued: Then What?”

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

CHICAGO

John F. Bibby, Jr.

+1.312.269.4240

jfbibby@jonesday.com

Daniel J. Bacastow

+1.312.269.4066

djbacastow@jonesday.com

David J. Kates

+1.312.269.1589

djkates@jonesday.com

Michael J. Mitchell

+1.312.269.4177

mmitchell@jonesday.com

Richard K. Tomei

+1.312.269.4091

rktomei@jonesday.com

Robert L. Capizzi

+1.312.269.1504

rlcapizzi@jonesday.com

Amy C. Curran

+1.312.269.4347

acurran@jonesday.com

BOSTON

Lynn L. Coe

+1.617.449.6884

llcoe@jonesday.com

NEW YORK

Valerie Pearsall Roberts

+1.212.326.3610

vroberts@jonesday.com

SAN FRANCISCO

S. Louise Rankin

+1.415.875.5777

srankin@jonesday.com

Jones Day publications should not be construed as legal advice on any specific facts or circumstances. The contents are intended for general information purposes only and may not be quoted or referred to in any other publication or proceeding without the prior written consent of the Firm, to be given or withheld at our discretion. To request reprint permission for any of our publications, please use our "Contact Us" form, which can be found on our web site at www.jonesday.com. The mailing of this publication is not intended to create, and receipt of it does not constitute, an attorney-client relationship. The views set forth herein are the personal views of the authors and do not necessarily reflect those of the Firm.