



## PUBLIC FINANCE UPDATE

### Post-Issuance Compliance Procedures for Issuers

On August 11, 2011, the Internal Revenue Service (the “IRS”) released revisions to the section of the Internal Revenue Manual (the “2011 IRM Revisions”)<sup>1</sup> that provides guidelines for the IRS’s voluntary closing agreement program (“VCAP”). The 2011 IRM Revisions, among other things, create incentives for issuers and conduit borrowers to establish written post-issuance compliance procedures by providing that an issuer (or conduit borrower) that has such written procedures in place before bringing a possible tax law violation to the attention of the IRS may receive more favorable treatment by the IRS.<sup>2</sup> In addition, as described below, having written procedures would enable issuers, in many cases, to identify violations at an earlier point in time, facilitating an earlier VCAP submission and, under the IRM Revisions, a reduced closing agreement amount.

#### History/Background

The tax exemption or other “tax advantage”<sup>3</sup> of a state or local bond depends not only on the reasonable expectations of the issuer of such bonds (and in the case of conduit bonds, the conduit borrower) on their issue date, but also on compliance over the term of the bonds with applicable requirements of the Internal Revenue Code of 1986 (the “Code”) relating to the use of the bond-financed facilities and various arbitrage restrictions. Bond counsel’s opinion rendered at closing, which is typically based on substantial due diligence prior to the sale and issuance of the bonds, is premised on continued compliance by the issuer (and the conduit borrower) with applicable use and arbitrage requirements over the term of the bond issue.<sup>4</sup>

<sup>1</sup> The Internal Revenue Manual is a guide used by IRS personnel in conducting IRS examinations.

<sup>2</sup> In general, an issuer that brings a violation to the IRS’s attention pursuant to VCAP receives more favorable treatment than an issuer whose violation is discovered in the context of an audit. The 2011 IRM Revisions now distinguish VCAP applicants between those that have established written procedures and those that have not. Having written post-issuance compliance procedures in place also facilitates an issuer’s completion of its information reporting form (Forms 8038-G, 8038, etc.) in connection with its financings and, for 501(c)(3) organizations that are conduit borrowers, the borrower’s Form 990, Schedule K.

<sup>3</sup> “Build America bonds” issued pursuant to the American Recovery and Reinvestment Act (“ARRA”), under which a direct subsidy payment equal to 35% of the interest on the bonds is made to the issuer, are an example of tax-advantaged bonds other than tax-exempt bonds. Tax credit bonds, such as qualified zone academy bonds, qualified school construction bonds and qualified clean renewable energy bonds, are other examples.

<sup>4</sup> It is customary for the documents for the bond issue to include appropriate covenants of the issuer (and conduit borrower) to comply with applicable use and arbitrage requirements and, more broadly, to take whatever action is necessary to preserve the tax exemption of the bonds.

In June 2007, the Advisory Committee on Tax Exempt and Government Entities issued a report entitled “After the Bonds are Issued: Then What?” (the “2007 ACT Report”), which emphasized the need for issuers and conduit borrowers to develop written, post-issuance compliance procedures. The 2007 ACT Report stated that “[t]he particular procedures which are appropriate may vary substantially, depending upon the size and complexity of the issuer/borrower, the complexity of the financing, the number of bond issues to be monitored, and the type of bond issue involved, *e.g.*, governmental general obligations, qualified 501(c)(3) bonds, multifamily housing bonds.” The 2007 ACT Report thus recognizes that, in implementing procedures, one size does not fit all and that compliance procedures may need to be tailored to the needs of the particular issuer.

Also in 2007, the IRS began the process of sending compliance check questionnaires to 501(c)(3) conduit borrowers and issuers.<sup>5</sup> The IRS intended these questionnaires, among other things, to elicit information from these entities regarding their post-issuance compliance policies and procedures, including their recordkeeping procedures relating to bond-financed property and the investment of proceeds.

On July 1, 2011, the IRS released its Final Report on Governmental and Charitable Financings, which summarized its findings in relation to the above two questionnaires. While most of the entities that responded indicated their understanding that the tax exemption of interest on debt issued by them or for their benefit was dependent on ongoing compliance with applicable tax requirements, few of the respondents had established written, post-issuance compliance policies and procedures. The IRS has repeatedly indicated its concern about the lack of such policies and procedures.

The IRS has put in place an additional compliance measure with respect to qualified 501(c)(3) bonds – the use of the federal information return. Over the last several years, the IRS has developed (and refined) a new Schedule K that is part of a 501(c)(3) organization’s annual information reporting return, Form 990. Form 990, Schedule K, is a means by which the IRS can gain access to certain information relevant to the post-issuance activities of 501(c)(3) organizations. Part III of Schedule K requests information relating to an organization’s private business use and unrelated trades or businesses with respect to facilities financed by tax-exempt bonds issued after 2002.<sup>6</sup>

## The 2011 IRM Revisions

While the above questionnaires and the IRS’s July 1, 2011, Report cited above evidence an increased focus by the IRS on post-issuance compliance procedures, the release on August 11, 2011, of the 2011 IRM Revisions is significant in that the IRS for the first time created specific consequences that differentiate between issuers and borrowers that have established written, post-issuance compliance procedures and those that have not.<sup>7</sup>

Paragraph 3 of Section 7.2.3.2.1 of the Internal Revenue Manual provides:

3. The issuer must include with the [VCAP] request an affirmative or negative statement as to whether it has adopted comprehensive written procedures intended to promote post-issuance compliance with, and to prevent violations of, the provisions of the Code related to tax-advantaged bonds. The issuer must also include a detailed description of the portion of such comprehensive procedures which relate to the violation which is the subject of the TEB VCAP request. The description of such written procedures should identify the authorized person(s) that adopted the procedures, the officer(s) with responsibility for monitoring compliance,

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<sup>5</sup> The IRS sent Form 13907 to 207 501(c)(3) organizations and sent Form 14002 to 200 state and local government issuers. Not all recipients responded to these questionnaires.

<sup>6</sup> In addition to bonds issued prior to 2003, bonds issued after 2002 to refund a pre-2003 bond issue are also exempt from the completion of Part III of Schedule K.

<sup>7</sup> For direct subsidy build America bonds and certain qualified tax credit bonds with respect to which issuers have opted to receive a direct subsidy rather than to provide a tax credit to investors, issuers are required to file periodically a Form 8038-CP in order to receive their subsidy. The person signing the return is required to declare under penalties of perjury that he or she has examined the return and that the statements in the return are, to the best of that person’s knowledge, true, correct and complete. The signing of this return has been viewed as another way the IRS requires issuers to assure, as of the date of such returns, that their bond issues continue to comply with applicable tax rules.

the frequency of compliance check activities, the nature of the compliance check activities undertaken, and the date such procedures were originally adopted and subsequently updated (if applicable). The extent to which an issuer has appropriate written compliance procedures will be an equitable factor that will receive consideration in determining appropriate resolution terms with respect to VCAP requests.

Section 7.2.3.4.4 of the IRM effectively provides that with respect to “resolution standards”<sup>8</sup> for violations that are based on a period of time after the date of a violation, such period of time will be shortened if the issuer had, prior to the date of the violation, “adopted written procedures to ensure that its tax-advantaged bonds remain in compliance with all post-issuance related federal tax requirements that are conditions to the tax-advantaged status of the bonds.”<sup>9</sup> Such shortened period would reduce the closing agreement amount an issuer would need to pay to resolve its VCAP request.

Further, under Section 7.2.3.4.2 of the IRM, the issuer would pay a higher amount (110% of what it would otherwise pay) if it submits a request more than six months after the violation occurred, and an even higher amount (more than 110% of what it would otherwise pay) if it submits a request more than one year after the violation. This change to the IRM provides an additional incentive to have written, post-issuance compliance procedures in place, with the presumption that the issuer would be better able to identify a violation earlier than it would have absent such procedures.

## Written Procedures

The release of the 2011 IRM Revisions was accompanied by a revised IRS web page entitled “TEB Post-Issuance Compliance: Some Basic Concepts.”<sup>10</sup> The web page provides, among other things, that issuers should adopt written procedures, applicable to all bond issues, that go beyond reliance on tax certificates included in closing documents. The IRS specifically stated that “[s]ole reliance on the closing bond documents may result in procedures insufficiently detailed or not incorporated into an issuer’s operations.”

The web page also states that written procedures should include provision for:

- Due diligence review at regular intervals;
- Identifying the official or employee responsible for review;
- Training of the responsible official/employee;
- Retention of adequate records to substantiate compliance (*e.g.*, records relating to expenditure of proceeds);
- Procedures reasonably expected to timely identify noncompliance; and
- Procedures ensuring that the issuer will take steps to timely correct noncompliance.

Finally, the IRS web page states that:

The goal of establishing and following written procedures is to identify and resolve noncompliance, on a timely basis, to preserve the preferential status of tax-advantaged bonds. Generally, an issuer that has established and followed comprehensive written procedures to promote post-issuance compliance is less likely than an issuer that does not have such procedures to violate the federal tax requirements related to its bonds.

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<sup>8</sup> Sections 7.2.3.4.2 and 7.2.3.4.3 of the Internal Revenue Manual provide for specific resolution standards associated with specific violations, which are often, though not always, the tax exposure on outstanding bonds for a particular period of time. Until the recent IRS modification, the accrual of the closing agreement amount, such as tax exposure, would begin on the date of the violation.

<sup>9</sup> The section goes on to provide that these requirements “are also satisfied when such post-issuance compliance procedures are implemented after the date of the violation if the issuer both timely identifies the violation following implementation of such procedures and submits its TEB VCAP request no later than 90 days after identification.”

<sup>10</sup> See <http://www.irs.gov/taxexemptbond/article/0,,id=243503,00.html>.

Paragraph 2(A) of Section 7.2.3.4.4 of the Internal Revenue Manual provides as follows with respect to the content of an issuer's written procedures:

- A. Such procedures must, at a minimum, specify the official(s) with responsibility for monitoring compliance, a description of the training provided to such responsible official(s) with regard to monitoring compliance, the frequency of compliance checks (must be at least annually), the nature of the compliance activities required to be undertaken, the procedures used to timely identify and elevate the resolution of a violation when it occurs or is expected to occur, procedures for the retention of all records material to substantiate compliance with the applicable federal tax requirements, and an awareness of the availability of TEB VCAP and other remedial actions to resolve violations. Generally, a reference to reliance on the bond documents, without more, will not qualify as written procedures that satisfy this paragraph.

## Recommendation

Issuers and conduit borrowers are strongly encouraged to develop and adopt workable, written post-issuance compliance policies and procedures in order to minimize the opportunity for tax law violations and, upon their occurrence, to enhance their ability to identify such violations promptly and take appropriate remedial action to preserve the tax advantaged status of outstanding debt. Please contact the Sidley Tax or Public Finance lawyer with whom you usually work for assistance in developing and adopting post-issuance compliance policies and procedures suitable to your particular needs.

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