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Increased Compliance Scrutiny of Tax-Exempt Bonds

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The federal government has been steadily increasing its scrutiny of tax-exempt bonds. As part of that effort, the Internal Revenue Service (IRS) has increased its focus on continuing compliance with federal tax law requirements for as long as the bonds remain outstanding.

For the past three decades, the Tax Code has required the filing of a tax form (IRS Form 8038/IRS Form 8038-G) in connection with the issuance of tax-exempt bonds. The IRS periodically updates and revises these forms, which request information about the issuer, the borrower (if different from the issuer) and the terms of the bonds, including use of proceeds, life of assets financed, interest rate and final maturity.

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Issuers of Bonds and Written Compliance Procedures

In 2007 and 2008, the IRS first sent questionnaires to 501(c)(3) organizations and issuers, respectively, regarding their procedures for monitoring compliance with federal tax law requirements after bond issuance. Establishing and maintaining such compliance procedures was not mandatory, but the questionnaires were the first step by the IRS in its analysis of the overall compliance by the municipal industry with the tax law requirements.

In 2011, the IRS revised its Form 8038 and Form 8038-G to ask issuers of tax-exempt bonds to disclose whether they have established written procedures to ensure compliance with the private use and arbitrage limitations applicable to tax-exempt bonds. Specifically, on the Forms, the issuers are asked the following:

1. Has the issuer established written procedures to ensure that all nonqualified bonds of the issue are remediated according to federal tax law requirements?

   Relevant tax law limitations include, but are not limited to (a) restrictions on use of proceeds; (b) restrictions on use of facilities financed with tax-exempt bonds; (c) restrictions on permissible users of facilities financed with tax-exempt bonds; (d) restrictions on change in use of bond-financed facilities, from permitted to impermissible use; and (e) requirements with respect to timing for expenditure of proceeds of tax-exempt bonds.
2. Has the issuer established written procedures to monitor a bond issue's compliance with arbitrage, investment yield restriction and rebate requirements of federal tax law?

Relevant tax law limitations include, but are not limited to; (a) restrictions on investment of bond proceeds pending disbursement; (b) restrictions on source of payment of debt service on bonds; (c) restrictions on investment of funds to be used to pay debt service; (d) computation of amount of excess investment earnings (if any) that must be rebated to the federal government; and (e) payment of any rebate amount.

These procedures are still not mandatory, but an issuer's failure to establish written procedures could serve as a "red flag" to the IRS, for bonds issued by an issuer that does not have such procedures might be seen, rightly or wrongly, as more likely to run afoul of tax law requirements. At the very least, the IRS might surmise that an issuer without written compliance procedures will be less likely to discover that problems have arisen after issuance. The fewer red flags that prod the IRS to open an audit with respect to an issue of bonds, the better. An issuer's establishment of such procedures can remove one potential red flag.

The Benefits to Colleges and Universities of Establishing Written Compliance Procedures

While technically the issuers of bonds (*e.g.* Wisconsin Health and Educational Facilities Authority, Illinois Finance Authority, Dormitory Authority of the State of New York) are typically responsible for tax-related liability, bond and loan documentation invariably places responsibility for tax law compliance (and responsibility for noncompliance) on the borrowers (*i.e.* colleges and universities). If the bonds become taxable (or are in jeopardy of being declared taxable by the IRS), the college or university will generally bear ultimate responsibility, financial and otherwise.

The best way in which a college or university borrower can minimize the likelihood that it will have to make payments in connection with bonds becoming "taxable" is to ensure that all federal tax law requirements are satisfied throughout the life of the bonds. The best way to decrease the likelihood of an audit by the IRS of a particular bond issue is to monitor the bonds and the bond-financed project for as long as the bonds that financed the project are outstanding.

Monitoring use of a bond-financed facility in the world of higher education is especially important because use of such facilities may constantly change. A bond-financed college gymnasium, bookstore, cafeteria, science laboratory or auditorium may change from its originally-anticipated use. Such commonplace actions as executing a new management agreement for the operation of a particular portion of a facility or permitting use of an auditorium by for-profit community theater groups, if in violation of tax law limitations, could be enough to jeopardize the tax-exempt status of bonds.

Colleges and universities should consider establishing written bond compliance procedures. By monitoring the long-term compliance of its bond issues and the facilities financed thereby, colleges and universities can (a) best prevent bonds from violating federal tax law requirements, (b) in the event a violation has occurred, more quickly discover the violation and (c) take the steps necessary to remedy the violation and prevent the bonds from becoming taxable.