

IRS EXAMINATIONS OF TAX-EXEMPT BONDS: AN AGENT'S PERSPECTIVE

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I. INTRODUCTION

The first federal income tax enacted after passage of the Sixteenth Amendment in 1913² exempted from federal taxation interest income from debt instruments issued by states and municipalities.³ For the most part, limitations on this exemption were not instituted until 1968.⁴ However, the Tax Reform Act of

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² The Sixteenth Amendment states that “Congress shall have the power to lay and collect taxes on incomes, from whatever source derived” U.S. CONST. amend. XVI. The first income tax “debut[ed]” in 1862 and was passed in an effort to help “finance the Civil War.” MICHAEL J. GRAETZ, *THE DECLINE (AND FALL?) OF THE INCOME TAX* 15 (1997). The tax rates imposed by this first income tax legislation periodically were raised and lowered, but the legislation eventually was repealed in 1872. *See id.* In 1894, the income tax was “reinstated,” but the Supreme Court struck down the 1894 income tax as unconstitutional because it was unequally apportioned among the states. *Id.* (*citing* *Pollock v. Farmers’ Loan & Trust*, 157 U.S. 429 (1895)). Congress was thus led to amend the Constitution and to subsequently enact the Revenue Act of 1913, Pub. L. No. 16, 38 Stat. 114 (codified as amended in scattered sections of 26 U.S.C.).

³ DENNIS ZIMMERMAN, *THE PRIVATE USE OF TAX-EXEMPT BONDS: CONTROLLING PUBLIC SUBSIDY OF PRIVATE ACTIVITY* 1 (1991). Zimmerman provides a good overview of the history of municipal bonds (as this term refers to bonds issued by both states and municipalities); more specifically, Zimmerman discusses the popular transition from state-issued bonds to bonds issued by local governments. *See id.* at 17-26. Further, Zimmerman notes that the use of municipal bonds to finance railroad construction in the mid- to late 1800s sparked the merger of private and public debt, which is akin to today’s systematic use of tax-exempt bonds. *See id.* at 20-1.

⁴ *See id.* For example, the Revenue and Tax Expenditure Act of 1968, Pub. L. No. 90-364, 82 Stat. 251 (repealed 1980), restricted the tax-exempt status of certain industrial development bonds. *See, e.g.*, Clayton Gillette, *Fiscal Federalism and the Use of Municipal Bond Proceeds*, 58 N.Y.U. L. REV. 1030, 1070-71 (1983) (stating that “Congress restricted use of the tax exemption for industrial revenue bonds in 1968”) and Melanie McGee Platt, *The Impact of TEFRA and the 1984 Act on Small Issue Industrial Development Bonds*, 33 EMORY L.J. 779, 798 (1984) (recounting the general history of tax treatment of industrial development bonds).

1986⁵ (the “1986 Act”) extensively revised the Internal Revenue Code (“IRC”) and, in the process, “thoroughly overhauled” the IRC’s tax-exempt bond provisions.⁶ In the late 1980s, the Internal Revenue Service (“IRS”) discovered transactions in which documents were backdated so that bond issuances could qualify for tax-exempt status under pre-1986 restrictions.⁷ Accordingly, the IRS began to examine tax-exempt bond issuances in earnest.⁸

Currently, the IRS has a small workforce examining tax-exempt bond issuances (some states are assigned only one agent), but it is a force that has had and will continue to have a major impact within the bond community. Indeed, this small force has raised legitimate questions as to valid tax-exempt status, resulting in the determination of taxability, and ultimately forcing issuers, counsel, underwriters, and conduit borrowers⁹ to pay significant amounts in taxes, penalties, and liability claims. The IRS is unlikely to reduce its efforts in this area. Consequently, attorneys who represent issuers and purchasers of tax-exempt bonds must be aware, at least on a cursory level, of the general process by which the IRS and its agents approach a tax-exempt bond examination, and they should be able to recognize when expert bond counsel is necessary. Therefore, this Paper provides an agent’s perspective of the basic process by which the IRS examines tax-exempt bond issuances.

⁵ Pub. L. No. 99-514, 100 Stat. 2781 (1986) (codified as amended at 26 U.S.C.).

⁶ ZIMMERMAN, *supra* note 3, at 1. Currently, interest income from tax-exempt bonds generally is excluded from gross income under I.R.C. § 103. *See* I.R.C. § 103(a) (2000).

⁷ Nicknamed “black-box deals” by IRS employees, these transactions were an obvious response to the 1986 Act’s limitations on the tax-exempt status of certain state- and municipality-issued bonds.

⁸ The IRS eventually articulated this effort in a 1993 announcement in the Internal Revenue Bulletin. *See* I.R.S. Announcement 93-92, 1993-24 I.R.B. 66. More specifically, the IRS “consolidat[ed] and coordinat[ed] all enforcement activities relating to tax-exempt bonds under the jurisdiction of the Assistant Commissioner (Employee Plans and Exempt Organizations) (‘EP/EO’).” *Id.* Further, the announcement stated that “EP/EO is expanding its examination program to include all types of tax-exempt bond transactions.” *Id.* This new examination program purportedly includes “significant levels of audit coverage,” prompt response “to abusive transactions,” and an increase in “effective use of tax-exempt bond information returns.” *Id.* Finally, the announcement solicited public comment on this new approach. *Id.* In fact, the public comments received led the IRS to “develop[] proposed examination guidelines (or instructions) for Internal Revenue Agents to use during examinations of municipal financing arrangements.” I.R.S. Announcement 95-61, 1995-32 I.R.B. 54.

⁹ “Conduit borrowers” refers to organizations that receive the proceeds from tax-exempt bonds issued by a governmental unit established pursuant to IRS Revenue Ruling 63-20. *See infra* notes 11-14 and accompanying text.

II. THE ROLES OF THE PARTIES¹⁰ TO AN EXAMINATION

A. Issuers

Tax-exempt bonds are issued by government entities or by government-sponsored nonprofit organizations, commonly referred to as “63-20 Corporations” or as “on-behalf-of” organizations.¹¹ Because an IRS examination of a tax-exempt bond issuance begins with the issuer, the examination will begin with the government (or its sponsored entity). However, because the government technically provides the bonds with their tax-exempt status, it is also considered the taxpayer for examination purposes.

As the taxpayer, a tax-exempt bond issuer has a major role in the examination process. It is therefore incumbent upon the issuer to understand its role in the examination process and its relationship to the bondholders. My experience has revealed that issuers are generally of the opinion that their role ends once the

¹⁰ This recitation of the parties to an examination does not include legal counsel, even though attorneys are an integral part of the examination process. Ordinarily, each party has its own counsel, and this author assumes that the attorneys understand their respective roles. From an academic standpoint, it is interesting to note that the bondholders, the parties most directly affected by a determination of taxability, usually are neither present nor represented during the examination process.

¹¹ The IRS allows certain nonprofit corporations, “formed under the general nonprofit corporation law of a state” and formed “for the purpose of stimulating industrial development within a political subdivision of the state,” to issue obligations “on behalf of the political subdivision.” Rev. Rul. 63-20, 1963-1 C.B. 24. In addition, the nonprofit corporation must meet the following requirements:

- (1) the corporation must engage in activities [that] are essentially public in nature;
- (2) the corporation must [not] be ... organized for profit (except to the extent of retiring indebtedness);
- (3) the corporate income must not inure to any private person;
- (4) the state or a political subdivision thereof must have a beneficial interest in the corporation while the indebtedness remains outstanding[,] and it must obtain full legal title to the property of the corporation with respect to which the indebtedness was incurred upon retirement of such indebtedness; and
- (5) the corporation must have been approved by the state or a political subdivision thereof, either of which must also have approved the specific obligations issued by the corporation.

Id. The terms for this type of entity—“63-20 Corporation” and “on-behalf-of” organization—derive from the IRS revenue ruling that provide for their use and from language within the revenue ruling that describes their purpose, respectively. *See id.* The issuance proceeds obtained by a 63-20 Corporation are then loaned to conduit borrowers, the ultimate users of the proceeds. *See infra* Part II.B.

bond documents are signed. For example, when discussing potential long-term problems with issuers, they occasionally replied that they had fulfilled their obligation upon signing the initial bond documents provided by the attorneys. On the contrary, issuers have an on-going responsibility to the bondholders to avoid actions that could cause taxability until the bonds are removed from the market.

B. Conduit Borrowers

63-20 Corporations do not issue bonds for their own use; the intent is to loan the issuance proceeds to private users to satisfy public purposes.¹² Although adherence to most of the pertinent IRC provisions is the issuer's responsibility, conduit borrower activity can cause a determination of taxability. Moreover, an issuer may be unaware of a potential violation of applicable IRC provisions without certain pre-issuance and post-issuance investigation into conduit borrower activity. For example, IRC section 144(a), which governs qualified small issue bonds, requires that capital expenditures for a property qualifying under the provisions of this section not exceed \$10,000,000 during a six-year period; this six-year period includes three years before the bond issuance and three years after the issuance.¹³ It was painfully obvious that conduit borrowers were unaware of many of the provisions within the IRC that may lead to bond taxability based on their activities, a mistake that could lead to an expensive settlement agreement with the IRS.

C. Trustees

An agent seeks trustee records sought during an examination to determine whether the use of the bond proceeds is appropriate and to confirm compliance with the arbitrage restrictions of IRC section 148.¹⁴ My experience reveals that trustees and their counsel generally are reluctant to release any records without a summons. Without commenting on whether this reluctance is appropriately founded in the trustee's obligations under federal or state law (to the extent any exist), it is worth

¹² More specifically, the private user must satisfy requirements contained in IRC sections 141 through 150.

¹³ I.R.C. § 144(a)(4)(ii) (2000). The \$10,000,000 capital expenditure limitation includes expenditures from the bond proceeds *and* from all other sources. *Id.* (emphasis added).

¹⁴ "Arbitrage bonds" are defined as bonds whose proceeds are "reasonably expected (at the time of issuance of the bond) to be used directly or indirectly" to "acquire higher yielding investments" or to "replace funds [that] were used directly or indirectly to acquire higher yielding investments." I.R.C. § 148(a). IRC section 103(b)(2) excepts arbitrage bonds from bonds eligible for tax-exempt status. I.R.C. § 103(b)(2).

noting that trustees occasionally request a summons to preserve the trustee's relationship with issuers and underwriters. In any event, the IRS willingly issues "friendly" summonses if necessary.

D. Underwriters

An experienced agent will request to review all information associated with a bond issuance collected by an underwriter through due diligence. It is from this information that an agent can best gain a true understanding of the financial aspects of a bond deal. However, the information collected during the underwriter's due diligence may contain sensitive information,¹⁵ and the underwriter may, or perhaps should, request a summons.

III. THE EXAMINATION PROCESS

A. Selecting Bond Issuances to Examine

The IRS generally employs three methods to select bond issuances for examination.¹⁶ First, the standard approach involves classification of returns filed by issuers.¹⁷ Whether an issuer files IRS Form 8038, 8038-G, or 8038-T, there are certain items on the return with a pre-determined tolerance level. If this level is exceeded, the return is referred to for possible audit. Not all returns selected through the classification system are examined; availability of resources and the potential problem with the issuance are significant factors that determine whether a particular issuance is examined.

The second method involves development of an information-gathering project.¹⁸ The IRS's Tax-Exempt Bond Division develops annual workplans in which "emerging issues and focus areas" are identified. Filed returns that involve an emerging issue or focus area are selected for examination. Although these examinations tend to be exploratory in nature, determinations of taxability have resulted from examinations of this origin.

¹⁵ Some information collected during due diligence may be subject to attorney-client privilege or some other form of privilege, but this is a legal issue beyond the scope of this paper.

¹⁶ See I.R.S. Internal Revenue Manual 7.6.2, § 5.3 (July 1999 version), at <http://www.irs.gov>.

¹⁷ *Id.*

¹⁸ *Id.*

Third, an issuance may be referred to the IRS for examination.¹⁹ Newspaper stories, informants, and tips from other government agencies are the chief methods by which the IRS obtains these referrals. Agents cannot, however, arbitrarily begin an examination solely based on these sources; a committee within the Tax Exempt Bond Division must approve all referrals before an examination begins. Nonetheless, referral-based examinations tend to be more aggressively performed than examinations of other origins.

B. The Examination Begins

As noted above, an issuer is the taxpayer for purposes of a tax-exempt bond examination, and consequently, the issuer will receive a letter from the agent assigned to the case. Attached to the letter will be a list of initial documents that the agent requests to review. The desired documents include the bond transcript, the underwriter's due diligence file, trust records, and all records of the use of the proceeds. As an agent, I also requested that a copy of the bond prospectus or private placement memorandum be submitted immediately. A review of these documents facilitates an overall understanding of the issuance before the remaining requested documents are received and reviewed.

Some of the standard documents included in the initial request may not, however, be in the possession of the issuer. Moreover, the issuer, especially a 63-20 Corporation, may not have been actively involved in the use of the proceeds and may be unable to answer certain questions posed by the examining agent. Therefore, the issuer may wish to file IRS Form 8821 (entitled "Tax Information Authorization"),²⁰ which authorizes the agent to obtain the records from the party who possesses the documents. More specifically, IRS Form 8821 allows the issuer and a conduit borrower to name each other "appointees," allowing the agent to discuss the transaction in full detail with both the Issuer and the conduit borrower without violating taxpayer confidentiality.²¹ Form 8821 does not, however, allow an appointee to "advocate [the other's] position."²²

¹⁹ *Id.*

²⁰ *See* I.R.S. Form 8821 (2002).

²¹ *See id.* at General Instructions.

²² *See id.* However, IRS Form 2848 (entitled "Power of Attorney and Declaration of Representative") may be executed between the issuer and its counsel and the conduit borrower and its counsel as advocates for their position. *See* I.R.S. Form 2848, General Instructions (2002).

In any event, the documents included in an agent's initial request may only be the starting point. An agent who wants to fully understand the transaction must also have an understanding of the industry in which the conduit borrower operates. Simple Internet research is a valuable tool for this purpose. For example, in an examination of a qualified small issue under IRC section 144(a),²³ inspection of the conduit borrower's website may yield information on the construction of the facility that the bond proceeds were used to finance, and it may provide time frames and costs. This information could help an agent determine whether the \$10,000,000 cap has been breached.²⁴ Various Internet sources to consider are sites about the, the conduit borrower and its particular industry, the issuer, and even competing organizations within the conduit borrower's industry. This research may begin at the time that the examination begins and continue until the issue is resolved.

Finally, most bond issues are very complicated transactions, and I found that creating a flowchart of the transaction was very useful in understanding the transaction. Copies of the flowchart were shared with the issuer and its counsel during the examination. I truly believe that flowchart use actually reduced the burden for the issuer and its counsel because it provided a higher degree of assurance to the issuer that I understood the transaction. During my tenure at the IRS, most tax-exempt bond agents did not create transaction flowcharts, but I encourage issuers and their counsel to request that the agent create a flowchart, or alternatively, create a flowchart for the agent.

C. The Examining Agent Seeks Advice

An agent examining a bond issuance may seek advice from legal counsel within the IRS. This advice takes one of two forms: Field Service Advice ("FSA") or a Technical Advice Memorandum ("TAM"). FSA is meant to direct the requesting agent in the development of the examination. The issuer does not have to be notified that the agent is requesting FSA, but the IRS will disclose the results of the request on its website.

An agent can request a TAM, or an issuer can request that the agent seek a TAM, although the Agent is not required to request a TAM on the issuer's behalf.²⁵

²³ See *supra* Part II.B. and accompanying notes.

²⁴ See *id.*

²⁵ Previously, agents were required to obtain TAMs before issuing determinations of taxability. See *infra* note 28.

TAMs consist of a statement of facts, applicable law, and the IRS's position on the issue(s) addressed. A copy of the TAM is submitted to the issuer, who has the opportunity to concur or to rebut, and the issuer's response is submitted to the IRS's national office along with the agent's position on the issue(s). As with FSA, TAMs are published on the IRS website.

D. Determination of Taxability

As soon as the IRS determines that a bond is taxable, a determination must be made as to tax liability. The process begins with calculating bondholders' tax exposure. The fact that, upon a determination of taxability, the bondholders, who have yet to be involved in the examination process, ultimately become the taxpayers underscores the issuer's duty to the bondholders.²⁶ After a determination of taxability, bondholders generally must include in their gross income calculation the interest income earned on the bonds. However, bondholders may be able to avail themselves of the three-year statute of limitations, which shields from taxability interest income earned more than three years from date of taxability determination.²⁷

Alternatively, an issuer can enter into a closing agreement that protects the bondholders. Upon a determination of taxability, the issuer agrees to pay a penalty that triggers with taxpayer exposure and that generally varies with the nature of the violation(s). The penalty may also vary with the issuer's ability and willingness to remove the bonds from the marketplace and how quickly that removal will occur.

E. The Appellate Process

Under section 3105 of the IRS Restructuring and Reform Act of 1998,²⁸ issuers and conduit borrowers have the right to appeal an IRS determination of taxability,²⁹ and the IRS is obligated to develop and maintain administrative

²⁶ See *supra* Part II.A.

²⁷ See I.R.C. § 6501(a) (2000). For example, a bond is issued with a term of thirty years. During the fifth year that the bond is outstanding, the IRS determines that the bonds are not tax-exempt. Therefore, the interest from years three, four, five and six through thirty (or for so long as the bonds are outstanding) is taxable. Interest earned on the bonds during the first two years after issuance remains tax-exempt.

²⁸ Pub. L. No. 105-206, 112 Stat. 685 (1998) (codified as amended in scattered sections of 26 U.S.C.).

²⁹ *Id.* at § 3105. Arguably, issuers have an obligation to bondholders to appeal an adverse decision. The National Association of Bond Lawyers noted that "Congress believed that issuers of governmental bonds, as parties with a strong incentive to ensure the continued tax-exemption of

procedures that provide for an appellate process, the aspects of which are outlined in Revenue Procedure 99-35.³⁰ Obviously, issuers and conduit borrowers are well served to have counsel that are experienced in this appellate process and that have knowledge of pertinent IRC sections.

If the agent's determination is upheld after an appellate process, the IRS will seek to enter into a closing agreement prepared by the IRS Appeals Section.³¹ Without a closing agreement, the case is returned to the district in which the issuance was examined.³² At this point, "the [d]istrict's proposed adverse determination shall become final[,] and the [d]istrict may begin the process of taxing the bondholders without further notice to the [i]ssuer."³³ The issuer should expect that the IRS subsequently would begin (if it has not already) compiling the identity of all bondholders, which obviously can be an extensive process. Issuers and conduit borrowers should nonetheless take heart—the National Association of Bond Lawyers noted that "Congress will evaluate judicial remedies in future legislation once the IRS's tax-exempt bond examination program has developed more fully and the Congress is better able to ensure that any such future measure protects all parties in interest to these determinations."³⁴

F. Voluntary Compliance Agreement Program

To encourage compliance with the IRC and other IRS rules and regulations and in an attempt to prevent taxation of bondholders, the IRS has established a voluntary closing agreement program for tax-exempt bonds ("TEB VCAP").³⁵ The

outstanding bonds, should have the opportunity to appeal IRS revocation of the tax-exempt status of the bonds, in order better to protect the holders of those bonds and the market." NABL Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1998*, at <http://www.nabl.org/library/fedtax/bluebook/jctappeal.html> [hereinafter NABL Report].

³⁰ See Rev. Proc. 99-35, 1999-2 C.B. 501. Although the specific administrative process by which issuers may appeal an adverse determination benefits issuers and conduit borrowers, this process eliminates the requirement that agents obtain a TAM in the event the agent makes an adverse determination. *See id.*

³¹ *See id.*

³² *Id.*

³³ *Id.*

³⁴ See NABL Report, *supra* note 27.

³⁵ See I.R.S. Notice 2001-60, 2001-2 C.B. 304.

theoretical underpinning of the TEB VCAP is that issuers may voluntarily “express a desire to resolve violations of the [IRC].”³⁶ Once instituted, the program protects the bondholders for the specific period and specific issues addressed by the voluntary agreement.³⁷ However, the TEB VCAP is not necessarily available to every issuer; certain conditions must be met before employing the program.

First, remediation generally must not be available “under existing remedial action provisions or tax-exempt bond closing agreement programs contained in regulations or other published guidance.”³⁸ Second, the issuance cannot already be under examination.³⁹ Note that a bond issuance is “under examination on the date a letter opening an examination on the issue is sent.”⁴⁰ Third, the tax-exempt status cannot already be at issue in any court proceeding or in the IRS appellate process.⁴¹ Finally, the violation cannot have been caused by “willful neglect.”⁴²

G. A New Tool in the IRS's Arsenal

In an effort to penalize the party(ies) who actually expose issued bonds to taxability, the IRS has begun to impose IRC section 6700, which imposes penalties against those parties involved in “abusive transactions.”⁴³ Section 6700 penalties historically have been imposed only on underwriters based on the assumption that they are the parties developing abusive shelters; however, the IRS currently is imposing the penalties against “underwriters, issuers, bond counsel, and conduit borrowers.”⁴⁴ Although I will not comment upon the legitimate application of

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Id.*

⁴³ I.R.C. § 6700.

⁴⁴ Ola Kinnander, *IRS Steps up Use of Section 6700, but Penalties Come Under Fire*, THE BOND BUYER, November 2, 2002, at ¶ 1, available at <http://www.cdfa.net/cdfa/press.nsf/pages/476> [hereinafter Kinnander]. “The IRS is concerned that many deals were created more to generate big fees for deal participants than to finance legitimate nonprofit or governmental purpose projects.” *Id.* at ¶ 3. See

section 6700 penalties to these various parties,⁴⁵ harsh penalties should be imposed against parties whose actions endanger the tax-exempt status enjoyed by bondholders and guarded by issuers.

The parties to a transaction should be concerned with the assessment of section 6700 penalties for reasons other than direct monetary loss; it is the IRS's position that 6700 does not indicate fraud but rather misrepresentation or misinformation.⁴⁶ Regardless of the euphemism, however—whether fraud, misrepresentation, or misinformation—the impact on the party's reputation is potentially devastating, especially because tax-exempt bond transactions are relatively specialized and those involved in their issuance and examination form a small community.

IV. CONCLUSION

The IRS is committed to aggressively examining tax-exempt bonds issued by state and municipal governments. In light of this fact, issuers and their counsel, conduit borrowers and their counsel, underwriters, and trustees must be diligent in the issuance of bonds. Specifically, issuers and conduit borrowers must be mindful of their continuing role post-issuance. At best, an examination creates added expense for the issuer; at worst, bondholders are exposed to tax liability, and the party whose actions (or omissions) created a determination of taxability are exposed to penalties and lawsuits by bondholders. An issuer need have only one issuance declared taxable to affect further sales of their issuances.

also Lynn Hume, *IRS Conducts 6700 Audit of Muni Issuer: Source Says Investigation Involves Blind Pool*, THE BOND BUYER, November 12, 2002, at ¶ 1, available at <http://www.cdfa.net/cdfa/press.nsf/pages/499> (“In what appears to be a first-of-a-kind-case in municipal bond enforcement, the [IRS] is conducting a so-called Section 6700 audit of a governmental issuer of municipal bonds to [determine] whether it should impose monetary penalties”).

⁴⁵ Mark Scott, National Director of the Tax-Exempt Bond Division, noted that ten percent of the issuances under examination involve section 6700 penalties and that those examinations “represent one-third” of the Division's time. Kinnander, at ¶ 6.

⁴⁶ *Id.* at ¶ 18.