



MEMORANDUM

TO **Clients and Interested Parties**

FROM **Orrick, Herrington & Sutcliffe LLP**

DATE **October 10, 2007**

RE ***Nonprofits Questioned by IRS About Post-issuance Tax Compliance of Their Outstanding Tax-exempt Bonds***

The Internal Revenue Service (the "IRS") has distributed several hundred tax compliance questionnaires (the "Questionnaire") to nonprofit corporations that have borrowed on a tax-exempt basis ("nonprofit borrowers") regarding their post-issuance compliance with various requirements for maintaining the federal tax exemption of interest on their bonds, including internal compliance procedures and recordkeeping functions. The Questionnaire, IRS Form 13907 (attached), is a joint initiative between the IRS Bond Division and the Exempt Organizations Compliance Division probing post-issuance compliance among certain organizations indicating an outstanding balance of tax-exempt bonds on their 2005 Form 990.

Post-Issuance Compliance – A New IRS Strategic Initiative

This initiative is part of a trend of increased IRS scrutiny of tax-exempt bond post-issuance matters.

The IRS's focus on post-issuance matters follows recent regulatory changes which generally require issuers and nonprofit borrowers to measure and account for private use over the combined term of the original bonds and any refunding bonds. The cumulative measurement period increases the need for the implementation of rigorous post-issuance compliance procedures, including periodic comprehensive tax compliance review and record keeping and retention policies. Issuers and nonprofit borrowers are now required to maintain material tax records for significant periods of time (20 to 30 years or longer), to support the position that the bonds are in compliance with applicable tax law.

The Questionnaire represents the second stage of the IRS post-issuance compliance program for nonprofit borrowers which began in August 2006. A test audit of about 30 nonprofit borrower financings last year found tax compliance problems in 10 of them. In addition to private use problems, the IRS found bonds exceeding 120% of the economic life of the financed facilities, allocation of monies to impermissible uses in connection with refundings, a variety of arbitrage problems and poor record retention.



Given the 2006 audit results and regulatory concerns regarding recordkeeping requirements relating to tax-exempt bonds by nonprofit borrowers, the IRS has also proposed adding a new schedule to IRS Form 990 (Schedule K) (attached). A nonprofit organization is required to file a Form 990 with the IRS every year regarding its financial operating results. Proposed Schedule K asks for detailed information regarding all outstanding bond issues of a nonprofit borrower, including information regarding operating, management and research contracts, as well as private use calculations.

Given the prominence of this new compliance effort, the National Association of Bond Lawyers and the Government Finance Officers Association recently published a post-issuance compliance checklist (attached). Nonprofit borrowers may wish to review the checklist which was recently submitted to the U.S. Treasury Department. The checklist addresses tax, securities and state law matters that will or may require post-issuance compliance actions.

Compliance Check Questionnaire

The IRS Questionnaire is divided into five parts, each focusing on a different aspect of post-issuance tax compliance. Most questions are in yes/no or multiple choice format, however, a few questions require written responses.

Part 1 asks general questions regarding the status of written procedures and guidelines employed by the nonprofit borrower to ensure post-issuance compliance. The questions include the identification of the individuals primarily responsible for post-issuance tax compliance, whether there are written procedures or guidelines for individuals to follow when more than one person is responsible for maintaining records needed to ensure post-issuance compliance and the status of training and education resources for persons responsible for such matters. Part 2 focuses on general record keeping procedures, including the duration for which records are retained, record keeping medium and a list of 17 specific questions regarding certain records that should be retained.

Part 3 focuses on monitoring bond investments and arbitrage compliance, including questions regarding documentation and document retention policies with respect to bond allocations, investment earnings of bond proceeds, guaranteed investment contracts, swaps and other financial derivatives, bond insurance, computation of rebate, bond yield, yield reduction payments and policies for monitoring yield restricted bond proceeds and arbitrage rebate exceptions.

Part 4 focuses on documentation and document retention policies regarding allocation of bond proceeds to expenditures including issuance costs, copies of invoices, bills, cancelled checks and lists of all bond financed property and equipment.

Part 5 asks a series of 24 questions regarding private business use, including the status of any operating, management, research, naming rights, lease or sublease arrangements with respect



to bond financed property. The Questionnaire seeks information on documentation and document retention policies with respect to private use and poses a general question (*requiring a written response*) regarding how the nonprofit borrower ensures that the bonds remain tax-exempt after the bonds are issued.

What Should You Do If You Receive an IRS Questionnaire

The Questionnaire is intended to help the IRS develop a statistical profile of post-issuance tax compliance by nonprofit borrowers as well as serve as a source for additional inquiries by the IRS. However, the manner in which a nonprofit borrower responds to the Questionnaire could dictate whether the IRS seeks further information or possibly initiates an audit. Accordingly, if you receive a Questionnaire from the IRS, we encourage you to contact one of the individuals listed below or any member of Orrick's public finance department before responding, in order to assure that all questions are properly and adequately addressed.

What Should You Do If You Do Not Receive an IRS Questionnaire

Even if an organization is not selected for a compliance check by the IRS, we recommend that nonprofit borrowers review and prepare draft responses to the Questionnaire. Preparing responses to the Questionnaire will highlight potential areas that warrant attention, such as recordkeeping, procedures for review of operating, management and research contracts, monitoring private use, arbitrage rebate and tracing the use of bond proceeds to specific property. Applying resources now to rectify an internal weakness regarding post-issuance tax compliance will prepare an organization for future compliance efforts including a possible IRS audit, as well as facilitate future refunding opportunities (which are affected by this information or the absence thereof). Preparing responses to the Questionnaire also might reveal actual post-issuance noncompliance that should be addressed before such matter is found in an IRS audit examination.

IRS Encourages Hiring of Outside Experts to Assist in Managing Post-Issuance Matters

Cliff Gannett, Manager of IRS Tax-Exempt Bonds, was recently interviewed about the Questionnaire initiative. In the interview, Gannett underscored the fact that organizations should seek outside assistance when attempting to comply with IRS post-issuance requirements. Regarding the need for external professional services, Gannett stated "I really think they need to make sure they have professional assistance in place...." In the same interview, Gannett also emphasized that issuers and nonprofit borrowers need to have a comprehensive record retention system in place that will serve as a roadmap when making decisions and to identify any actions that could potentially render the interest on the bonds taxable.



In light of these comments, you may wish to consider outside assistance with respect to your overall responsibility for monitoring tax compliance. Those that have effective post-issuance compliance programs are significantly more likely to respond to an IRS inquiry on a successful and cost-effective basis.

Orrick and Bond Logistix Can Help with Post-Issuance Tax Compliance Matters

To assist issuers and nonprofit borrowers in meeting ongoing post-issuance monitoring responsibilities, Bond Logistix LLC ("BLX") an independent SEC registered advisory firm, wholly owned by Orrick, Herrington & Sutcliffe LLP, offers a wide range of post-issuance services, including periodic private use review and tabulation, private activity bond monitoring and analysis, internal audits, analysis of post-issuance tax compliance procedures and review of tax record and documentation procedures. BLX also offers a comprehensive financial and consultative services to the public finance community. With more than 50 finance professionals dedicated to public finance in seven offices nationwide, BLX is well qualified to assist and guide issuers and nonprofit corporation borrowers with all elements of post-issuance compliance. The post-issuance compliance services of BLX are closely coordinated with Orrick's national leading public finance practice. A post-issuance tax compliance program can be tailored to meet the specific needs and circumstances of any nonprofit borrower.

For more information about the our post-issuance compliance program please contact:

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