

A 10-Step Program for Nonprofit Borrowers in Denial

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It has been observed that the world consists of two kinds of people: those who divide the world into two types of people, and those who don't.

The section 501(c)(3) borrower world, by contrast, consists of at least three types of institutions. One type of institution devotes substantial resources to bond compliance and maintains comprehensive, well-organized bond compliance records and procedures. Their formidable bond compliance "teams" are led by people who, when they're not polishing their bond compliance procedures, test their smoke alarm batteries once a week, like to buy something called "travel insurance," and pay nanny tax on the teenager who baby-sits their children every other Saturday. There is no improving on perfection, and this article will not even try.¹

At the opposite end of the 501(c)(3) bond compliance spectrum is another type of institution, whose bond compliance program, and attitude toward bond compliance in general, can be best described as — to use a technical phrase — "really bad." Often the staff at those institutions is working with a short time horizon — by the time the IRS audit notice lands in the mailbox, they will be long gone, they figure. There is not much we can offer them either.

¹The enthusiasm of some institutions for 501(c)(3) bond compliance may be illustrated by the following. As discussed below, in 2007 the IRS sent detailed questionnaires to 207 section 501(c)(3) borrowers requesting information about some aspects of their bond compliance procedures. The IRS received responses from 203 of the 207 questionnaire recipients. Interestingly, it also received responses from two other institutions, even though it had not sent them a questionnaire. See http://www.irs.gov/pub/irs-tege/interim_report_-_draft_09-11-08_v1.pdf. That compliance strategy — volunteering to participate in IRS compliance initiatives that don't apply to you — is not one that we would generally endorse.

Between these extremes lies the section 501(c)(3) borrower to whom this article is addressed. For them, responsibility for bond compliance falls ultimately on a well-meaning person, say the assistant vice president of finance, whose failure in many cases to implement a systematic bond compliance program is not due to a lack of conscientiousness, but rather to a lack of resources and time (he already has a day job, or sometimes the equivalent of two or three day jobs). Bond compliance procedures for those institutions often reside entirely within the head of the assistant vice president of finance, consisting of chestnuts like: "federally sponsored research contracts OK, commercially sponsored contracts maybe not"; "need to spend bond proceeds fast"; "call counsel if we want to hire someone to run the cafeteria." Sometimes that collected wisdom can add up to a compliance program that hits most of the key points. But usually there are significant omissions — often involving record retention — and if the assistant vice president of finance walks out the door, the bond compliance program goes too.

Borrowers overlook bond compliance at their peril. The consequences of violating the 501(c)(3) bond rules can include loss of the bonds' tax-exempt status, significant liability to the IRS or bondholders, reputational damage, and inability to access the tax-exempt bond market in the future. Further, beginning with the 2008 tax year, more detailed reporting regarding bond compliance will be required on Schedule K to Form 990 (with especially detailed reporting beginning with the 2009 year).

This article provides an overview of 10 steps a section 501(c)(3) institution might take to implement a pragmatic post-issuance bond compliance program. It is not meant as a complete guide to post-issuance compliance; institutions will need to fill in the gaps through discussions with counsel or by consulting more detailed written sources (such as the tax certificates prepared in connection with the bond issues, or a compliance guide prepared by a law or accounting firm).

A. General Legal Background

1. Arbitrage and private business use. Under sections 103 and 141-150,² qualifying bonds issued by state or local governmental issuers are entitled to tax-exempt status, meaning interest on the bonds is excluded from gross income of bondholders. Qualifying tax-exempt bonds include so-called 501(c)(3) bonds under section 145, which are bonds issued for the benefit of organizations described in section 501(c)(3).

²References to the code are to the Internal Revenue Code of 1986, as amended.

For interest on 501(c)(3) bonds — and other types of tax-exempt bonds — to qualify for tax-exempt status, numerous detailed tax rules must be satisfied. Most of those rules fall into two categories: arbitrage and private business use. The arbitrage rules generally prohibit, in the absence of an applicable exception, proceeds of a bond issue from being invested at a yield in excess of the bond yield. This is known as the requirement of “yield restriction.”³ Even if an exception to yield restriction applies, the borrower generally will be required to “re-bate” to the IRS any earnings in excess of the bond yield, unless an exception is satisfied.⁴

The private business use rules generally prohibit more than about 3 percent⁵ of the property financed by the 501(c)(3) bond issue from being used by (1) any person other than a section 501(c)(3) organization or a state or local governmental entity, or (2) a section 501(c)(3) organization in an unrelated trade or business.⁶ Examples of arrangements that could give rise to private business use include leases of bond-financed property;⁷ management or service agreements relating to bond-financed property⁸ (for example, food service or physician service contracts or parking garage management agreements), contracts under which research performed by the section 501(c)(3) organization in bond-financed property is sponsored by a private business user,⁹ and any “unrelated trade or business” within the meaning of the unrelated business taxable income rules.¹⁰

Some exceptions or safe harbors from private business use are available. Those include management or service contracts that comply with Rev. Proc. 97-13¹¹ (which

places restrictions on variable compensation and the length of the contract term), management or service contracts that qualify as incidental services (such as janitorial and office equipment repair contracts),¹² sponsored research contracts that comply with the safe harbor of Rev. Proc. 2007-47¹³ (which places restrictions on the provision of intellectual property rights to private research sponsors), and, in some circumstances, leases of bond-financed property to other section 501(c)(3) organizations¹⁴ or on an infrequent, short-term basis.¹⁵ Private business use is calculated on a bond-issue-by-bond-issue basis by averaging the annual private business use percentages for property financed by the issue over the applicable measurement period (generally equal to the lesser of the original expected useful life of the property or the term of the bond issue).¹⁶

2. IRS enforcement and new Schedule K. These issues should be front and center for section 501(c)(3) borrowers, given the significant expansion of bond reporting requirements on the revised Form 990. The prior Form 990 included several questions regarding the borrower’s outstanding tax-exempt bonds, but the questions were not prominent or clearly drafted and, to some extent, were ignored by the section 501(c)(3) borrower community (at least by the second and third kinds of borrowers described above). The revised version of Form 990 (which applies for tax years beginning on or after January 1, 2008), including new Schedule K, requires significantly more bond-related information to be provided than the version it replaces. In particular, for tax years beginning on or after January 1, 2009, Schedule K asks for information on use of proceeds, arbitrage, and private business use for post-2002 bond issues, including, most notably, private business use calculations.¹⁷ (Private business use information and calculations, however, are not required for issues that refunded pre-2003 issues.) Thus, the release of the revised Form 990 and Schedule K amplifies the importance of adopting a bond compliance program — many borrowers will now be required to calculate and report annually on private business use and other bond-related matters.

The expanded focus on 501(c)(3) bonds in the revised Form 990 builds on earlier IRS efforts to police this area. The first initiative targeting 501(c)(3) bonds began in 2006, when the IRS initiated audits of approximately 30 section 501(c)(3) borrowers in the healthcare and housing

³See section 148(a); reg. section 1.148-2.

⁴See section 148(f); reg. section 1.148-3 and -7.

⁵Technically, the limit is 5 percent of the net proceeds of the issue, but because proceeds used to finance costs of issuance (including underwriter’s discount) count as private business use (which can constitute up to 2 percent of the bond issue), the effective limit can be reduced to 3 percent. See sections 145(a) and 147(g). (However, some bonds issued before 1987 or that refinance bonds issued before 1987 may be entitled to a 25 percent limit on private business use. See Tax Reform Act of 1986, section 1313.)

⁶See sections 145(a) and 141(a) and (b). A violation of the private business use limitation will not result in the loss of tax-exempt status for the bonds unless the bonds also violate the private payment or security limitation. The private payment or security limitation is violated if, generally, more than 5 percent of the debt service on the bonds is derived from payments in respect of property subject to private business use or is secured by property (or payments in respect of property) subject to private business use. *Id.* Because the private payment or security limitation can be difficult to measure and apply, borrowers generally seek to keep their bond issues within the private business use limitation.

⁷See reg. section 1.141-3(b)(3).

⁸See reg. section 1.141-3(b)(4).

⁹See reg. section 1.141-3(b)(6).

¹⁰See section 145(a)(2)(A). An activity may be considered an unrelated trade or business under section 513 (and therefore may give rise to private business use) even though it may not actually produce any unrelated business taxable income reported on Form 990-T.

¹¹1997-1 C.B. 632, *Doc 97-1101*, 97 *TNT* 8-24.

¹²See reg. section 1.141-3(b)(4)(iii)(A).

¹³2007-29 IRB 108, *Doc 2007-15284*, 2007 *TNT* 124-9.

¹⁴For example, a lease to an unaffiliated section 501(c)(3) organization should not give rise to private business use if (1) the lessee organization is not itself using the property in a way that gives rise to private business use, and (2) the lease itself is furthering the lessor organization’s tax-exempt purposes (which may be the case if the lessor and lessee are affiliates or engaged in collaborative activities).

¹⁵See reg. sections 1.141-3(d)(3)(ii) and 1.513-1(c).

¹⁶See reg. section 1.141-3(g).

¹⁷Issues with outstanding principal amounts of \$100,000 or less need not be reported. See IRS instructions to Form 990, Schedule K.

sectors, reportedly finding many instances of noncompliance. Later, the IRS in 2007 mailed “compliance check questionnaires” to 207 section 501(c)(3) borrowers. The questionnaires covered borrowers’ procedures for maintaining post-issuance compliance, record retention, and knowledge of applicable requirements.¹⁸ The compliance check initiative was apparently designed as a way for the IRS to efficiently promote 501(c)(3) bond compliance while conserving enforcement resources for what continues to be the IRS bond office’s leading priority — combating abusive arbitrage transactions across the broader tax-exempt bond sector.

A principal focus of the questionnaire, and of the IRS’s public comments on the questionnaire, was whether the borrower has written procedures addressing post-issuance compliance. Although there is no requirement in the tax law for a borrower to have written procedures, the IRS apparently believes that a borrower that has them is more likely to maintain compliance with the 501(c)(3) bond rules than a borrower that does not.

B. Implementing the Bond Compliance Program

To prepare for Schedule K and the possibility of an IRS audit, borrowers should put in place (if they have not already) a post-issuance compliance program for their outstanding bond issues. We recommend the following 10 steps:

1. Designate responsible persons and a compliance coordinator. An important initial step in implementing a postissuance compliance program is to decide who will be responsible for administering and overseeing the program. We recommend that for each discrete compliance task, the borrower designate a single individual as the responsible person for that task. We further recommend that for larger institutions where there are multiple responsible persons, one of the responsible persons be designated the compliance coordinator, who is tasked with coordinating the activities of all the responsible persons.

2. Conduct an initial private business use compliance review. Another important initial step is for the borrower to calculate the private business use percentage of each of its outstanding bond issues. We generally recommend focusing on the most recently completed fiscal year first. To conduct that review, the borrower will need to know the specific capital projects that were financed or refinanced with proceeds of each bond issue, and the amount of bond proceeds (including both sale proceeds and investment proceeds) that were actually spent¹⁹ on the projects.

To identify private business use in bond-financed projects during the most recently completed fiscal year, the following would be a typical procedure:

- Leases, management contracts. The compliance coordinator should make appropriate inquiries (ideally through a written questionnaire)²⁰ of the director of facilities or other relevant persons regarding the uses of each bond-financed facility. Leases to for-profit organizations²¹ and unaffiliated section 501(c)(3) organizations²² will generally give rise to private business use unless an exception is satisfied.²³ Management or service contracts that do not qualify as incidental services²⁴ should be analyzed under the safe harbor provided by Rev. Proc. 97-13.
- Research agreements. The compliance coordinator should consult with the research office to determine whether the institution has entered into sponsored research agreements relating to bond-financed property that may give rise to private business use. Research agreements providing for commercial sponsors to obtain rights in intellectual property are the most likely sources of private business use and should be reviewed against the safe harbor provided by Rev. Proc. 2007-47.
- Unrelated trade or business. The compliance coordinator should ask the tax office (or other office responsible for preparing Form 990-T) to identify all arrangements relating to bond-financed property that may constitute an unrelated trade or business under the UBTI rules; those arrangements will generally give rise to private business use whether or not the arrangement actually produces a liability for unrelated business income tax.²⁵

For each outstanding bond issue, the borrower can then create a spreadsheet, or series of spreadsheets, that calculates the amount of private business use of the issue. The spreadsheet should first calculate the private business use percentage of each project financed by the issue, which is most commonly done on a relative square footage basis. (In some cases, however, other measurement approaches may be more appropriate, such as relative fair market rental values, time of use, or revenues.²⁶) The spreadsheet should then aggregate the private business use percentages for the individual projects (weighted on the basis of the amount of bond proceeds applied to each), and add costs of issuance,²⁷ to produce the overall private business use percentage for the issue.²⁸

²⁰A written questionnaire is ideal because it can be retained and help satisfy the borrower’s record retention obligations. See Step 8 below.

²¹See reg. section 1.141-3(b)(3).

²²The act of leasing space to an unaffiliated section 501(c)(3) organization would generally be treated as an unrelated trade or business for the lessor section 501(c)(3) organization. See sections 513 and 145(a)(2)(A).

²³See *supra* notes 14 and 15.

²⁴See reg. section 1.141-3(b)(4)(iii)(A).

²⁵See *supra* note 10.

²⁶See reg. section 1.141-3(g)(4).

²⁷See *supra* note 5.

²⁸The procedures described above are for calculating the amount of private business use for the most recently completed

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¹⁸See <http://www.irs.gov/taxexemptbond/article/0,,id=186653,00.html>.

¹⁹That is, records of *projected* expenditures for the projects (for example, from the tax certificate/tax regulatory agreement or official statement) are generally not sufficient. For a refunding issue, the actual expenditures on projects financed by the refunded issue (or, in a series of refundings, the original refunded issue) should be identified.

TAX PRACTICE

Hopefully the private business use percentages calculated by the borrower for its outstanding bond issues will be comfortably below the applicable limit.²⁹ If they aren't, the borrower should discuss alternatives with counsel. Alternatives may include: (1) considering whether a given project was financed in part with equity or taxable debt, which sometimes may be allocated (instead of bond proceeds) to private business use of the project; (2) "blending down" the overall private business use percentage over the term of the bonds by committing to reduce the private business use percentage for future years; (3) reconsidering whether any of the positions taken in the compliance review were too conservative, or whether the private business use percentage could be calculated more finely (and perhaps reduced) if more data are obtained; (4) if the bonds are a relatively recent new money issue, considering whether proceeds could be reallocated away from the project subject to private business use, to another project that is not subject to private business use³⁰; (5) considering whether the "private payment or security" test may be applicable³¹; or (6) if all else fails, considering the possibility of entering into a closing agreement with the IRS.

3. Conduct annual follow-up reviews. After the initial private business use review has been completed, borrowers should keep the review up to date by conducting annual follow-up reviews. One reason for these annual reviews is to reflect any new private business use arrangements (or the termination of existing private business use arrangements) in the borrower's calculations. This is particularly important in light of the requirement to report private business use percentages annually on Schedule K to Form 990. Another goal, particularly for a larger organization, is to remind the responsible persons of their compliance responsibilities. To conduct the survey, the compliance coordinator should follow the same procedures as for the initial compliance review, although the process should be much simpler because the findings in the initial compliance review (or previous year's follow-up review) can be used as a starting point.

4. Screen proposed arrangements for potential private business use. Because the limit on private business use is

fiscal year. Technically, however, private business use for a given bond issue is calculated over the term of the bond issue (and, in the case of some refundings, the term of the refunded issue) by averaging the private business use percentages for each year over the applicable measurement period. See reg. section 1.141-3(g)(2) and -13. Accordingly, a borrower may be required, if the bonds are audited, to establish its private business use percentages for prior years as well. We would recommend that borrowers discuss with counsel whether a review of prior-year private business use should be undertaken. The borrower may sometimes determine, in consultation with counsel, not to review prior-year uses, either because a prior-year review may not be necessary (for example, if the bond-financed projects have been in service for only a few years and the borrower's current uses of the relevant facilities are relatively clean), or because a prior-year review may be impossible because the applicable records do not exist and cannot be reconstructed.

²⁹See *supra* note 5.

³⁰See reg. section 1.148-6(d); prop. reg. section 1.141-6(a).

³¹See *supra* note 6.

low (often just 3 percent)³² but the penalties for noncompliance are high, borrowers must be vigilant in screening all new proposed arrangements for private business use — if those arrangements relate to bond-financed facilities. Arrangements that should be screened for private business use before being entered into (or renewed), to the extent they relate to bond-financed facilities, include the following: (1) leases; (2) management or service contracts (such as food service contracts, agreements with physician groups, and parking garage management agreements); (3) sponsored research agreements; (4) potential unrelated trade or business arrangements; (5) arrangements transferring ownership of bond-financed property, whether by sale or long-term lease; (6) joint venture, partnership, or limited liability company agreements; and (7) naming rights agreements. The compliance coordinator should identify responsible persons for reviewing each of these types of arrangements.

If the responsible person determines, with the compliance coordinator, that there may be private business use associated with a proposed arrangement, options would include the following: (1) modifying the contract to eliminate the private business use (for example, in the case of a noncompliant service contract, make the changes necessary for the contract to comply with Rev. Proc. 97-13); (2) determining (with counsel) whether any equity or taxable debt was applied to the facility that can be allocated to the private business use; (3) calculating the amount of private business use produced by the arrangement, to determine whether entering the arrangement would cause the private business use percentage for the issue to exceed the applicable limit or otherwise increase to an unacceptably high level; or (4) for a relatively recent new money issue, considering whether bond proceeds could be reallocated away from the project subject to private business use, to another project that is not subject to private business use. If none of those options is feasible and the borrower still wants to enter into the arrangement, the borrower may need to take remedial action to eliminate the private business use that would otherwise arise.³³ Remedial action is most often accomplished by redeeming or defeasing the portion of the bond issue allocable to the arrangement within the required deadlines.

5. Ensure proceeds are invested in permissible ways. To comply with the arbitrage rules, borrowers generally must follow the rules for establishing the fair market value of investments acquired with bond proceeds; failure to do so may result in an IRS finding of "yield burning"³⁴ that can jeopardize the tax-exempt status of the issue. When the bonds are issued, bond counsel will typically confirm that the original investments acquired

³²See *supra* note 5.

³³See reg. section 1.141-12.

³⁴Yield burning generally occurs when the borrower accepts a lower-than-fair-market return on the investment of bond proceeds in a situation when it may have no incentive to maximize the return on the investment (for example, if each incremental dollar of additional yield would be required to be rebated to the IRS in any event). That represents, in effect, a diversion of the federal subsidy associated with tax-exempt

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with the bond proceeds (for example, in a refunding escrow, a construction fund, or a reserve fund) will meet those requirements. Often those requirements are satisfied either by investing bond proceeds in State and Local Government Series Securities from the Treasury Department (the purchase price of which is deemed to be their fair market value)³⁵ or by acquiring investments through the detailed “three-bid” process described in the Treasury regulations.³⁶ But after the bonds have been issued, the borrower becomes responsible for compliance with those rules. The borrower should not acquire any investments with bond proceeds after the issue date of the bonds without confirming that the investments will be treated as being acquired at fair market value and as being in compliance with any applicable yield restriction requirements.

6. Ensure proceeds are spent on permissible expenditures. The borrower should ensure that any expenditures of bond proceeds qualify for financing with tax-exempt debt (among other things, the expenditures must be covered by the public notice required under the 1982 Tax Equity and Fiscal Responsibility Act,³⁷ the expenditures must satisfy the “120 percent rule” (which compares the expected useful lives of the projects with the weighted average maturity of the bonds),³⁸ no more than 2 percent of the proceeds may be spent on costs of issuance,³⁹ and any use of proceeds to reimburse the borrower for expenditures made before the issue date of the bonds must satisfy the detailed reimbursement rules).⁴⁰ Those requirements should have been addressed in connection with the issuance of the bonds, so the key is for the borrower to ensure that it spends proceeds in a manner consistent with the borrower’s expectations as expressed in the tax certificate/tax regulatory agreement, official statement, and other documents prepared at the time of the bond issuance. The borrower should not deviate from those expectations before discussing the matter with counsel.

7. Ensure rebate is calculated and paid. Unless an exception is satisfied, during the term of a bond issue, borrowers must compute and pay rebate (if owed) to the IRS at prescribed intervals during the term of the bond issue, and again on retirement of the issue.⁴¹ The most common sources of rebate liability are investments of proceeds in a construction fund that were not spent quickly enough to meet the so-called two-year or 18-month spending exceptions to rebate,⁴² as well as earnings on proceeds in a reserve fund. The borrower should make sure that a rebate computation firm has been retained to calculate rebate on all of the borrower’s issues

with potential rebate liability. The compliance coordinator should give the firm the information it requests to prepare the calculations, which would include documents from the transcript and records of expenditures and earnings. The arrangement with the firm may allow the firm to perform its responsibilities automatically and at the appropriate intervals, without request by the borrower. Still, because rebate compliance is ultimately the borrower’s responsibility, the responsible person should keep track of the applicable deadlines for calculating rebate and ensure the firm is performing its duties on a timely basis. If any rebate is owed, the borrower should arrange for the bond issuer to file Form 8038-T with the IRS and forward the borrower’s payment to the IRS.

8. Retain appropriate records. Record retention is another vital part of the borrower’s post-issuance compliance responsibilities. If the bonds are audited, the burden will be on the borrower to establish that the requirements for tax-exempt status have been satisfied. If the borrower cannot verify compliance with those requirements by producing adequate records, the IRS could determine that the bond issue is taxable.

The records that must be maintained will vary to some extent from bond issue to bond issue, but generally will include the following: (1) the entire bond transcript, which will include several tax-focused documents such as the tax certificate or tax regulatory agreement, Form 8038, verification report, and certifications of the underwriter and other parties; (2) documents establishing the expenditure of bond proceeds, such as requisitions; (3) documents establishing the expenditure of taxable debt or equity, if relevant⁴³; (4) records showing the acquisition and disposition of, and earnings from, investments of bond proceeds; (5) records establishing that the investments of bond proceeds were acquired in compliance with the fair market value rules (for example, under the three-bid process)⁴⁴; (6) documents reflecting compliance with the rebate requirement, such as the rebate computation firm’s report and the Form 8038-T, or records establishing that proceeds were spent fast enough to qualify for a spending exception to rebate; (7) documents evidencing uses of bond-financed projects, such as management and service contracts, research agreements, leases, and records relating to unrelated trades or businesses; (8) documents prepared during the initial private business use review and annual follow-up reviews, such as questionnaire responses and private business use calculations; and (9) other documents relating to the tax compliance of the bond issue, such as records relating to any swap entered into regarding the issue, and records

interest to investment providers. Yield burning has been a leading target of IRS enforcement efforts in the tax-exempt bond area for many years.

³⁵See reg. section 1.148-5(d)(6)(i).

³⁶See reg. section 1.148-5(d)(6)(iii).

³⁷See section 147(f).

³⁸See section 147(b).

³⁹See section 147(g).

⁴⁰See reg. section 1.150-2.

⁴¹See reg. section 1.148-3(e).

⁴²See reg. section 1.148-7.

⁴³This would be relevant if the borrower allocates the taxable debt or equity to private business use or if the borrower uses tax-exempt bond proceeds to refinance projects originally financed with taxable debt or to reimburse itself for expenditures originally paid with equity.

⁴⁴To qualify for the three-bid safe harbor, the regulations describe records that must be retained. See reg. section 1.148-5(d)(6)(iii)(E).

relating to any remedial action taken on arrangements that would otherwise give rise to private business use.

We recommend that borrowers assign the principal responsibility for retaining those records to one or more responsible persons. Some categories of records should probably be maintained in a central location (for example, bond transcripts, records of expenditures, and records of investments). Other records would ideally be kept centrally as well, although this may be unfeasible for larger borrowers. If so, there should at least be a central record of where those records are being maintained, to permit their quick retrieval in the event of an IRS audit.

IRS policy requires that records generally be retained for the life of the bond issue plus three years (or, if the bonds are refunded, for the life of the combined bond issue plus three years).⁴⁵ Records can be maintained either in hard copy or electronically, although if electronic records are to be kept, the requirements of Rev. Proc. 97-22⁴⁶ must be satisfied.

Of course, particularly for older issues, not all of the records will be available. But fortunately, not all of them will be crucial for every issue. Counsel can help borrowers determine whether the gaps that may exist in their records are important, and if so, whether any steps are available to close the gaps or mitigate their impact.

9. Satisfy Form 990 reporting requirements. The revised Form 990, in particular the new Schedule K, requires borrowers to report significantly more information on bond compliance than the prior Form 990. As noted above, the revised Form 990, along with Schedule K, applies to the borrower's tax years beginning on or after January 1, 2008, meaning that most borrowers would not actually file a revised Form 990 until 2010. Reporting is required only for bonds that were issued after 2002. For the borrower's first tax year beginning on or after January 1, 2008, only Part I of Schedule K must be completed; for later years, the schedule must be completed in its entirety.

Part I of Schedule K asks for general information about each outstanding post-2002 bond issue (issuer name, issue date, purpose, etc.). That information should be readily available to the borrower. Part II asks for details regarding the specific uses of the proceeds of each

issue (proceeds used for capital expenditures, reserve fund, costs of issuance, etc.). That information should largely come from the borrower's expenditure records, which it would gather in the process described in Step 8 above. The questions in Part III focus on whether any property financed by post-2002 issues (excluding issues that refunded bonds issued in 2002 or before) may be subject to private business use; most notably, those questions ask for specific private business use percentages. Those questions should be readily answerable for borrowers who have completed an initial private business use review or an annual follow-up review for the year in question. The questions in Part IV focus on arbitrage-related matters, including information on guaranteed investment contracts, swaps, and rebate compliance. That information should also be found in the borrower's records, which it would gather in Step 8.

In our view, the introduction of the revised Form 990, and Schedule K, should not add appreciably to the substantive responsibilities for borrowers, because the information required to complete Schedule K should be easily derived from a borrower's compliance program, which the borrower should be following anyway (to maintain the bonds' tax-exempt status). The more novel aspect of Schedule K is that it sets a real deadline; borrowers who procrastinate will soon run out of time.

10. Adopt written procedures. Technically, there is no requirement that borrowers put their bond compliance procedures in writing. But having written procedures will help coordinate the activities of the numerous people involved in post-issuance compliance and help ensure continuity despite the inevitable turnover in personnel. In short, having written procedures probably increases the likelihood that the borrower will do what is required to maintain the bonds' tax-exempt status. Also, the IRS believes that written procedures are a good idea. If the IRS discovers a post-issuance compliance problem on audit, a borrower that has made a good-faith effort to comply, including by adopting and following written procedures, would be in a much better position with the IRS than one who has not.

C. Conclusion

Section 501(c)(3) borrowers are facing unprecedented pressures these days — budgets are tight, staffing is lean, and schedules are packed. But Schedule K is here, and an IRS auditor may not be far behind. Now is the time to implement a practical bond compliance program.

⁴⁵See <http://www.irs.gov/taxexemptbond/article/0,,id=134435,00.html>.

⁴⁶1997-1 C.B. 652, Doc 97-7339, 97 TNT 50-8.

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