IRS to Conduct Potential Nationwide Review of Private Business Use in Bond-Financed Space

Recently, IRS officials indicated that the IRS is contemplating the large-scale distribution of a compliance survey designed to obtain information about the compliance of 501(c)(3) bond issues with the private business use requirements. While the officials provided no further details on the timing or scale of the potential initiative, it very well may be modeled on the recent "compliance check" focusing on tax-exempt hospitals' compliance with certain requirements for tax-exempt status, including in particular community benefit activities. The detailed community benefit compliance check questionnaires (approximately 80 questions over nine pages) were sent to over 600 hospitals in the spring of 2006. Hospitals were allowed a relatively brief period in which to respond.

While the compliance surveys may be "voluntary," if this initiative is pursued, the IRS would presumably base its decision on which institutions' bonds to audit based upon the responses (or lack of responses) to the surveys, among other factors. Failure to comply with the complex regulations governing private business use may result in an institutions' bonds being declared taxable retroactive to the date of issuance. Thus, any response to a survey that suggests that the institution has not complied with these regulations (or failure to respond to a survey) could trigger an audit and have a material adverse effect on the institution and its bonds.

While it may be possible to obtain extensions of time within which to complete a survey (as was the case for the community benefit compliance check), any extensions provided by the IRS may still be insufficient for larger tax-exempt borrowers to assemble all necessary data, particularly if such borrowers have not closely kept track of their private use compliance. We recommend that our clients with outstanding tax-exempt debt take the following steps as soon as possible to be better prepared should the client receive a survey:

1. Confirm you know where your bond proceeds were spent. Review the availability and completeness of information on expenditures of proceeds of each outstanding bond issue and determine whether requisitions or other backup information is available. If the institution does not have adequate records, determine whether the conduit issuer or other source (attorneys, accountants, investment bankers) may have retained records that could help. This may be a time-consuming process and is best commenced early.

2. Confirm you know about all current private business uses in financed space. This includes leases to third parties (including in some cases leases to unrelated non-profit organizations); sponsored research agreements that do not comply with Rev. Proc. 97-14; and management and service agreements that do not comply with Rev. Proc. 97-13.

3. Measure the use, and if your private business exceeds the allowable percentage, seek further assistance. In general, bonds issued after 1986 have an allowable private business use of 5 percent of the proceeds of the issue, less the amount of the issue used to finance costs of issuance (typically, although not always, approximately 2 percent). This means most borrowers have an effective private business use limitation of 3 percent. This is obviously a very

small number, and in order to protect the tax-exempt status of the bonds, it is very important that a borrower not exceed this limit. If your analysis suggests your institution is close or over the limit we recommend immediate consultation with outside counsel.

Contact Information

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