Client Alert

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CURRENT ISSUES RELEVANT TO OUR CLIENTS MARCH 2013

Public Finance Tax Update

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Federal Subsidies to Issuers of Build America Bonds and Direct Pay Tax Credit Bonds Are Being Reduced by Sequestration

On March 1, 2013, President Obama issued an order for certain automatic cuts to federal spending. President Obama issued the order under a "sequestration" law previously enacted by Congress. The automatic cuts to federal spending include a reduction in federal payments to issuers of build America bonds (*"BABs"*) and certain direct-pay tax credit bonds, including Qualified Zone Academy Bonds (*"QZABs"*).

In August 2011, Congress voted for the threat of "sequestration" of certain federal funds, which means automatic across-the-board cuts in certain categories of federal spending, as a mechanism to force itself to act on deficit reduction. Sequestration was originally scheduled to begin in January, 2013, but Congress delayed the implementation of sequestration for two months—from January, 2013 to March, 2013.

The cuts to federal spending are set forth in a report prepared by the Office of Management and Budget (the *"OMB"*), which was released on March 1, 2013 (the *"OMB Report"*). The OMB Report sets forth the cuts to payments that are scheduled to be made by the federal government to: (i) issuers of BABs, including Recovery Zone Economic Development Bonds (*"RZEDBs"*), (ii) QZABs, (iii) Qualified School Construction Bonds (*"QSCBs"*), (iv) Qualified Energy Conservation Bonds (*"QECBs"*), and (v) New Clean Renewable Energy Bonds (*"NCREBs"*). The OMB Report shows a total reduction of $218 million from an original budget amount of $4.265 billion for the five categories of bonds affected.

The OMB Report states that the reduction in payments to issuers of BABs and other direct-pay bonds would be 5.1 percent. However, the current sequester is for the entire fiscal year ending September 30, 2013. Accordingly, since the spending cuts were not implemented at the beginning of the fiscal year in October, the spending cuts will take place over a period of under seven months, rather than over a period of twelve months from the beginning of the fiscal year, and OMB estimates that the effective rate of the reductions to direct pay bonds may be higher.

On March 4, 2013, the Internal Revenue Service (the *"IRS"*) posted on its website additional details concerning the cuts by the federal government to payments to issuers of direct-pay bonds. According to the IRS posting, the IRS will apply the sequester reduction to direct-pay amounts claimed by an issuer on any Form 8038-CP, Return for Credit Payments to Issuers of Qualified Bonds, filed with the IRS which results in a payment to such issuer on or after March 1, 2013. The IRS will apply the sequestration reduction rate until the end of the fiscal year (September 30, 2013) or intervening Congressional action, at which time the sequestration rate is subject to change. Issuers should continue to complete Form 8038-CP in the manner provided by the instructions to the Form 8038-CP when requesting payment from the federal government for direct-pay bonds.

The IRS posting provided that, as determined by the OMB, payments to issuers from the budget accounts associated to direct-pay bonds are subject to a reduction of 8.7 percent of the amount budgeted for such payments. The IRS further provided that "[a]ffected issuers will be notified through correspondence that a portion of their requested payment was subject to the sequester reduction. Issuers should use this correspondence to identify the portion(s) of amounts requested that were subject to the sequester reduction."

The full IRS posting is located at: http://www.irs.gov/Tax-Exempt-Bonds/Effect-of-Sequestration-on-Certain-State-and-Local-Government-Filers-of-Form-8038CP. Issuers with any questions about the status of refunds claimed on Form 8038-CP, including any sequester reduction, may contact IRS Customer Account Services at 1-877-829-5500.

IRS Releases Tax Exempt Bonds FY 2013 Work Plan

The Internal Revenue Service (the *"IRS"*) recently released its Tax Exempt Bonds FY 2013 Work Plan. The FY 2013 Work Plan identifies the operating priorities for the office of Tax Exempt Bonds (*"TEB"*) and provides program guidance and direction to all TEB employees.

Set forth below are the specific initiatives for FY 2013 related to the general program work of TEB.

Enforcement & Compliance Reviews – This work includes examinations of bond-related returns, compliance reviews prior to refundable credit payments for direct-pay bonds, compliance check questionnaires, classification and referral analysis, as well as market data research and analysis. Highlights for FY 2013 include:

- Market segment examination work will focus on governmental bonds, qualified 501(c)(3) bonds, qualified small issue bonds, various exempt facility bonds including airports, solid waste and sewage, various disaster relief bonds, build America bonds, and qualified school construction bonds.
- Arbitrage-focused examinations will cover various market segments including advance refunding bonds, notes, and student loan bonds, as well as rebate payment verification and other examinations of Form 8038-T.
- Compliance check questionnaires evaluating the post-issuance compliance monitoring policies and procedures of issuers of governmental bonds.

Voluntary Compliance – The processing of requests under the TEB Voluntary Closing Agreement Program (*"VCAP"*) continues to be high priority. TEB also implements enhancements to the VCAP program to improve the customer experience and encourage issuer participation. Highlights for FY 2013 include:

- The completion of a high volume of requests submitted pursuant to Announcement 2012-14 relating to qualified student loan bonds.
- Publication of a new form to serve as an application checklist for submitting VCAP requests to assist issuers in ensuring their applications are complete.

Guidance, Education & Outreach – TEB continues to support the delivery of guidance and other educational assistance to issuers and other market stakeholders to promote voluntary compliance through a greater understanding of tax responsibilities and how to prevent unintended violations. Highlights for FY 2013 include:

- Continued support to Chief Counsel and Treasury offices in the publication of the proposed arbitrage regulations.
- New web-based educational resources relating to the TEB examination process.
- Continued outreach to customers on TEB programs and compliance matters including ongoing communication and information sharing with state officials, participation in stakeholder association conferences, as well as IRS-sponsored teleconferences and webinars.

While TEB general program work and other project work ensure a broad coverage of compliance matters relating to tax-exempt bonds, tax credit bonds, and direct-pay bonds, much of TEB's work in FY 2013 will center on the following areas of focus.

Abusive Transactions – TEB will continue to identify and respond to abusive arbitrage-motivated transactions and other impermissible tax schemes. Highlights for FY 2013 include:

- Continued prioritization of enforcement work focused on pricing manipulation or false certifications relating to investments, hedges, or the bonds themselves.

- Continued use of civil penalty examinations under section 6700 and other statutory authorities on transaction participants or other parties involved in the abusive matter.

- Continued coordination with IRS Criminal Investigations and Fraud offices in the development of referral items relating to possible criminal or civil investigations.

Post-Issuance Compliance – TEB will continue to promote the use of post-issuance compliance monitoring practices (including the implementation of written procedures) as an effective means for issuers to meet their tax responsibilities and ensure the continued compliance of their obligations. Highlights for FY 2013 include:

- Publication of a report presenting research from TEB's compliance practices research project identifying the circumstances and transactional decisions that can lead to tax violations as well as factors issuers should consider in detecting and avoiding future noncompliance.

- Revisions to Publications 4077, 4078, and 4079, which provide an overview of the federal tax requirements applicable to governmental bonds, qualified 501(c)(3) bonds, and other qualified private activity bonds, including expanded information on post-issuance compliance.

Arbitrage – The issuance of bonds for the primary purpose of diverting arbitrage will remain TEB's highest compliance risk and enforcement focus. Highlights for FY 2013 include:

- Continued prioritization of enforcement work relating to arbitrage-motivated transactions, including those involving long investment periods or large investment amounts.

- Continued analysis of trading and other financial data from external informational databases to identify bond issues with higher risk of noncompliance.

- Continued prioritization of the processing of requests for recovery of overpayment of rebate to ensure the timely payment of refunds due to issuers.

Financial Restructurings – TEB will continue to identify and analyze potential tax compliance risks resulting from actions taken by issuers or other parties in response to their financial hardship or general market liquidity constraints. Highlights for FY 2013 include:

- Continued coordination with Federal, state and local governments, Indian tribal governments, and other IRS offices to identify and resolve compliance matters with insolvent or bankrupt governmental entities.

- Continued development of educational resources and targeted outreach efforts to issuers of financially distressed securities to assist them in understanding their tax responsibilities and how to avoid unintended adverse consequences for their obligations.

Governmental and Charitable Financings – TEB will continue to maintain a high priority on examination, voluntary compliance, education, and outreach programs focused on governmental bonds and qualified 501(c)(3) bonds reflecting their relative prominence in the municipal bond market. Highlights for FY 2013 include:

- Continued examination presence focused on arrangements that increase noncompliance risk due to excessive private business use.

- Continued coordination and information sharing with Exempt Organizations, including the development and analysis of referral information.

Direct-Pay Bonds – Direct-pay bonds present unique compliance and fraud deterrence risks that require heightened levels of review. Highlights for FY 2013 include:

- Continued coordination of enforcement, voluntary compliance, and educational programs as well as forms, processing, and prepayment review systems to ensure the effective administration of this high profile market segment.
- Development of Internal Revenue Manual examination procedures for direct-pay bonds.
- Continued support to Chief Counsel and Treasury offices in the development of technical and procedural guidance relating to direct-pay bonds.

The FY 2013 Work Plan also identifies additional high priority projects, including (i) employee training and development initiatives, (ii) a Form 8038 series return enhancement project, (iii) a comprehensive update to the Internal Revenue Manual examination procedures for tax-exempt bonds, tax credit bonds, and direct-pay bonds and (iv) a notice describing a new process for allocating unused volume cap authority to issue new clean renewable energy bonds in coordination with Chief Counsel and Treasury offices.

IRS Releases Report on Avoiding Troubled Tax-Advantaged Bonds

The Internal Revenue Service (the *"IRS"*) office of Tax Exempt Bonds (*"TEB"*) recently released a report entitled "Avoiding Troubled Tax-Advantaged Bonds: A Study of Issuer Compliance Considerations" on the IRS TEB website. This report seeks to provide aid to issuers of tax-advantaged bonds municipal bonds. It identifies some considerations for issuers of such bonds and is TEB's initial step toward producing public resource products that assist issuers in avoiding troubled transactions. According to the IRS website, for more than a decade TEB observed some of the worst problems in the municipal industry and then witnessed the efforts taken (by leaders in state and local government, the professional communities that support them, and various regulatory bodies) to address them. Many of these complex compliance issues facing issuers of tax-advantaged municipal debt still exist.

According to the IRS, publishing the report is a part of TEB's continuing effort to provide practical steps and products that may be helpful to issuers of tax-advantaged municipal bonds. The report covers three phases of the life cycle of bonds, each with various considerations, of which an issuer should be aware. These three identified phases are (1) the transaction development phase, (2) the transaction execution phase, and (3) the post-issuance phase. Watch for the TEB presentation of phase one "Transaction Development" in an upcoming webinar scheduled for this fall.

The IRS welcomes comments and feedback on the report. Comments and feedback may be submitted to TaxExemptBondQuestions@irs.gov and should include the phrase "Avoiding Troubled Tax-Advantaged Bonds Question" on the subject: line.

The complete report is available at http://www.irs.gov/Tax-Exempt-Bonds/IRS-Releases-Report-on-Avoiding-Troubled-Tax-Advantaged-Bonds by clicking on the link "Avoiding Troubled Tax-Advantaged Bonds."

IRS Releases New Voluntary Closing Agreement Program Request Form

The Internal Revenue Service (the *"IRS"*) recently released the new Form 14429, Tax Exempt Bonds Voluntary Closing Agreement Program Request. Completion, in full, of the new form is a requirement before a submission to the Tax Exempt Bonds Voluntary Closing Agreement Program (*"TEB VCAP"*) is accepted. The purpose of the new form is to assist issuers in organizing TEB VCAP submission requests and to ensure that their submissions are complete, in accordance with IRS requirements. Use of the new form should prevent delays in processing a request because of missing information, as well as facilitate the process for accepting and assigning requests.

The Tax Exempt Bonds (*"TEB"*) function, within the Tax Exempt & Government Entities Division, administers TEB VCAP. Generally, TEB VCAP provides remedies for issuers of tax-advantaged bonds (tax-exempt bonds, tax credit bonds, and direct-pay bonds) who voluntarily come forward to resolve a violation of the federal tax requirements applicable to a bond issue that the issuer cannot self-correct under programs described in the Treasury Regulations or other published guidance. An issuer will generally receive a more favorable treatment in resolving its tax violation under TEB VCAP than it would for the same tax violation discovered during an examination of its bonds by the IRS. As such, TEB VCAP encourages issuers, and other parties involved in tax-advantaged bond transactions, to exercise due diligence in complying with the applicable federal tax laws. TEB VCAP also provides a vehicle to correct violations as expeditiously as possible before discovery of the violations during an IRS examination.

Additional information about TEB VCAP and the Form 14429 is available at http://www.irs.gov/Tax-Exempt-Bonds/New-Voluntary-Closing-Agreement-Program-Request-Form.

Have You Adopted Post-Issuance Compliance Procedures?

The Internal Revenue Service (the *"IRS"*) has announced that it will begin to include questions concerning post-issuance compliance procedures and the implementation of such procedures in the information document requests that it sends to issuers of tax-exempt and tax-advantaged bonds. "Tax-advantaged bonds" include build America bonds and tax credit bonds, such as Qualified Zone Academy Bonds. The IRS sends an "information document request" to an issuer on Form 4564, Information Document Request, when a bond issue is under examination.

Although there are currently no federal statutory or regulatory requirements that require an issuer or a conduit borrower of bond proceeds to adopt written compliance procedures for tax-exempt or tax-advantaged bonds, the IRS is increasingly asking issuers and conduit borrowers questions about such written procedures. For example, the IRS asks questions about written compliance procedures on Forms 8038, 8038-G and 8038-TC and on Schedule K to Form 990 (a form filed by certain charitable and educational tax-exempt organizations). The IRS also asks about such procedures when it sends issuers compliance check questionnaires that target specific types of bond issues.

Written compliance procedures enable issuers and conduit borrowers to better comply with the federal tax provisions that apply to tax-exempt and tax-advantaged bond issues. In addition, the IRS has sought to encourage the adoption of written compliance procedures by providing that whether an issuer has appropriate written compliance procedures will be an "equitable factor" taken into consideration by the IRS in settlement with an issuer under the IRS's Voluntary Closing Agreement Program (*"VCAP"*). VCAP is an IRS program under which issuers can voluntarily approach the IRS to correct problems with a tax-exempt or tax-advantaged bond issue.

We encourage issuers who do not currently have written post-issuance compliance procedures, or who wish to update such procedures, to contact us.

If you would like to discuss any of the issues addressed in this Client Alert please contact Jeffrey D. Berry at (312) 845-3713 or berry@chapman.com; David J. Cholst at (312) 845-3862 or cholst@chapman.com; Anthony R. Rosso at (312) 845-3913 or rosso@chapman.com; or Brent L. Feller at (312) 845-3822 or feller@chapman.com. To learn more about Chapman, please visit us online at chapman.com.