Client Alert

CURRENT ISSUES RELEVANT TO OUR CLIENTS MARCH 2012

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Public Finance Tax Update

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2012 IRS Tax Exempt Bonds Work Plan

The IRS released its Tax Exempt Bonds Work Plan, Planning Guidelines for the 2012 Fiscal Year. The IRS uses the work plan to provide guidance and direction to IRS employees working with tax-exempt obligations.

The work plan is divided into two sections. Section One of the work plan provides guidance for the customer education and outreach activities of the IRS. Section Two of the work plan provides guidance for IRS compliance activities, which are designed to monitor and increase compliance with the provisions of the tax law governing tax-exempt obligations.

As part of its customer education and outreach activities, the IRS will continue to support educational programs and to assist professionals who provide tax advice or monitor post issuance use or arbitrage compliance. As part of this effort, the IRS will continue to participate in workshops, seminars, and meetings sponsored by bond industry groups and to improve and expand voluntary compliance programs. The IRS also plans to host a webinar during the fiscal year that will focus on various tax filing and compliance issues relating to arbitrage requirements or qualified 501(c)(3) bonds.

As part of its compliance activities, the IRS will focus on identifying and correcting noncompliance by, among other activities, continuing to: (i) conduct examinations using standardized procedures and audit guidelines; (ii) process requests for refund of arbitrage payments; (iii) measure the compliance levels of market segments by conducting project initiatives and identifying emerging trends; (iv) apply Section 6700 promoter penalties, where appropriate; (v) conduct pre-payment and post-payment compliance activity with respect to the direct pay bonds payment process; (vi) coordinate with other business operating divisions to apply tax to bondholders and conduit borrowers, when appropriate; (vii) identify best practices and recommend changes in procedures; and (viii) coordinate with, and refer appropriate cases to, other IRS functions.

The compliance and program management staff is responsible for, among other things: (i) issuing compliance check questionnaires with respect to qualified school construction bonds; (ii) processing Voluntary Closing Agreement Program submissions; (iii) assisting field personnel in the identification and development of complex and emerging technical issues; (iv) administering the IRS's quality review of closed examination cases; and (v) operating the bondholder unit for the purpose of identifying bondholders of tax-exempt bonds and tax credit bonds, when appropriate.

For fiscal year 2012, the principal activity of the program will be to continue to participate in ongoing investigations of arbitrage motivated and/or abusive transactions. Training activities will continue to be conducted, as necessary, to ensure consistent and uniform issue development and resolution. The IRS will continue to focus on abusive and arbitrage driven transactions involving long investment periods or large investment amounts, including requests for recovery of overpayment of rebate, examinations of Form 8038-Ts to determine rebate compliance, penalty determination examinations for late filed rebate payments, as well as examinations of bond issues determined by the arbitrage team to have a greater likelihood of arbitrage noncompliance. According to the work plan, the issuance of bonds for the primary purpose of diverting rebatable arbitrage remains the highest compliance risk and enforcement focus.

In fiscal year 2012, the IRS will initiate examination projects focused on specific types of bonds. Such work will include student loan bonds, pooled bond financings, independent multi functional special district financings, and advance refunding bonds. During fiscal year 2012, the IRS expects to complete projects relating to working capital financings, small governmental lease financings, and various types of governmental and charitable financings involving management contracts, research agreements, naming rights, and other public-private partnership arrangements.

The IRS's direct pay bonds compliance team will continue coordinating the IRS's enforcement, voluntary compliance, and educational programs as well as the IRS's forms, processing, and pre-payment compliance review systems to ensure the effective administration of this high profile market segment. The team will continue to analyze compliance risks and evaluate referral information as well as coordinate issues identified in examination and voluntary compliance cases. The team will also continue to identify and develop potential compliance initiatives and educational programs for direct pay bonds.

The state government relationships team will continue its efforts to establish ongoing lines of communication between the IRS and state officials responsible for the issuance and compliance monitoring of state and local bonds. The financial restructuring compliance team will continue to identify potential tax compliance risks related to tax-exempt bonds and tax credit bonds resulting from actions taken by issuers or other parties in response to their financial hardship or general market liquidity constraints.

The IRS has identified the following as its examination categories for fiscal year 2012 and will allocate its resources to the following areas: (i) abusive arbitrage-motivated transactions; (ii) pooled financing bonds; (iii) tax and revenue anticipation notes and other working capital financings; (iv) tax promoter penalties (Section 6700); (v) tax increment bonds; (vi) advance refunding bonds; (vii) independent multi functional special district financings; (viii) student loan bonds; (ix) qualified 501(c)(3) bonds; (x) governmental bonds; and (xi) other specialty bonds and tax-credit bonds.

IRS and MSRB Enter into Memorandum of Understanding

In late 2011, the IRS and the Municipal Securities Rulemaking Board ("MSRB") issued a memorandum of understanding allowing the IRS access to certain MSRB proprietary information products.

As described in the memorandum of understanding, the MSRB wishes to assist the IRS in carrying out its administration and enforcement activities regarding tax-exempt and tax credit bonds. Therefore, the MSRB will make available to the IRS its information products, as requested, at no charge. Additionally, IRS personnel will be provided with access to a proprietary intranet website developed by the MSRB for use by regulatory authorities, including any successor intranet website or platform. The website contains standardized and customized reports derived from MSRB information products and other non-public data. The MSRB will also provide training to IRS personnel on the use of the website and the interpretation of website reports.

The IRS intends to use the website and the MSRB information products available through the website to review municipal securities transaction detail for purposes of administering and enforcing compliance with the federal internal revenue laws applicable to the municipal bonds market. This includes researching municipal securities trade data as part of a compliance effort to monitor practices related to the establishment of issue price for federal tax purposes and other matters. Information contained in website reports may provide evidence for further inquiry with respect to tax-exempt and tax credit bond issues, including administration and enforcement activities.

The IRS has publicly stated that its tax-exempt bond office has formed a seven-person group that is using information from the MRSB's Electronic Municipal Market Access website and other MSRB information to analyze municipal bond issue price.

Administration Proposes BAB Reinstatement and Other Bond Changes

The US Department of Treasury has released its general explanation of the tax proposals in the Obama administration's proposed fiscal year 2013 budget. The administration's proposals include provisions that, if enacted, would reinstate and expand the build America bond program and provide various changes to the tax provisions relating to municipal bonds.

Build America Bonds. Build America bonds, which were authorized under the American Recovery and Reinvestment Act of 2009, are federally taxable bonds issued by states and local governmental entities that provide for a federal tax credit equal to 35 percent of the interest payments on the bonds. In the case of certain new money build America bonds for capital projects, the federal government makes direct payments to the issuer equal to this 35 percent credit. The ability to issue build America bonds expired at the end of 2010.

The administration proposal would reinstate and make permanent the ability to issue build America bonds at a reduced credit rate of 30 percent through 2013 and 28 percent thereafter. The proposal would also expand the eligible uses for build America bonds to include the following: (1) original financing for governmental capital projects, as under the initial authorization of build America bonds; (2) current refundings of prior public capital project financings for interest cost savings where the prior bonds are repaid within 90 days of issuance of the refunding bonds; (3) governmental working capital financings, subject to a thirteen-month maturity limitation; and (4) financing for Section 501(c)(3) nonprofit entities, such as nonprofit hospitals and universities.

Current Refundings. Generally, tax-exempt bonds may be issued for current refunding purposes, meaning such tax-exempt bonds are used to redeem or retire prior bonds within 90 days of the issuance of such tax-exempt bonds. Certain maturity limitations apply to current refunding bonds issued as private activity bonds. From time to time, the tax law has allowed the issuance of other types of bonds, such as build America bonds and tax credit bonds, providing borrowing subsidies to state and local governments through direct payment subsidies or through tax credits to investors. Certain of these state or local bonds may have volume caps, time deadlines for bond issuance, or transitional provisions for program restrictions. The administration's proposal includes a general statutory provision that sets forth parameters for allowable current refundings of state and local bonds where such state and local bond program or provision does not otherwise allow current refundings or expressly address the treatment of current refundings (including bonds for which volume caps or time deadlines applied to the issuance of the original bonds). Current refundings would be authorized so long as (i) the issue price of the current refunding bonds is no greater than the outstanding principal amount of the refunded bonds or, in the event the refunded bonds were issued with more than a de minimis amount of original issue discount or premium, no greater than the adjusted issue price or the accreted present value of the refunded bonds and (ii) the weighted average maturity of the current refunding bonds is no longer than the remaining weighted average maturity of the refunded bonds.

Reducing the Value of Certain Tax Expenditures. Under current law, individual taxpayers may reduce their taxable income by excluding certain types or amounts of income, claiming certain deductions in the computation of adjusted gross income, and claiming either itemized deductions or a standard deduction. One exclusion from taxable income is the interest income on tax-exempt state and local bonds. The administration's proposal would limit the tax value of specified deductions or exclusions from adjusted gross income that would otherwise reduce taxable income in higher tax brackets. A similar limitation would apply under the alternative minimum tax. The income exclusions and deductions limited by this provision would include, among other things, any tax-exempt state and local bond interest. The proposal would be effective for taxable years beginning after December 31, 2012.

Arbitrage Simplification. Generally, gross proceeds of tax-exempt bonds are subject to an arbitrage rebate requirement. In certain cases, amounts may also be subject to a yield restriction requirement under which amounts may not be invested at a yield greater than the yield on the bonds. The administration's proposal contains three simplification provisions relating to the arbitrage limitations applicable to tax-exempt bonds. First, the proposal would generally repeal this yield restriction requirement, except in the case of advance refunding escrows and other situations to be identified in regulations. Second, there would be a new three-year spending exception to the arbitrage rebate requirement (in addition to the existing six-month, eighteen-month, and two-year exceptions) that would apply to certain fixed rate bonds (including private activity bonds) other than advance refunding bonds. Third, the proposal would expand the small issuer exception to the arbitrage rebate requirement to increase the maximum amount of bonds that a small issuer generally may issue in a year from $5 million to $10 million (indexed for inflation) and to eliminate the requirement that issuers have general taxing power.

Eliminate the Five Percent Private Use Limit. Generally, to avoid being private activity bonds, no more than 10 percent of the proceeds of a governmental bond issue may be used in a private business use. However, this 10 percent limit is reduced to five percent in the case of certain private uses that are not related to, or are disproportionate to, the governmental uses of the issue. The administration is proposing to eliminate this five percent limit on unrelated or disproportionate private business use.

Expand Eligible Uses of Single Family Mortgage Bonds. Qualified mortgage bonds are tax-exempt private activity bonds the proceeds of which are used to finance home mortgages. The mortgages must meet numerous requirements. The administration is proposing to eliminate two of those requirements: the requirement that the homes financed by the mortgage loans have a purchase price that is no more than certain maximums and the current prohibition on using qualified mortgage bonds for mortgage refinancings.

Current Refundings of Tax-Exempt Bonds in Certain Disaster Relief Bond Programs

Notice 2012-3, Current Refundings of Tax-Exempt Bonds in Certain Disaster Relief Bond Programs (the "Notice"), provides guidance on current refunding issues that refund outstanding prior issues of bonds that qualify for tax-exempt bond financing under certain disaster relief bond programs. In particular, this Notice applies to current refunding issues that are used (directly or indirectly in a series of current refunding issues) to refund tax exempt bonds that met the qualification requirements for one of the following programs: (i) qualified Gulf Opportunity Zone Bonds; (ii) qualified Midwestern disaster area bonds; and (iii) qualified Hurricane Ike disaster area bonds (collectively, "Qualified Bonds").

The statutory provisions relating to Qualified Bonds are silent regarding the ability to current refund these bonds after the applicable bond issuance deadlines expired. The Notice provides administrative guidance regarding the current refunding of Qualified Bonds. The Notice provides that, pending the promulgation and effective date of future administrative or regulatory guidance, taxpayers may rely on the guidance provided in the Notice.

A current refunding issue that meets the requirements of the Notice may be issued after the specified deadline for the issuance of the original Qualified Bonds and continue to be treated as an issue of Qualified Bonds. In addition, in the case of such a current refunding issue, a designation of the original Qualified Bonds by a specified state or local governmental official or state bond commission that meets the designation requirement is treated as meeting this designation requirement for the current refunding issue without further designation or further official state or local governmental action.

For a current refunding issue to meet the requirements of the Notice, the following must be satisfied:

1. the original Qualified Bonds must have been issued before the deadline for the issuance of such bonds, as applicable, or any statutory extension of such deadline;

2. the issue price of the current refunding issue is no greater than the outstanding stated principal amount of the refunded bonds, except that, for refunded bonds originally issued with more than a de minimis amount of original issue discount or premium, the present value of the refunded bonds must be used in lieu of the outstanding stated principal amount to determine the maximum issue price of the current refunding issue; and

3. the current refunding issue otherwise meets all applicable requirements for the issuance of tax-exempt private activity bonds as Qualified Bonds, including, without limitation, the requirement that the average bond maturity be no longer than 120 percent of the average reasonably expected economic life of the facilities financed or refinanced with the net proceeds of such issue.

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.