

# Policies and Procedures - Financial Services

## Policy 13.1 Post-Issuance Compliance

### EXHIBIT B

#### Internal Revenue Service Recordkeeping Frequently Asked Questions (FAQs)

##### Why keep records with respect to tax-exempt bond transactions?

Section 6001 of the Internal Revenue Code provides the general rule for the proper retention of records for federal tax purposes. Under this provision, every person liable for any tax imposed by the Code, or for the collection thereof, must keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe. Section 1.6001-1(a) of the Income Tax Regulations amplifies this general rule by providing that any person subject to income tax, or any person required to file a return of information with respect to income, must keep such books and records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by that person in any return of such tax or information.

The IRS regularly advises *taxpayers* to maintain sufficient records to support their tax deductions, credits and exclusions. In the case of a tax-exempt bond transaction, the primary taxpayers are the beneficial holders of the bonds. However, in most cases, the beneficial holders of tax-exempt bonds will not have any records to support their exclusion of the interest paid on those bonds. Instead, these records will generally be found in the bond transcript and the books and records of the issuer, the conduit borrower, and other participants to the transaction. Therefore, in order to ensure the continued exclusion of interest by the beneficial holders, it is important that the issuer, the conduit borrower and other participants retain sufficient records to support the continued exclusion being taken by the beneficial holders of the bonds. Pursuant to this statutory regime, IRS agents conducting examinations of tax-exempt bond transactions will look to these parties to provide books, records, and other information documents supporting the bonds continued compliance with federal tax requirements.

Additionally, in the case of many private activity bonds, the conduit borrowers are also primary taxpayers. For instance, the conduit borrower will generally deduct the interest indirectly paid on the bond issue through the loan documents. Conduit borrowers are also often entitled to claim depreciation deductions for bond-financed property. Consequently, conduit borrowers should maintain sufficient records to support their interest deductions, depreciation deductions or other tax deductions, exclusions or credits related to the tax-exempt bond issue.

Moreover, issuers and conduit borrowers should retain sufficient records to show that all tax-exempt bond related returns submitted to the IRS are correct. Such returns include, for example, IRS Forms 8038, 8038-G, 8038-GC, 8038-T, and 8038-R.

In addition to the general rules under section 6001, issuers and conduit borrowers are subject to specific recordkeeping requirements imposed by various other Code sections and regulations. For example, section 1.148-5(d)(6)(iii)(E) of the arbitrage regulations requires that an issuer retain certain records

necessary to qualify for the safe harbor for establishing fair market value for guaranteed investment contracts and investments purchased for a yield restricted defeasance escrow.

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### **Who may maintain records?**

Read together, section 6001 of the Code and section 1.6001-1(a) of the Regulations apply to taxpayers and persons filing tax returns, including returns related to tax-exempt bond transactions (i.e., Forms 8038, 8038-G, 8038-GC, 8038-T, 8038-R, 8328, 8703). This encompasses several parties to the bond transaction including:

1. issuers as the party responsible for satisfying the filing requirements under section 149(e) of the Code;
2. conduit borrowers for deductions taken for payment of interest on outstanding bonds or depreciation of bond-financed facilities; and
3. bondholders, lenders, and lessors as recipients of exempt income from the interest paid on the bonds.

Since many of the same records may be examined to verify, for example, both the tax-exempt status of the bonds and the interest deductions of the conduit borrower, it is advisable for the bond documents to specify which party will bear the responsibility for maintaining the basic records relating to a bond transaction. Additional parties may also be responsible for maintaining records under contract with any of the parties named above. For example, a trustee may agree to maintain certain records pursuant to the trust indenture.

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### **What are the basic records that should be retained?**

Although the required records to be retained depend on the transaction and the requirements imposed by the Code and the regulations, records common to most tax-exempt bond transactions include:

- Basic records relating to the bond transaction (including the trust indenture, loan agreements, and bond counsel opinion);
- Documentation evidencing expenditure of bond proceeds;
- Documentation evidencing use of bond-financed property by public and private sources (i.e., copies of management contracts and research agreements);
- Documentation evidencing all sources of payment or security for the bonds; and
- Documentation pertaining to any investment of bond proceeds (including the purchase and sale of securities, SLGs subscriptions, yield calculations for each class of investments, actual investment

income received the investment of proceeds, guaranteed investment contracts, and rebate calculations).

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**Are these the only records that need to be maintained?**

No, the list above is very general and only highlights the basic records that are typically material to many types of tax-exempt bond financings. Each transaction is unique and may, accordingly, have other records that are material to the requirements applicable to that financing. The decision as to whether any particular record is material must be made on a case-by-case basis and could take into account a number of factors, including, for instance, the various expenditure exceptions. Moreover, certain records may be necessary to support information related to certain requirements applicable to specific types of qualified private activity bonds. With respect to single and multifamily housing bonds as well as small issue industrial development bonds, examples of such additional material records include:

Single Family Housing Bonds	<ul style="list-style-type: none"><li>• Documents evidencing that at least 20% of proceeds were available for owner financing of targeted area residences.</li><li>• Documentation evidencing proper notification of each mortgagor of potential liability of the mortgage subsidy recapture tax.</li></ul>
Multi-Family Housing Bonds	<ul style="list-style-type: none"><li>• Documentation evidencing that the facility is not used on a transient basis.</li><li>• Documentation evidencing compliance with the income set-aside requirements.</li><li>• Documentation evidencing timely correction, if any, of noncompliance with the income set-aside requirements.</li></ul>
Small Issue Industrial Development Bonds	<ul style="list-style-type: none"><li>• Documentation evidencing compliance with the \$10,000,000 limitation on the aggregate face amount of the issue.</li><li>• Documentation evidencing that no test-period beneficiary has been allocated more than \$40,000,000 in bond proceeds.</li></ul>

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**In what format must the records be kept?**

All records should be kept in a manner that ensures their complete access to the IRS for so long as they are material. While this is typically accomplished through the maintenance of hard copies, taxpayers may keep their records in an electronic format if certain requirements are satisfied.

Rev. Proc. 97-22, 1997-1 C.B. 652 provides guidance to taxpayers that maintain books and records by using an electronic storage system that either images their hardcopy (paper) books and records, or transfers their computerized books and records, to an electronic storage media. Such a system may also include reasonable data compression or formatting technologies so long as the requirements of the revenue procedure are satisfied. The general requirements for an electronic storage system of taxpayer records are provided in section 4.01 of Rev. Proc. 97-22. A summary of these requirements is as follows:

1. The system must ensure an accurate and complete transfer of the hardcopy books and records to the electronic storage system and contain a retrieval system that indexes, stores, preserves, retrieves, and reproduces all transferred information.
2. The system must include reasonable controls and quality assurance programs that (a) ensure the integrity, accuracy, and reliability of the system; (b) prevent and detect the unauthorized creation of, addition to, alteration of, deletion of, or deterioration of electronically stored books and records; (c) institute regular inspections and evaluations; and (d) reproduce hardcopies of electronically stored books and records that exhibit a high degree of legibility and readability.
3. The information maintained in the system must be cross-referenced with the taxpayer's books and records in a manner that provides an audit trail to the source document(s).
4. The taxpayer must maintain, and provide to the Service upon request, a complete description of the electronic storage system including all procedures relating to its use and the indexing system.
5. During an examination, the taxpayer must retrieve and reproduce hardcopies of all electronically stored books and records requested by the Service and provide the Service with the resources necessary to locate, retrieve, read and reproduce any electronically stored books and records.
6. The system must not be subject, in whole or in part, to any agreement that would limit the Service's access to and use of the system.
7. The taxpayer must retain electronically stored books and records so long as their contents may become material in the administration of federal tax law.

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### **How long should records be kept?**

Section 1.6001-1(e) of the Regulations provides that records should be retained for so long as the contents thereof are material in the administration of any internal revenue law. With respect to a tax-exempt bond transaction, the information contained in certain records support the exclusion from gross income taken at the bondholder level for both past and future tax years. Therefore, as long as the bondholders are excluding from gross income the interest received on account of their ownership of the tax-exempt bonds,

certain bond records will be material. Similarly, in a conduit financing, the information contained in the bond records is necessary to support the interest deduction taken by the conduit borrower for both past and future tax years for its payment of interest on the bonds.

To support these tax positions, material records should *generally* be kept for as long as the bonds are outstanding, plus 3 years after the final redemption date of the bonds. This rule is consistent with the specific record retention requirements under section 1.148-5(d)(6)(iii)(E) of the arbitrage regulations.

Certain federal, state, or local record retention requirements may also apply.

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### **How does this general rule apply to refundings?**

For certain federal tax purposes, a refunding bond issue is treated as replacing the original new money issue. To this end, the tax-exempt status of a refunding issue is dependent upon the tax-exempt status of the refunded bonds. Thus, certain material records relating to the original new money issue and all material records relating to the refunding issue should be maintained until 3 years after the final redemption of both bond issues.

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### **What happens if records aren't maintained?**

During the course of an examination, TEB agents will request material records and information in order to determine whether a tax-exempt bond transaction meets the requirements of the Code and regulations. If these records have not been maintained, then the issuer, conduit borrower or other party may have difficulty demonstrating compliance with all federal tax law requirements applicable to that transaction. A determination of noncompliance by the IRS with respect to a bond issue can have various outcomes, including a determination that the interest paid on the bonds should be treated as taxable, that additional arbitrage rebate may be owed, or that the conduit borrower is not entitled to certain deductions.

Additionally, a conduit borrower who fails to keep adequate records may also be subject to an accuracy-related penalty under section 6662 of the Code on the underpayment of tax attributable to any denied deductions. Section 6662 of the Code imposes a penalty on any portion of an underpayment of tax required to be shown on a return that is attributable to one of several factors, including negligence or disregard of rules or regulations. Section 1.6662-3(b)(1) of the Regulations provides that negligence includes any failure by the taxpayer to keep adequate books and records or to substantiate items properly. Under section 6662(a) of the Code, the penalty is equal to 20 percent of the portion of the underpayment of tax attributable to the negligence. Section 6664(c)(1) provides an exception to the imposition of accuracy-related penalties if the taxpayer shows that there was reasonable cause for the underpayment and that the taxpayer acted in good faith.

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### **Can a failure to properly maintain records be corrected?**

Yes, a failure to properly maintain records can be corrected through the Tax Exempt Bonds Voluntary Closing Agreement Program (TEB VCAP). This program provides an opportunity for state and local government issuers, conduit borrowers, and other parties to a tax-exempt bond transaction to voluntarily come forward to resolve specific matters through closing agreements with the IRS. For example, the TEB Office of Outreach, Planning & Review has resolved arbitrage rebate concerns in cases where issuers have approached the IRS and reported a failure to retain sufficient records to determine, precisely, the correct amount of arbitrage rebate due on a bond issue. Notice 2001-60, 2001-40 I.R.B. 304 <http://www.irs.gov/pub/irs-irbs/irb01-40.pdf> provides more information about this program including the procedures for submitting a VCAP request.

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### **Are there exceptions to the general rule regarding record retention for certain types of records?**

No, but TEB encourages members of the municipal finance industry to submit comments and suggestions for developing record retention limitation programs for specific types of bond records, for specific classes of tax-exempt bond issues, or for specific segments of the bond industry. Comments can be submitted in writing to TEB and sent to the following address:

Internal Revenue Service (TE/GE)  
Attention: Clifford J. Gannett, Director, TEB  
T:GE:TEB, Rm. 583  
1111 Constitution Ave., NW  
Washington, DC 20224

You may also contact TEB by calling 202-283-2999 (not a toll-free call).

**EXHIBIT C**

**Internal Revenue Service Tax Compliance Guide**

**EXHIBIT D**

**Internal Revenue Service Notice 2008-31 – Voluntary Closing Agreement Program**