IRS sets audit strategy for tax-exempt bonds in 2019

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WASHINGTON -- Audit examinations on excessive cost of issuance for private activity bonds, defeasance, and public safety or jail bonds are part of the Internal Revenue Service compliance strategy for the 2019 fiscal year that began Oct. 1.

All three areas are new additions to the work plan of the Tax Exempt and Government Entities Business Operating Division, IRS officials said.

David Horton, the acting TE/GE commissioner, and Robert Choi, the acting deputy, included the compliance strategy in a 2019 program letter posted on the IRS website.

Vicky Tsilas, a partner Ballard Spahr, and former head of Branch 5 in the IRS chief counsel's office.
Brian Tumulty, The Bond Buyer

Last year the 2018 IRS work plan for the division included hedge terminations; economic life and weighted average maturity); safe harbors for guaranteed investment contracts; and rules for qualified hedges.

The IRS declined comment on the shift in audit priorities for 2019, but Ed Oswald, a tax partner at Orrick Herrington & Sutcliffe in Washington, said it's normal.

"Each year strategically they generally focus on different subjects," Oswald said. "Perhaps if there is a problem they continue."

Excessive cost of issuance that would adversely impact the tax-exempt status of private activity bonds was the topic the IRS most recently covered in an "issue snapshot" that was published on its website.

The July 27 issue snapshot provided 10 examples of costs that are subject to the 2% limitation on issuance costs as well as several audit tips.

"I think that's an interesting tie-in," said Vicky Tsilas, a partner at Ballard Spahr who recently headed Branch 5 in the IRS Chief Counsel's Office. "The IRS has been publishing snapshots, which are basically two pages, and folks have been asking, 'Do these actually signify what the IRS is going to be targeting?' and the IRS says, 'Well, not necessarily.'"

Oswald said the 2% cost of issuance limitation for PABs could be "a fruitful area" for IRS enforcement. "Given that the 2% limit is a bright line, for a regulator to look at it, is certainly reasonable," he said.

Violations of the 2% limitation may be most likely for smaller issuances.

Oswald said the 2% limitation might be met at the closing, but a few weeks later the issuer may get another bill and pay it, resulting an unintended error.

Notices of defeasance are required to be filed with the IRS.

For instance, a university might have issued tax-exempt bonds to pay for construction of multiple buildings, but years later decide to sell one of them and defease the bonds by taking them off the market.

Oswald speculated that the IRS will review those filings to determine whether the conditions were met and double check the math.

As for public safety bonds, Tsilas said she interprets that compliance area as focusing on “the jail facilities and they have been auditing those for a couple of year now.”

The Bond Buyer has reported on several audits where tax-exempt bonds issued for jails and detention facilities have been determined to be taxable because of an excess private use of the facility. Often it has involved contracts issuers or borrowers have with the U.S. Marshals Service or U.S. Immigration and Customs Enforcement to house federal prisoners being detained as undocumented immigrants.

“Over the last three years, I would say the IRS has been targeting these jail facilities and The Bond Buyer has reported on them,” Tsilas said. “To me it signifies they don’t intend to let up on these audits.”

Oswald agreed “this is maybe a little more of the same because they found some problems there and are looking more.”

“For people not steeped in this, everyone kind of knows what private business use is,” Oswald said. “When you emphasize that the federal government is treated as private business use, people are often dumbfounded by that, asking, ’How can that be?’”

The choices made by the IRS for its audit priorities have become “even more of a black box” since the service began using a data-driven approach, said Todd Cooper, a partner in the public finance group at Locke Lord who chairs the American Bar Association’s taxation section’s tax-exempt financing committee.

“Sometimes the topics they choose can be a bit of a mystery to those of us who don’t have access to the information the IRS has,” Cooper also said. “But they are able to see a bigger picture than any of us in private practice, who only see the transactions with which we are involved and those we hear about in talking to other practitioners and those we hear about at conferences.”

The IRS said last December it expected to close 577 audits in the tax exempt bond office in the fiscal year ending Sept. 30, 2018, down from the 717 in fiscal 2017 but slightly higher than the 570 it concluded in 2016.

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