A Review of Compliance Standards for the Retention of Records Regarding Tax-Exempt and Tax-Credit Bonds: The New Playing Field

by Peter J. Miller and Fay D. Dupuis

The auction-rate securities failures in the bond market in 2007, coupled with the recent recessionary economy, motivated the federal government to act in two ways with respect to municipal bond finance. On one hand, the federal government has expanded the opportunities for local governments to participate in tax-exempt or tax-credit financings on their own behalf and as conduit issuers for private enterprise, in order to stimulate economic recovery[1] while, on the other hand, the Government has sought in different ways to tighten regulation of bond market professionals (including local government issuers) to protect the safety of investors.[2] Both of these actions increase the importance of maintaining accurate records of tax-exempt or tax-credit municipal bond transactions, and justify a review of the record retention standards that may have been in place for some time.

Understanding the Need – Tax and Securities Law Compliance

Placement of the complete bond transcript on the law library shelf is only the beginning of compliance in this area, and, although the need for maintaining detailed records may not be immediately evident (particularly if the municipality is an issuer of conduit bonds subject to continuing disclosure agreements), there are sound legal and policy reasons for municipalities to ensure compliance with increased scrutiny by the Security and Exchange Commission (SEC) and the Internal Revenue Service (IRS) of the municipal securities market.[3]

Federal Tax Audits - The Issuer Stands in the Shoes of the Taxpayer

It may be difficult to appreciate that a municipal bond issuer is subject to an IRS audit when, after all, it is the bondholders of the municipality's bonds who are earning income on the bonds, and either paying tax or claiming exemptions.[4] Nonetheless, it is the issuer, not the bondholder, that the IRS will turn to for an audit of a municipal bond issue for the purposes of providing notices, drafting correspondence, and making its requests for information and documents. The IRS prioritizes its audits of municipal bond issues based upon a perceived degree of risk of the abuse of tax exemptions or credits, but, because the IRS also maintains a general audit program, there is no predictability of which issues will come under audit scrutiny.

Initially, IRS requests for documentation may be routine. However, where the focus of the audit is the qualification of the bonds for tax exemption or tax credit, the IRS requests for information may be particularly detailed. Without a standardized retention and storage policy for retrieval of transaction-related documents, a municipality may find the production of the requested information to be costly and time-consuming.[5]

Experience with IRS audits indicates that the primary focus of the IRS audit inquiry is often the actual expenditure of the bond proceeds. In typical project finance, bond proceeds will be fully expended within 18 to 36 months of the bond issuance. In an audit of the financing of a multi-year capital project, for example, the issuer may need to review and provide construction invoices in order to ensure that bond proceeds were, in fact, spent as projected, that management contracts did not exceed federal requirements for length or payment, or that there was no excess amount of private use in mixed-use projects for the benefit of exempt organizations. The IRS will be interested in learning whether or not the proceeds were spent on qualifying costs (meaning, generally, capital expenditures for equipment and allowed issuance costs), and will expect scrupulously maintained records on this point. Although such expenditures might not have been made directly by the municipality, it will still bear the responsibility for the production of appropriate documentation of these expenditures, unless it has explicitly shifted the burden of production to another party pursuant to a continuing disclosure agreement.

Post-Transaction Reports

The IRS requires the issuers of tax-exempt and tax-credit bonds to file a federal information report of issuance shortly after the new bonds are issued.[6] The timing of such reports will vary depending on the jurisdiction involved and the nature of the bond issue. Similarly, the issuers of tax-exempt obligations have ongoing responsibilities: to periodically inspect the yields earned over the life of the bonds to assure that arbitrage limits are not exceeded, or that compensation is made to the federal government as an anti-abuse device. The IRS will be interested in the investment of bond proceeds to determine whether there has been any excess yield on bond proceeds that is reportable to the IRS as rebatable proceeds of arbitrage under the Internal Revenue Code ("I.R.C.").[7] Arbitrage rules require examination every five years during the life of the bond, and at any redemption or other disposition.[8]

State agencies in most states require reports of issuance to be made in order to measure the numbers and amounts of tax-exempt and tax-credit bonds that are issued within the states.[9] This is particularly relevant with regard to bond issues which are issued subject to a program or statewide ceiling. While these reports are often made immediately upon closing of the bond transaction, the responsibility for the report remains with the issuer, and may require the issuer's documentation, post-closing.[10]

Continuing Disclosure

Regulations of the SEC must also be satisfied when bond issues are subject to

reporting requirements related to material events affecting the bond issue, and to annual reporting of underlying fiscal soundness.[11] Issuers who would otherwise be subject to continuing disclosure typically enter into agreements that shift the burden of production of documents to, and claim indemnity from, a counter-party, such as a conduit borrower. This practice should still be encouraged; however, the SEC's recent effort to increase market transparency in bond transactions through amendment of its rules has changed the timing of material event disclosures affecting outstanding bonds.[12] Disclosure must be made to the Municipal Securities Rulemaking Board (through its computerized reporting system, EMMA[13]), generally within ten business days after the occurrence of the material event. The rule amendments also eliminate many of the transaction exemptions that were previously available.[14] Accordingly, the numbers of bond issues that now must comply with these disclosure rules is on the rise, and records supporting the required filings must be maintained to ensure that notices are filed in keeping with time limits in the amended rule. Prudence would suggest that a policy and process for immediate notification, by the counter-party, of material events subject to disclosure, and ensuring access to documents, be implemented to assure issuer compliance in a timely manner.

What Records Should Be Kept?

The records that must be maintained and made available for inspection will depend on the nature of the bonds the issuer has financed. It is strongly recommended—and, in some cases, essential—that an issuer of bonds have a written policy for the retention of documents in order to establish compliance with tax-exempt or tax-credit tax rules.

With respect to project finance generally, documents subject to the written retention policy may include:

- Construction invoices for which bond proceeds have paid or been used to reimburse project costs.
- Appraisals of facilities and feasibility studies, including on utility and access, and environmental studies.
- A record of public comments made by any official or employee of the issuing body with respect to the bonds or the financed project.
- All correspondence, including electronic correspondence (both internal and external), from the initiation of the first contact through to bond issuance.

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- The official proceedings relating to the bonds, including: the bond transcript; official intent or other resolutions or ordinances; minutes of each meeting where the bond issue was the subject of any discussion, and minutes of each public hearing required to be held under state or federal law; correspondence and any proceedings related to the allocation of ceilings on the program or the statewide issuance of particular types of bonds; and post-issuance reports to state or federal officials, including variations on IRS Form 8038, as needed.
- All correspondence, including electronic correspondence (both internal and external), with any underwriter regarding the proposed or actual marketing, or the sale, of the bonds.
- Copies of invoices or expense logs, and correspondence relating to fees, costs, expenses, and legal fees incurred by the issuer or, to the extent these are paid for with proceeds of the bonds, other transaction parties.
- All correspondence, including electronic correspondence (both internal and external), with respect to any re-marketings, conversion of modes of any bonds, or with respect to any derivative agreement put into place or replaced with respect to bonds.
- All supplemental transcripts amending the proceedings as a result of post-issuance changes to bonds.
- All records, including those of the trustee, regarding the initial disposition; the retention and earnings of bond proceeds, including gains or losses on investments; reports regarding arbitrage compliance; and payments of rebate or yield-reduction payments.
- All records concerning the post-issuance fees of the issuer or the trustee for bond administration.
- Where applicable, all records concerning compliance with federal, state, or local prevailing wage statutes or ordinances.
- All correspondence, including electronic correspondence (both internal and external), regarding the post-issuance dispositions of bond-financed assets or facilities.
- All management contracts and correspondence related to management contracts, and tenant population

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censuses, for projects under Internal Revenue Code § 501(c)(3), and tenant income information for multi-family housing bonds.

- All proceedings relative to election results demonstrating the incumbency of officials participating in any phase of bond transactions, including post-issuance compliance.
- All documents relating to compliance with continuing disclosure obligations, where necessary.
- All correspondence, including electronic correspondence (internal and external), related to audits of tax-exempt or tax-credit bonds.

Record Retention and Maintenance

The content of business records subject to retention will often be held by municipal governments in electronic storage systems, defined by the IRS as:

> a system to prepare, record, transfer, index, store, preserve, retrieve, and reproduce books and records by either: (1) electronically imaged hardcopy documents to an electronic storage media; or (2) transferring computerized books and records to an electronic storage media using a technique such as "COLD" (computer output to laser disk), which allows books and records to be viewed or reproduced legibly (including reproduction by hardcopy) without the use of the of the original program.[15]

IRS procedure requires that the data retained by such a system be indexed to retrieve documents, and that the system be capable of reproducing the documents accurately and reliably and be designed to prevent the deterioration of the data stored. Such systems must be regularly evaluated to insure proper control and maintenance. The IRS recommends that such evaluations include data sampling. The issuer should have the systems manuals for its storage systems available for IRS review. Older storage systems, including those for documents available only on microfiche, are also considered "books and records" within the purview of I.R.C. § 6001 and are, therefore, also subject to this retention and, maintenance standard.[16] Civil penalties and, in the case of willful violations of these procedures, criminal penalties are available to the IRS for enforcement of its record retention rules.

Issuers who may be using off-site storage facilities or whose documents are hosted by off-site servers should further include, in their written policies, a demonstration that the physical safety and security of documents was considered and periodically reviewed, in the event that documents do become damaged or destroyed while off the issuer's premises.[17]

Written policies and procedures that guide and document the municipality's efforts to comply with federal and state disclosure and document retention requirements will become an essential element of an issuer's adequate preparation in responding to federal audits of tax-exempt and tax-credit bond transactions.

All of the records discussed above must, at a minimum, be maintained so long as any bonds of the issue are outstanding, plus a statutory limitation period of an additional three years.[18] When calculating the period of time to retain documentation, it is important to bear in mind that any current or advance refunding bonds issued in exchange or upon redemption of the original bonds will extend this retention period for the life of the refunding bond and the additional three-year statutory limitation period.

Mitigation of Risk

There are several ways in which municipal governments can mitigate the risks associated with the retention of documents related to their tax-exempt or tax-credit obligations. As discussed, it may be mandatory (and certainly, good policy) to draft and enforce a records retention policy, including a process for auditing vendors engaged to perform the retention on behalf of the issuer. Such a policy should include a list of the records that must be maintained and by whom; how the records will be kept; an identification and description of the storage system; and specify the accessibility protocols.

Parties who may share in this risk by contract, by indemnification, or through other provisions of the original transaction documents include conduit borrowers and indenture trustees. Conduit borrowers also have their own incentive to retain records: Because they deduct the interest expense on their tax-exempt debt and claim the depreciation on bond-financed assets, they have an independent responsibility under I.R.C. § 6001 to maintain records. However, in order to increase the issuer's ability to comply with any audit requests, it is prudent to include an indemnification provision in the loan or lease agreement employed in connection with the financing of the project, and require that the conduit borrower maintain the documents that establish tax exemption (including the transcript, the tax documents, and annual or other periodic reports).

In some cases, the trustee in a conduit transaction assumes the role of the "gatekeeper" for bond proceeds, making payments from a project fund in response to the borrower's disbursement requests. Disbursement requests are often accompanied by invoices and agreements, which evidence the project cost and can be used as documentation for the issuer. Provisions can be placed in the indenture document that require the trustee to maintain these records of disbursements and supporting invoices, so that the issuer has access in the event of an IRS audit.

Conclusion

It is likely that municipal bond issues will be more closely scrutinized in the future. New regulations place an increasing burden on municipalities to produce the records of their bond issuance and the related transaction information,

and for longer periods of time. Written policies and procedures that guide and document the municipality's efforts to comply with federal and state disclosure and document retention requirements will become an essential element of an issuer's adequate preparation in responding to federal audits of tax-exempt and tax-credit bond transactions. Issuers of conduit bonds should also consider placing specific language in any loan and lease agreements to require the borrower to maintain, preserve, and expeditiously provide to the issuer, all documents relating to the transaction, so that the issuer may comply with any IRS audit of the bond issue.

Notes

1. The American Recovery and Reinvest-ment Act of 2009, Pub. L. 111-5, 123 Stat. 115 (2009), enacted February 17, 2009 (the "Recovery Act") created a host of temporary bond programs that offered either tax exemption or tax credit directly to municipal issuers or to investors, e.g., Recovery Zone Economic Development and Facilities Bonds (Title I, Subtitle E, Section 1401 *et seq.*), direct and indirect tax credit Build America Bonds (Title I, Subtitle F, Section 1531 *et seq.*), and revised participation in bank qualified small issuer financings (Title I, Subtitle E, Section 1502 *et seq.*).
2. An increase in regulation of market professionals to protect consumers of securities products was one of, if not the prime, purposes behind the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. 111-203, 124 Stat. 1376 (2010) (enacted July 21, 2010), and the recent changes to 17 C.F.R. 240.15c2-12, regulations of the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934, as amended. *See* SEC Release No. 34-62184A (Aug. 09, 2010), Amendment to Municipal Securities Disclosure (available at http://www.sec.gov/rules/final/2010/34-6218a.pdf. In this release, the SEC states: "[t]he Commission believes that investors and other municipal market participants today should be able to obtain continuing disclosure information regarding demand securities so that they can make more knowledgeable investment decisions and effectively manage and monitor their investments so as to reduce the likelihood of fraud facilitated by inadequate disclosure." *Id.* at 11.
3. To synergize enforcement efforts, the SEC and IRS have entered into a memorandum of understanding (MOU) aimed at improving compliance with the rules of the two agencies, according to a statement released in March 2010. The two agencies stated that they will share information on "market risks, practices and events related to municipal securities." *See SEC and IRS Agree to Work More Closely Regarding Municipal Bond Enforcement*, Mar. 02, 2010, with a link to the MOU available at www.sec.gov/news/press/2010/2010-30.html.
4. In general, the Internal Revenue Code, I.R.C. § 6001, imposes obligations on any taxpayer to maintain those records necessary to establish a tax position taken on an IRS return. The section requires that persons liable for tax imposed by the Code keep records and comply with rules and regulations of the Secretary, which may include providing records that the Secretary deems sufficient to show whether the person is liable or not for tax under the Code. The accompanying Treasury Regulations at §1.6001-1(e) require that such records be kept available for inspection so long as the contents may become material in the administration of IRS law. In the context of municipal bond issues subject to audit, the municipal issuer files an information return with IRS under one of the variations of Form 8038. It is the information submitted in this Form, and the consequences of that information, that, in part, subject the municipal issuer to a first contact by IRS in audit. *See* Internal Revenue Manual § 4.81.5.
5. *See supra* Internal Revenue Manual at § 4.81.5.6.1.
6. I.R.C. § 149(e) and Treas. Reg. §§ 1.149(e)-1 and 5f.103-3.
7. I.R.C. § 148.
8. *See* Treas. Reg. § 1.148-3(e).
9. In the tax-exempt arena, programs are often limited in cumulative amount per year or per program. *See e.g., generally*, I.R.C. § 146, which imposes an annual limitation on the aggregate principal amount of private activity bonds which may be issued in each state.
10. *See, e.g.,* Ohio Admin. Code Ch. 122-4, Restricted Bonds, for typical state law-required compliance with issuance and post-issuance notices with respect to allocations for private activity bonds.
11. The general scope of Rule 15c2-12 requires an "obligated person" (which, by definition, includes an issuer of municipal securities) to cause to be provided material event notices regarding important changes affecting the securities, and annual financial operational and audited financial reports, unless the particular bond issue is subject to exemption from such requirements.
12. Under a former version of Rule 15c2-12, post-issuance disclosure of material events was subject to a subjective timeliness requirement that did not impose a ten-business-day limit. Accordingly, there was sufficient time to entertain discussion and confirm that reporting was being made by the counter-party. Under the rule as revised, that time is not as available and, therefore, access to the material information as a result of records maintenance is desirable.
13. The Electronic Municipal Market Access (EMMA) is a comprehensive online information source for investors of municipal bonds. *See* http://emma.msrb.org.
14. For instance, in 2009, through amendments to Rule 15c2-12, the SEC eliminated the exemption from continuing disclosure for variable-rate demand obligations, which brings an entire and heavily traded securities market within the purview of compliance with this aspect of federal securities law. *See* SEC Release *supra* note 2 at 14-15.
15. Rev. Proc. 97-22, 1997-1 C.B. 652, 1997-13 I.R.B. 9 (Mar. 13, 1997).
16. Rev. Proc. 81-46, 1981-2 C.B. 621, 26 C.F.R. 601.105.
17. *See generally*, 36 C.F.R. Ch. XII for the document maintenance standards required of federal agencies, including maintaining documents in a manner that keeps them intact, legible, dry, and free from fire or other natural or environmental hazards.
18. I.R.C. 6501(a).

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