

**Working With the IRS: Audit, VCAP and Other IRS Interactions**  
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**Chair:**

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This session will focus on the recent changes to the Internal Revenue Manual, discuss application of the official intent requirement under Treasury Regulations § 1.150-2, and the current status of the Voluntary Compliance Agreement Program (VCAP).

This session is open to practitioners only. The session will discuss current trends for issuer and conduit borrower interactions with the Internal Revenue Service (IRS) relating to post-issuance compliance matters and enforcement activities. The session is also intended as a forum for practitioners to share their recent experiences interacting with the IRS.

**I. Examination Procedures and Changes – Internal Revenue Manual § 4.81.5 – “Conducting the Examination**

1. **Introduction.** Internal Revenue Manual § 4.81.5 (the “Examination Procedures”) details the procedures and requirements for the conduct of agents and their managers before, during, and after an examination of tax-exempt bonds.
2. **Latest Revisions.** The Examination Procedures were significantly revised on August 5, 2021. These latest revisions to the Examination Procedures reflect the most recent organizational structure of TE/GE and TEB, incorporate a number of items of interim guidance and also appear intent on making the Examination Procedures for TEB more consistent with the examination procedures used in other areas within TE/GE. Though some revisions appear to be ministerial or minor, many revisions are significant and reflect a departure from prior examination procedures. Issuers under examination following the August 2021 revisions may find that the records and information requested, as well as areas being examined, may be considerably different than those conducted prior these revisions.
  - a. **Scope of Examination** – IRM § 4.81.5.4.1. – The Examination Procedures state that there are three phases to the examination process: planning, execution and resolution. IRM § 4.81.5.4. After receiving a particular assigned case, the agent is directed to develop an examination plan, using their professional judgment to set the scope of the examination. IRM § 4.81.5.4.1. In determining the scope of the examination, the agent is directed to consider the following minimal criteria:
    1. the reason the issue was selected;
    2. the materiality of the issue (dollar amount, permanency and timing);
    3. impact on taxpayer compliance or taxpayer behavior; and,
    4. a risk analysis of costs and benefits in pursuing.

- b. Discretion of Agents and Managers. The new emphasis in the discretion of the agent (and the agent's manager) in determining the scope of the examination has a number of important implications. For example, the TEB program appears to be utilizing more standard form information document requests than was the case in prior years and there may be more inconsistency regarding how similar types of examinations are conducted. The new Examination Procedures specifically contemplate that not all examinations are the same size, scope or complexity. As a practical matter, many examinations may be full scope examinations or limited scope examinations, although they are not categorized as such and there is no longer a distinction set forth in the Examination Procedures.
- c. Risk Analysis and Examination – IRM § 4.81.5.7.2 – This section provides the agent and the manager with the parameters to determine the scope of the examination before and during the examination. The changes reiterate the agent's discretion to change the scope of the examination during examination. The depth to which a compliance issue is to be reviewed will be based on:
  - 1. type of records available or expected to be made available for consideration of the issue;
  - 2. complexity of the issue;
  - 3. materiality of the issue;
  - 4. whether the issue was identified in the assignment process as needing more in–depth review (e.g., a referral); and
  - 5. whether the issuer or another entity with control over bond proceeds had “strong internal controls or post–issuance compliance procedures.”
- d. Bond Redemption During Examination – IRM § 4.81.5.7.2.1 – If an issuer redeems 100% of the outstanding principal amount of the bonds during an exam, the agent, group manager, and program manager, may close the examination. Importantly, direct pay bonds, bonds for which appropriate rebate is not paid, and where an issuer asks to negotiate or enter into a closing agreement are not eligible for examination closure under this section. If bonds are redeemed and the case closed, in certain circumstances, a bondholder may be referred to another division for examination. Closure is not mandatory but discretionary, and should reflect the following:
  - 1. What are the reasons for noncompliance?
  - 2. Is the transaction abusive?
  - 3. Were interested parties involved in aspects of the transaction that resulted in noncompliance?
  - 4. Were reasonable steps taken by the issuer/borrower to ensure compliance with the law?
  - 5. Did the issuer/borrower take steps to self–correct prior to the start of the exam?
- e. Determination of Appropriate Records to Review – IRM § 4.81.5.8.2 and Common Records – IRM § 4.81.5.8.3
  - 1. The Examination Procedures describe detailed records that generally should be reviewed, including records of expenditures, records of investments, records related to the use of the financed facilities and records to establish issue price. IRM § 4.81.5.8.2(5), (6) and (7).
  - 2. Common records identified in 4.81.5.8.3 provide a non–exhaustive list of records which the agent may seek in the examination process. This list provides insight into the expanded records that agents may seek on examination.

3. Note that *summary* records could be used by an agent to determine bond proceeds investment and expenditures of bond proceeds as well as qualifying uses of a project. See IRM § 4.81.5.9.1. However, whether an agent may rely on those summary records depends on accuracy and reliability of the records as determined by the agent. The agent may evaluate post issuance compliance monitoring procedures and internal controls as well as sampling records to determine appropriateness and reliability of such summaries. See IRM § 4.81.5.9.1.7. The agent may perform more rigorous testing if the agent receives referral information that records are inconsistent, the agent’s experience with the issuer or conduit borrower), “transaction professional” or experience with certain types of bonds suggest that a higher likelihood of inaccuracy exists with the summary information.
- f. Requesting Information – IRM § 4.81.5.10.1.1 – The Examination Procedures direct an agent to contact the issuer by mail when an examination is opened. TEB now uses a single letter, similar to opening letters used by other TE/GE divisions. IRM § 4.81.5.10.1.1. TEB sends an initial information document request (“IDR”) with the opening letter. IRM § 4.81.5.10.1.1(4). The agent will call the issuer after the longer of 10 business days or 14 calendars after mailing of the opening letter. The agent will:
1. Confirm the issuer received the letter and IDR,
  2. Discuss the issues being examined and the items being requested on the IDR, and
  3. Confirm the time for producing the requested information.
- An Issuer can elect to direct the agent to contact its representative to conduct the call and subsequent communications through a Form 2848 or Form 8821 for a conduit borrower.
- One important threshold question for any issuer or conduit borrower when a bond examination is initiated by the IRS is whether to retain legal representation. The practice varies. Many issuers and conduit borrowers may respond to examinations in early stages, without officially naming a representative, particularly if the examination is perceived to be routine. Other issuers appear to have adopted the practice of retaining counsel to represent them in all bond examinations. Issuers and conduit borrowers who have not consulted with counsel may inadvertently complicate their positions by responding to questions without the input of counsel.
- g. Tour of the Facility – IRM § 4.81.5.13.1 – Agents are advised that facility tours, including interviews of key personnel and inspection of records can be an important part of an examination. It is unclear whether the recent increase in IRS funding from the Inflation Reduction Act will increase facility tours. The Examination Procedures identify certain facilities that may not warrant a facility tour: inherently governmental facilities such as highways, bridges, schools, and parks, facilities not visible during inspection such as sewers, and where no facilities were financed. For all other facilities, the agents should take into account the following factors:
1. Are the financed facilities conducive to impermissible private business use such that a site visit is warranted?
  2. Is the financed project unusual or complex?
  3. Is the arms-length valuation of facilities acquired with bond proceeds unclear, such as purchases from related parties, developer driven

- transactions, recent sales prior to bond-financed acquisition, etc.? If so, it may be useful to physically inspect the facilities for case development.
4. Are allocations between qualified bond-financed facilities and equity-financed nonqualified facilities unclear or complex?
  5. Would it be more appropriate to review the required records on site, for example, to review voluminous records?
  6. For qualified private activity bonds, would a tour of the facilities help identify the financed facilities and determine whether these facilities qualify for bond financing?
  7. Can the necessary information be obtained virtually or through the electronic transfer of records?
- h. Communicating Identified Noncompliance – IRM § 4.81.5.17.1 – Following consultation with their manager, the agent is directed to discuss that potential with the taxpayer or the taxpayer’s representative as soon as possible. IRM § 4.81.5.17.1. IRS agents and managers are directed *not* to initiate closing agreement discussions with the issuer or its representative; closing agreement discussions may be initiated solely at the request of the issuer or representative. The IRS agent may inform the issuer or its representative that closing agreements are to be used to resolve tax matters. If the issuer or representative requests a closing agreement, the IRS agent is directed to initiate the closing agreement process pursuant to IRM § 4.81.6. Note that if a closing agreement is requested after 100% of outstanding bonds are redeemed, the agent cannot close the examination under the discretion provided in IRM § 4.81.5.7.2.1 “Bonds Redeemed During Examination”.
  - i. Examinations Resulting in the Issuance of an Advisory – IRM § 4.81.5.17.2 – If the agent concludes that the bonds are in compliance, it may close the examination with a “No Change Letter.” An agent may also decide to issue an “advisory” to the taxpayer, if the agent determines that the bonds are in compliance but there is potential for future noncompliance; for example, an agent may send an advisory to an issuer if they determine that there is private business use of a facility that, if continued, would result in noncompliance. IRM § 4.81.5.17.3. Depending on potential for future noncompliance, the agent and manager may determine a referral or information notice for a future examination is recommended.
  - j. Closing Agreement – IRM § 4.81.5.17.6 – Agents and managers are directed not to initiate closing agreement discussions (see above). Such discussions must now be initiated by the Issuer or its representative. The procedures for closing agreements can be found at IRM § 4.81.6. “Tax Exempt Bonds Examination Program and Procedures, Closing Agreements.”
  - k. Technical Assistance Requests – IRM § 4.81.5.19 – The taxpayer may ask for a technical assistance request orally or in writing. Rev. Proc. 2021-2 § 5.02. The field office may approve or deny the request for the TAM. If denied, the issuer may appeal the decision with a written statement to the TEB Program Manager within 30 days after notification of the denial. The TEB Program has 45 days to make its determination to approve or deny the request. No appeal of the TEB Program Manager’s decision is permitted. During the consideration period, the agent is directed to cease all audit activity.
3. Official Intent, Reimbursement Allocations and Enforcement
    - a. Reimbursement Expenditures. The rules in Treasury Regulations § 1.150-2 (the “Reimbursement Regulations”) determine when capital expenditures paid from funds other than proceeds of debt prior to the issue date of the tax-advantaged bonds may be reimbursed with the proceeds of a subsequent tax-advantaged

- borrowing. The Treasury Department promulgated the Reimbursement Regulations to prevent issuers and 501(c)(3) and other conduit borrowers from improperly allocating bond proceeds to expenditures paid before issuance.
- b. Preissuance Expenditures. Bond proceeds cannot be allocated to a pre-issuance expenditure paid with funds other than proceeds of debt unless the expenditure meets the requirements of Treasury Regulations § 1.150-2. Bond proceeds allocated to such expenditure generally will not be deemed spent unless the following elements are met:
1. The issuer (or, in the alternative, in a qualified 501(c)(3) bond financing, the conduit borrower) adopted or expressed an official intent (meeting the requirements of Treasury Regulations § 1.150-2 (e)(1)) not more than 60 days after payment of the original expenditure;
  2. The expenditure is a capital expenditure, a cost of issuance of the bond, an extraordinary working capital or a grant; and,
  3. The reimbursement is made not later than 18 months after the later of (a) the date of the expenditure or (b) the date the project was placed in service or abandoned, but not more than three years after the date of expenditure. For small issuers, the 18-month period is extended to 3 years and the 3 year expenditure timing period limit is eliminated.
- c. Official Intent. An issuer must declare its official intent to reimburse an expenditure for a reimbursement allocation to be valid. Official intent means an issuer's (or 501(c)(3) conduit borrower's) declaration of intent to reimburse an original expenditure with proceeds of an obligation and satisfies the requirements of Treasury Regulation §1.150-2(e).
1. Form. The issuer may be made "in any reasonable form", such as by resolution, action taken by authorized representative authorized or designated to declare an issuer's official intent, or specific legislation authorizing issuance of the obligation.
  2. Project Description. The official intent generally describes the project for which the original expenditure is paid. The project can include any property, project, or program (e.g., highway capital improvement program, hospital equipment acquisition, or school building renovation). A project description is sufficient if it identifies, by name and functional purpose, the fund or account from which the original expenditure is paid (e.g., parks and recreation fund or recreational facility capital improvement program).
  3. Reasonable Deviations In Project Descriptions. Deviations between the project identified in the official intent and the actual project financed will not invalidate the official intent if the actual project is reasonably related in function to the described project. As an example, hospital equipment is a reasonable deviation from hospital building improvements but a city office building rehabilitation is not a reasonable deviation from highway improvements.
  4. Amount of Obligations. The official intent must also state the maximum principal amount of obligations expected to be issued for the project.
  5. Reasonableness. The issuer must have a reasonable expectation to reimburse the expenditures. An official intent cannot be declared as a matter of course or in an amount substantially in excess of the amount expected to be necessary for the projects. Patterns of failure to reimburse expenditures are evidence of unreasonableness.
- d. Required Language for Official Intent. Prior to the adoption/promulgation of the Reimbursement Regulations, the Treasury Department released both proposed

regulations (the “Proposed Regulations”) and interim regulations (the “Interim Final Regulations”) to address concerns arising in connection with reimbursement allocations for governmental and qualified 501(c)(3) bonds which were not subject to the official activity rules applicable to private activity bonds. The Proposed Regulations and the Interim Final Regulations each mandated specific language to be included in any official intent resolution.

- e. Enforcement. Must certain language such as “to reimburse” or “reimburse” be included in any valid declaration of official intent?

1. Hypothetical 1:

- a. Board of Supervisors for County A passes an official intent resolution in Year 1 and includes the following language: “The County intends to issue obligations to finance Rural Highway 415 (the “Highway Project”). The Highway Project is expected to cost \$10 million.” In Year 2, the County undertakes the Highway Project and issues tax-exempt bonds later in the year to pay for (a) preissuance capital costs of \$1 million and (b) the remaining costs of the Highway Project.
- b. Does the lack of the word “reimbursement” or “to reimburse” cause the resolution to fail as a valid intent resolution?
- c. Does the reimbursement resolution need to identify the total expected cost of the project or must the resolution only identify the total amount of bonds to be issued for the project.
- d. If the resolution is challenged as a valid official intent, what actions do issuers have at their disposal to challenge such a position? Appeal? TAM? PLR?

2. Hypothetical 2:

- a. Board of Supervisors for County B passes an official intent resolution in Year 1 and includes the following language: “The County intends to issue obligations to reimburse costs for rural highway 2022 (the “Highway Project”). The obligations issued for the Highway Project are expected to be approximately \$5 million.” In Year 2, the County undertakes the Highway Project and issues tax-exempt bonds of \$11 Million later in the year to pay for (a) preissuance capital costs of \$1 million and (b) the remaining costs of the Highway Project.
- b. Does resolution qualify as an official intent even though the actual amount of bonds exceeds the amount identified in the official intent resolution?
- c. What are the alternatives to rectify the discrepancy? Should the County pass a new resolution? Should the new principal amount be \$11 million or \$1 million?

4. VCAP Administrative Process and the COVID Pandemic

- a. Form 14429 Update. In February of 2020, the IRS updated Form 14429, Tax-Exempt Bonds Voluntary Closing Agreement Program Request. The previous version of Form 14429 promulgated in 2019 required issuers and conduit borrowers where relevant, to fill out the form in accordance with supplemental instructions set forth in IRM § 7.2.3. Certain questions were not required to be answered and the wording of certain **questions were altered**. The 2020 version of Form 14429 updates the questions and adds penalty of perjury language that was

previously required in a supplement to the Form. It should be noted that IRM § 7.2.3 has not been updated to reflect that Form 14429 has been updated.

- b. Processing of Requests. It is unclear whether or the extent to which processing timelines for VCAP requests were impacted by the IRS office closures in 2020 and subsequent impacts from the COVID Pandemic affected the processing of VCAP requests. If processing times were impacted, how can practitioners get a better understanding of the current timelines for processing VCAP requests?
- c. VCAP Resolution Standards and the COVID Pandemic. IRM § 7.2.3 provides resolution standards for specific violations of rules applicable to tax-exempt bonds and certain direct pay bonds. If the violation for which a VCAP request is made does not fit within the requirements of the applicable resolution standard in set forth in IRM § 7.2.3.4.3 or IRM § 7.2.3.4.4, an issuer may resolve the VCAP general procedures on “appropriate terms.” Such “appropriate terms” provided by the IRS will be determined based on facts and circumstances.
  1. Timing Requirements. Generally, VCAP resolutions standards apply to requests received within one year of the date of the deliberate action giving rise to the VCAP request. If an issuer does not submit deliberate action the request within one year of the compliance failure or, if later, the latest date specified by the applicable resolution standard, the issuer must use the general procedures and, resolve the violation on the basis of “appropriate terms” given the facts and circumstances.
  2. COVID Pandemic Impacts on Timing Requirements. No formal guidance has been promulgated indicating whether the IRS would allow applicable resolution standards to be used if a VCAP requests made after 1 year from a identified violation was due to impacts from the COVID Pandemic.
    - a. Example. Can issuers use an applicable resolution standard if staffing shortfalls or government mandated office closures caused by the COVID pandemic prevents a VCAP request to be submitted?

Further, if the identified violation was caused in significant part by impacts from the COVID pandemic, can issuers seek relief to use a resolution standard or pay a lower amount under the resolution standard?

- b. Example. Can an issuer use the resolution standard for failure to redeem bonds within 90 days following the close of the expenditure period for certain tax credit bonds if the project completion was delayed due to construction crew shortages or inability to acquire necessary construction materials?
- c. Example. Can an issuer use the resolution standard for excessive private use if government mandates prohibit compliance (e.g. prohibitions on commercial evictions) or staffing shortages and office closures impact the ability to monitor projects and coordinate use of facilities with the private activity rules under Internal Revenue Code § 141?