

# **Module O**

## **Audit Techniques — Introduction**



## Module O

# Audit Techniques — Introduction

## Overview

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**Purpose**

The purpose of this module is to introduce the agent to the tax-exempt bond examination program and to discuss audit concerns and procedures in conducting an examination.

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**Case Study**

A case study accompanies this module. At appropriate times throughout this module, handouts will be distributed to you, and you will be asked to demonstrate what you have just learned. These assignments are indicated and described in blocks entitled “Case Study” throughout the module.

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## Overview, Continued

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### Objectives

At the end of this Module you will be able to:

1. Identify the goals of the tax exempt bond examination program.
2. Compare tax exempt bond examinations to traditional exempt organization examinations.
3. Describe available resources and reference materials for conducting a bond examination
3. Apply disclosure rules to bond examinations.
4. Identify and analyze returns required to be filed by bond issuers.
5. Prepare an audit plan or checklist.
6. Apply auditing techniques.
7. Negotiate and draft a closing agreement.
8. Secure the names of bondholders.
10. Apply appropriate procedures for a defaulted bond.
11. Prepare closing documents for a bond examination.

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# Section 1

## Introduction to Bond Examinations

### Overview

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**Purpose** This section provides an overview of the history and goals of the bond examination program. It explores the similarities between traditional exempt organization examinations and bond examinations. Reference materials are identified. The responsibilities and support provided by the various organizational components involved in the program are identified.

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**Objectives** At the end on this lesson the student will be able to:

- Identify the goals of the tax exempt bond examination program.
- Compare tax exempt bond examinations to traditional exempt organization examinations.
- Describe available resources and reference materials for conducting a bond examination.

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**In This Section** This section contains the following topics:

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## Background

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**Announcement  
93-92**

In Announcement 93-92, 1993-24 I.R.B. 66, the Internal Revenue Service announced the consolidation and coordination of all enforcement activities relating to tax-exempt bonds under the jurisdiction of the Assistant Commissioner, Employee Plans and Exempt Organizations (EP/EO). EP/EO expanded its examination program to include all types of tax-exempt bond transactions. Goals of the program include:

- Achieving significant levels of audit coverage,
- Responding promptly to abusive transactions,
- Increasing the effective use of information returns, AND
- Encouraging issuers to take an active role in ensuring that their bond issues comply with the Internal Revenue Code and Regulations.

To help achieve the goals of the program, Exempt Organization (EO) agents who are specialists in examining tax-exempt bonds are required.

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## Traditional Examinations vs. Bond Examinations

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- Goals:  
Traditional  
Exam vs. Bond  
Exam**
- The goals of a traditional exempt organization examination and a tax-exempt bond examination are similar:
- Confirm qualification for continued tax-exempt status, AND
  - Determine if there is any tax liability or rebate associated with the bonds whether or not tax-exempt status continues
- 

**Audit Steps:  
Traditional  
Exam vs. Bond  
Exam**

Similarities in audit steps in a traditional tax-exempt organization examination and a tax-exempt bond examination are reflected in the chart below.

| <b>Audit Step</b>      | <b>Bond Exam</b>   |
|------------------------|--|
| Pre-audit              | Review returns filed: 8038, 8038-G, 8038-T, 8038-GC  |
| Historical Information | Review bond transcript to gain insight into purpose of bond issue and parties involved.        |
| Current Status         | Determine current status of bonds — outstanding, refunded, defaulted?                          |
| Interviews             | Interview appropriate officials and other significant parties involved with bond issue.        |
| Tour                   | Tour bond-financed facilities if appropriate.  |
| Contracts & Agreements | Review key contracts and agreements.   |
| Financial Information  | Confirm expenditure of bond proceeds for intended project and do appropriate testing.          |
| Related Tax Liability  | Determine if rebate calculation is required. Has Form 8038-T been filed? Adjustment required?  |
| Conclusion             | Continued tax-exempt status or tax consequences if bonds do not qualify for tax-exempt status. |

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# References

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**Examination  
Reference  
Materials**

In conducting an examination of tax-exempt bonds, the following materials are available for guidance:

- IRM 7.6.2 Examination Guidelines for Municipal Financing Arrangements,
- Tax-Exempt Bond Training Course,
- CPE Articles,
- Tax-Exempt Bond Technical Field Conference Materials,
- Code and Regulations,
- Revenue Rulings and Revenue Procedures, AND
- Court Cases, Private Letter Rulings, Technical Advice Memorandums

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**Primary  
Reference  
Guide**

IRM 7.6.2 Examination Guidelines for Municipal Financing Arrangements should be used by the agent as the primary reference guide for procedures in conducting an examination. The Guidelines include the following sections:

- General Examination Procedures
- Administrative Procedures
- Procedures for Obtaining Names of Bondholders
- Closing Agreement Procedures
- Model Closing Agreement
- Sample Letters

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**Local  
Procedures**

When conducting an examination, local procedures and requirements should also be considered.

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## Assistance: Roles and Responsibilities

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### **Examination Assistance & Coordination, National Office, District Counsel**

In conducting an examination, it is important to coordinate with National Office and district counsel if questions arise or if there is an indication the bonds may not qualify for exempt status. The roles and responsibilities and interactions of the various offices involved in the tax-exempt bond program are discussed below.

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### **Assistant Commissioner EP/EO**

The Assistant Commissioner EP/EO is responsible for enforcement of municipal financing arrangements. Responsibilities include:

- Setting policies, objectives and procedures for the program,
- Coordinating activities of the Regions and Key Districts such as entering into closing agreements and taxing income of bondholders, AND
- Coordinating with other functional areas and governmental agencies.

The Exempt Organization Division will implement the examination program.

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### **Associate Chief Counsel, Financial Institutions and Product Branch (FI&P)**

The Associate Chief Counsel (Domestic) is responsible for providing legal support to the Regions, Key Districts, Assistant Commissioner EP/EO and District Counsel on Financial matters relating to tax-exempt bonds. Responsibilities include:

- Carrying out all activities relating to matters in litigation,
- Providing case specific advice to the Assistant Commissioner EP/EO, Regions, Key Districts and Appeals,
- Publishing regulations, revenue rulings, revenue procedures, notices and announcements, AND
- Issuing private letter rulings and technical advice memorandums.

Financial Institutions and Products Branch of the Assistant Chief Counsel (Field Service) and Branch 5 of the Office of the Assistant Chief Counsel (Financial Institutions & Products) FI&P are the offices within Chief Counsel primarily responsible for matters relating to tax-exempt bonds.

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## Assistance: Roles and Responsibilities, Continued

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### Key District Office

The Key District Office is responsible for implementing the program in their district. Responsibilities include:

- Examining tax-exempt bond issues,
  - Negotiating closing agreements with assistance from National Office,
  - Submitting reports to National Office,
  - Participating in special projects and initiatives, AND
  - Coordinating with other governmental agencies.
- 

### District Counsel Bond Liaison

A District Counsel attorney is assigned to each region as a liaison (District Counsel Bond Liaison) responsible for coordinating cases for that region. Responsibilities include:

- Providing substantive legal arguments,
  - Assisting in the development of facts necessary to support the legal analysis,
  - Assisting in complying with procedures such as preparing requests for summons,
  - Assisting in preparing field service and technical advice requests, AND
  - Assisting in determining whether to enter into a closing agreement,
  - Assisting in the administrative appeal process. **(See Rev. Proc. 99-35, 1999-41 I.R.B. 501, Exhibit O-10.)**
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### Early Contact District Counsel Bond Liaison

To facilitate coordination, it is important to contact the District Counsel Bond Liaison early in the examination if questions arise or if there is an indication that interest on a tax-exempt bond may not be excludable from gross income.

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## Section 2

### Disclosure

#### Overview

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**Purpose** This section identifies the potential participants in a bond transaction and explains how parties may be affected if bonds lose their exempt status. The section highlights the general disclosure rules as well as what constitutes return information in specific instances. Related examination procedures are also discussed.

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**Objectives** At the end of this lesson, the student will be able to:

- Apply disclosure rules to bond examinations.
- Identify the participants in the transaction.
- Define “return” and “return Information” for purposes of IRC section 6103(b).
- Identify consent forms permitting disclosure of information
- Determine when issuers must be notified about third party contacts.

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**In this Section** This section contains the following topics:

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# Introduction

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**Background** Disclosure is an important issue in all examinations but can be more complicated in a bond examination due to the number of participants in a bond financing, and the potential parties that could be affected if the bonds lose tax-exempt status.

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**Potential Participants in a Bond Exam** In a bond examination, participants may include:

- Issuer,
- Conduit Borrower,
- Trustee,
- Bond Counsel,
- Others — Underwriter, Financial Advisor,
- Bondholders, AND
- Representatives for any of the parties listed above.

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**Potential Parties Affected if Bonds Lose Exempt Status** If bonds lose tax-exempt status, parties affected may include:

- Issuer,
- Bondholders,
- Conduit Borrower,
- Trustee, AND
- Others.

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## Introduction, Continued

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### **Types of Bond Examinations**

In bond examinations, disclosure concerns can depend on the type of examination and the party with which the examination began.

The types of examinations are:

- Issuer Examination — No Conduit Borrower,
  - Issuer Examination With Conduit Borrower, OR
  - Conduit Borrower Examination.
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## Return Information

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### General Rule for Disclosure IRC Section 6103(a)

The general rule regarding disclosure of returns and return information is found in IRC section 6103(a), which provides that:

**Returns and return information shall be confidential, and except as authorized by this title —**

**(1) no officer or employee of the United States \* \* \***

**shall disclose any return or return information obtained by him in any manner in connection with his service as such officer or an employee or otherwise or under the provisions of this section.**

Thus return and return information are to be kept confidential unless disclosure is permitted by some specific provision of the Internal Revenue Code.

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### Definition of “Return” Under IRC section 6103(b)(1)

Under IRC section 6103(b)(1) a “return” is any tax or information return, declaration of estimated tax, or claim for refund including supporting schedules, which is filed with IRS.

Thus, a return would include Form 8038 or Form 8038-G.

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### Definition of “Return Information” Under IRC Section 6103(b)(2)

Under IRC section 6103(b)(2) “return” information includes the taxpayer's:

- identity,
- the nature, source or amount of his income, assets, or liabilities,
- whether or not the taxpayer's return is being or will be investigated, and
- any other data received by, recorded by, prepared by, furnished to or collected by the IRS with respect to a return or with respect to the determination of the existence (or possible existence) of liability under the Internal Revenue Code.

The distinction between "return" and "return information" is significant, because in some situations the statute permits disclosure of one, but not the other.

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## Return Information, Continued

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**Information Relating to Compliance with Bond Provisions is Return Information**

Information collected or received by IRS relating to compliance with the tax-exempt bond provisions involves the liability or potential liability of specific persons under the Internal Revenue Code. As such, it is return information protected by IRC section 6103.

The **bond issuer** is responsible for filing Form 8038. The Service considers the **bond issuer to be the taxpayer** for examination purposes, even though bondholders may ultimately be affected if the bonds lose tax-exempt status.

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**Form 8038 Exam Information is Return Information for Issuer AND All Bondholders**

Information that is collected during the examination of Form 8038 by IRS is the return information of both the issuer AND the bondholders.

Technical advice may be requested, and the issuer may negotiate a closing agreement with the IRS if there is a problem with the tax-exempt status of the bonds.

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**Return Information for Individual Bondholders**

If there is a problem with the tax-exempt status of the bonds, and an agreement between the parties cannot be reached, the IRS may issue notices of deficiency to bondholders for interest on the bonds.

A bondholder notice of deficiency and any other information generated during the examination of an individual bondholder is the return information of the affected bondholder, but is NOT return information of the issuer or any other bondholder.

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**Return Information for Conduit Borrower in Conduit Borrower Exam**

If a conduit borrower return (Form 990 or 1120) is under examination, information generated during the examination is the conduit borrower's return information. Even if there is some relationship to a bond matter, the information remains the conduit borrower return information so long as the information pertains to some aspect of the conduit borrower's liability under the Internal Revenue Code.

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## Return Information, Continued

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**Return  
Information for  
Conduit  
Borrower in  
Conduit  
Borrower  
Exam  
(continued)**

**Example**

Tax-exempt bond proceeds are used in an unrelated trade or business by a section 501(c)(3) organization under examination. There appears to be a problem with private use where the permitted amount (5 percent) may have been exceeded.

Even though there is some relationship to a bond matter (potential loss of tax-exempt status), the information collected during the organization's examination related to whether the organization has unrelated trade or business tax liability would be the 501(c)(3) organization's return information.

If a separate bond examination is opened (issuer examination), information gathered as part of the bond examination would be the issuer's and bondholders' return information.

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The different types of bond examinations and disclosure implications are discussed below.

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## Issuer Examination With No Conduit Borrower

**Disclosure issues**

A revenue agent opens a bond examination of 1993 County A General Revenue Bonds. May IRS disclose return information relating to whether interest on the bonds is tax-exempt to the issuer, bondholders, trustee or others?

| Party   | Disclosure  |
|---|---|
| Issuer and Bondholders                                | <p>IRS could discuss issues involving whether or not interest on the bonds is exempt because it is the issuer's and bondholder's return information.</p> <p>This information could also be discussed with representatives of the issuer or bondholders if a valid power of attorney is filed.</p>   |
| Trustee   | <p>Issues involving whether or not interest on the bonds is exempt could NOT be discussed without the issuer's consent.</p> <p>Investigative disclosures would be permitted under IRC section 6103(k)(6) to obtain information that is not otherwise reasonably available.</p> <p>If interest on bonds is taxable, the trustee or other person paying interest on bonds could be notified under IRC section 6103(e) (persons having material interest) because it is the payor's responsibility to file Forms 1099.</p> |
| Others — Bond Counsel, Underwriter, Financial Advisor | <p>Issues involving whether or not interest on the bonds is exempt could NOT be discussed without the issuer's consent.</p> <p>Investigative disclosures would be permitted under IRC section 6103(k)(6) to obtain information that is not otherwise reasonably available.</p>  |

Consents permitting disclosure of bond examination information are discussed below.

## Issuer Examination With Conduit Borrower

**Disclosure Issues**

A revenue agent examines a qualified small issue bond under IRC section 144(a), the proceeds of which were loaned by City A to Company B (conduit borrower) to build a manufacturing facility. May IRS disclose return information relating to whether interest on the bonds is tax-exempt to the issuer, bondholders, conduit borrower, trustee, and others?

| Party   | Disclosure   |
|---|--|
| Issuer and Bondholders                                | Same as Issuer Examination With No Conduit Borrower.   |
| Conduit Borrower                                      | <p>Issues involving whether or not interest on the bonds is exempt could NOT be discussed without the issuer's consent.</p> <p>Investigative disclosures would be permitted under IRC section 6103(k)(6) to obtain information that is not otherwise reasonably available. The conduit borrower may have information regarding bond compliance such as capital expenditures relating to the \$10 million cap.</p> <p>If the conduit borrower wants to participate in the examination, the issuer's consent to disclosure MUST be obtained.</p> |
| Trustee   | Same as Issuer Examination With No Conduit Borrower.   |
| Others — Bond Counsel, Underwriter, Financial Advisor | Same as Issuer Examination With No Conduit Borrower.   |

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## Issuer Examination With Conduit Borrower, Continued

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**Consent Forms  
Permitting  
Disclosure of  
Bond  
Examination  
Information**

Sample consents permitting disclosure of bond examination information to the conduit borrower, conduit borrower's counsel, and others are in **Exhibits O-1 and O-2**.

- Form 8821, *Tax Information Authorization*
- Draft Consent Form

All persons that will be involved in meetings, discussions, or correspondence with IRS personnel concerning the bonds should be listed on the consent.

No disclosures should be made to the conduit borrower's representative or others unless they are listed on the consent.

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## Conduit Borrower Examination

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**Conduit  
Borrower  
Examination  
Resulting in a  
Bond  
Examination**

While examining a section 501(c)(3) organization, a revenue agent discovers the organization borrowed proceeds of a tax-exempt bond issue for construction of a multi-purpose center. The bonds were issued by City X and are qualified section 501(c)(3) bonds. The agent determines that there is an unrelated trade or business activity taking place in the center that was not reported on Form 990-T. The agent is concerned about the private use limitations under IRC sections 145 and 141 due to the unrelated trade or business activity. As a result, a separate bond examination is opened.

What are the disclosure implications for the issuer, bondholders and conduit borrower for both examinations?

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## Conduit Borrower Examination, Continued

Conduit  
Borrower  
Examination  
Resulting in a  
Bond  
Examination  
(continued)

| Party                  | Conduit Borrower Exam Disclosure   | Bond Exam Disclosure  |
|------------------------|--|---|
| Issuer and Bondholders | <p>Information relating to whether interest on bonds is tax-exempt may be disclosed.</p> <p>Other information relating to exam — UBIT liability, could not be discussed without conduit borrower's consent</p> | <p>Information relating to whether interest on bonds is tax-exempt may be disclosed.</p>  |
| Conduit Borrower       | <p>Information relating to exam issues, other than whether interest on bonds is tax-exempt, may be disclosed.</p>  | <p>Investigative disclosures would be permitted under IRC section 6103(k)(6).</p> <p>Issues involving whether or not interest on bonds is tax exempt could not be discussed without issuer's consent.</p> <p>No consent is needed to disclose factual information related to UBIT liability that comes from bond examination.</p> |

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## Conduit Borrower Examination, Continued

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### Key Point

It is important to remember that an agent could not discuss issues involving the tax-exempt status of bonds in a conduit borrower examination without opening a bond examination first and obtaining consent from the issuer.

This is potentially the most difficult area because of the overlapping issues and possible concurrent examinations. From a disclosure standpoint, it is important to segregate which information came from which examination.

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### Revocation of Tax-Exempt Status of Conduit Borrower

While examining a section 501(c)(3) organization, a revenue agent finds that the organization's earnings have inured to certain officers and their family members. The agent also discovers the organization's facilities were constructed with proceeds from a tax-exempt bond issue. The IRS determines the organization is no longer exempt from tax, and the organization agrees to this determination. As a result of the revocation, the bonds are no longer tax-exempt.

Q: What can IRS disclose to the issuer and bondholders concerning the examination and its effect on the bonds?

A: The Service could disclose the revocation to the issuer and bondholders. Because the revocation of the organization affects the tax status of the bond interest, it is the issuer's and bondholders' return information. Other information concerning the organization's examination should NOT be disclosed.

If the organization wanted to get involved in any settlement with IRS regarding the bonds, it would need a consent from the issuer. Otherwise, the Service could only state the general legal principle to the organization that revocation of its exempt status would make the interest on the bonds taxable.

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### Further Guidance

Disclosure issues related to bond examinations can be complex. If additional guidance is needed, consult:

- Disclosure Guide for Tax-Exempt Bond Examinations,
  - District Counsel Bond Liaison, OR
  - Disclosure Officer.
-

## Notice of Third-Party Contacts

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|   |   |
|---|---|
| <b>Background</b>                           | Under Prior law, Service employees could contact persons other than the taxpayer to obtain information relating to either the determination or collection of tax. The taxpayer would not necessarily be informed about whom the Service had contacted.  |
| <b>Congress' Intent</b>                     | Congress intended that taxpayers know with whom the Service has been in contact regarding their tax liabilities.  |
| <b>Restructuring and Reform Act of 1998</b> | Congress enacted section 3417 of the RRA of 1998. This re-designated IRC section 7602(c) and (d) as IRC sections 7602(d) and (e) and added a new section 7602(c).   |
| <b>Service Obligations</b>                  | <p>The new law imposes three obligations upon the Service:</p> <ul style="list-style-type: none"><li>• Taxpayers must be notified in writing of any anticipated third party contacts, before the agent actually contacts the third party.</li><li>• Letter 3164 is used to notify the taxpayer. <b>(See Exhibit O-3.)</b></li><li>• The Service must record and report contacts with third parties using Form 12175 <b>(See Exhibit O-4)</b>, AND</li><li>• This information must be provided periodically to and upon request by the taxpayer. <b>(See Exhibit O-5 for Letter 3173).</b></li></ul> |

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## Notice of Third-Party Contacts, Continued

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### Exceptions

Notice is NOT required in the following situations:

- Any contact authorized by the taxpayer, (**See Exhibit O-6 for Form 12180**),
  - If the Service determines that such notice would jeopardize collection of any tax,
  - If the release of the information would subject the third parties to reprisals, OR
  - With respect to any criminal investigation.
- 

### Impact on Bond Program

Issuers must be notified about the possible contact with third parties in the initial contact letter.

A list of third party contacts will need to be sent to the issuer periodically or as requested.

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### Effective Date

These provisions are effective for contacts made after January 18, 1999, 180 days after enactment (July 22, 1998.)

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# Section 3

## Examination Procedures

### Overview

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**Purpose** This section reviews bond examination procedures from case assignment through closing procedures.

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**Objectives** At the end of this lesson the student will be able to:

1. Identify and analyze returns required to be filed by bond issuers.
2. Prepare an audit plan or checklist.
3. Apply auditing techniques

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**In This Section** This section contains the following topics:

| Topic                         | See Page |
|-------------------------------|----------|
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| Setting the Appointment       | O-32     |
| Obtaining Information         | O-34     |
| Initial Information           | O-36     |
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| Use of Bond Proceeds Schedule | O-40     |
| Assistance from Others        | O-46     |
| Change Case                   | O-47     |
| No-change Case                | O-50     |
| Closing Procedures            | O-51     |

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## Beginning an Examination

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### Case Assignment

Tax-exempt bond examinations can begin several different ways:

- Manager assigned return — National Office Project or general bond program,
- Coordinated Examination Program (CEP) case involving a hospital or university, organization may have one or more bond issues,
- Agent referral on a non-CEP case,
- Referral from other federal agency, such as the Securities and Exchange Commission, OR
- Newspaper article, informant.

Form 8038 or 8038-G assigned by an agent's manager will indicate an issuer examination. These forms are filed by bond issuers when bonds are issued and are discussed in detail later in this section.

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### Issuer Level Examination

Although bondholders may ultimately be liable for tax on the interest income if bonds do not qualify for exempt status, IRS considers the bond issuer to be the taxpayer for examination purposes. Reasons include:

- Issuers are primarily responsible for structuring the transaction,
- Issuers have access to much of the information necessary to determine whether the bonds continue to qualify for tax-exempt status, AND
- Issuers are responsible for insuring that bond proceeds are spent and invested in compliance with the Code and Regulations.

The majority of bond examinations start with the issuer. The letter of examination is sent to the issuer and books and records related to the bond issue are requested from the issuer.

The issuer is the taxpayer for disclosure purposes, requesting technical advice and entering into closing agreements. That does not mean other parties involved in the bond issue cannot participate in the examination, as was discussed in the Disclosure section of this module.

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## Beginning an Examination, Continued

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### Conduit Borrower Examination

In a CEP case or an agent referral on a non-CEP case, an entity that received bond proceeds (conduit borrower) will already be under examination.

A conduit borrower is a non-governmental entity that is loaned bond proceeds by an issuer for a non-governmental project. The issuer acts only as a conduit. Most private activity bonds involve conduit borrowers, including:

- Qualified 501(c)(3) bonds under IRC section 145,
- Qualified small issue bonds under IRC section 144, AND
- Exempt facility bonds under IRC section 142.

In the case of qualified 501(c)(3) bonds, the conduit borrower is a 501(c)(3) organization. In the case of exempt facility bonds or qualified small issue bonds, the conduit borrower is typically a corporation or partnership.

The conduit borrower normally has documentation concerning the issuance of the bonds as well as investment and expenditure of bond proceeds. An agent can review information in possession of the conduit borrower as part of the conduit borrower examination and determine whether a formal examination of the bond issue (an “issuer level examination”) is necessary.

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### Establishing Bond Cases on AIMS

Bond examinations are established on AIMS on Non Master File using Form 5588. Each bond issue constitutes one examination which should be established one time on AIMS.

**See IRM 7.6.2.5.9.1 and IRM 7.6.2.5.9.2, Examination Guidelines for Municipal Financing Arrangements** for information on time reporting and case controls.

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### Statutes on Bond Cases

Although bond examinations do not have statutes of limitations, the agent should be aware of bondholder statutes for computing taxpayer exposure if the interest on a bond issue becomes taxable, or a closing agreement is negotiated.

Taxpayer exposure is the amount of tax the U.S. Treasury could collect if bondholders paid tax on the interest they have earned and will earn on the bonds.

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## Beginning an Examination, Continued

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### Statutes on Bond Cases (continued)

The concept of taxpayer exposure and closing agreements will be covered in detail later in this Module.

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### Information Returns Filed by Bond Issuers

Information returns are required to be filed by bond issuers under IRC section 149(e) for tax-exempt bonds issued after 12/31/86. The information specified by Congress is listed in IRC section 149(e)(2). IRS has several different information returns depending on the type and issue price of a bond issue.

- Form 8038 — Information Return for Tax-Exempt Private Activity Bond Issues (See Exhibit B-1)
- Form 8038-G — Information Return for Tax-Exempt Governmental Obligations (See Exhibit B-2)
- Form 8038-GC — Information Return for Small Tax-Exempt Governmental Bond Issues (issue price is less than \$100,000) (See Exhibit C-1)

These forms are required to be filed by the 15th day of the second calendar month after the close of the calendar quarter that the bonds were issued. These forms are filed at the Ogden Service Center, Statistics of Income Unit.

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### Form 8038-T

Form 8038-T, Arbitrage Rebate and Penalty in Lieu of Arbitrage Rebate, is required to be filed if any arbitrage rebate or penalty in lieu of rebate is due. This form is generally due 60 days after the end of every 5th bond year during the term of the bond issue and after the last bond in the bond issue has been discharged.

If Penalty in Lieu of Arbitrage Rebate is elected for a construction issue, Form 8038-T is required to be filed for each applicable 6-month period after the date the bonds are issued. Form 8038-T is also filed at the Ogden Service Center. (See Exhibit C-2)

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### Note

While these forms were not developed by IRS for audit purposes, and may be subject to future revision, they provide useful information that can be used in planning an examination. Forms 8038 and 8038-G are discussed below.

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## Beginning an Examination, Continued

Form 8038

| Section                                      | Information/Potential Audit Questions   |
|--|---|
| Part I — Reporting Authority                 | Name and address of issuer, name of issue, date of issue. Date of issue is important to know for applying bond law.   |
| Part II — Type of Issue                      | Identifies type of qualified private activity bond, IRC section and whether any elections have been made. Audit tests can be designed based on IRC section and any elections that have been made.   |
| Part III — Description of Bonds              | Description of bonds includes final maturity date, weighted average maturity of bonds and yield on issue. This section can be reviewed to reveal any unusual debt service pattern, example — principal and interest on bonds payable at maturity date.  |
| Part IV — Uses of Original Proceeds of Issue | Expenditure of bond proceeds including issuance costs, proceeds allocated to a reasonably required reserve or replacement (4R) fund, proceeds used to refund prior issues. Issuance costs are limited under IRC section 147(g), a 4R fund would require a rebate calculation under IRC section 148 if 5 years have passed from the date of issue and any refunded bonds may impact the bonds under examination. |
| Part V — Description of Property             | Description of property financed by non-refunding proceeds — land, buildings, and equipment — qualified property? Private use?  |
| Part VI — Description of Refunded Bonds      | Description of refunded bonds — identifies related bond issue(s) to analyze during examination for potential impact on bonds under examination.   |
| Part VII — Miscellaneous                     | Election to pay penalty in lieu of rebate indicates Form 8038-T has been filed.   |
| Part VIII — Volume Cap                       | Information concerning compliance with state volume cap, qualified 501(3) bonds — \$150 million limit on nonhospital bonds under IRC section 145(b)(2)  |

*Continued on next page*

## Beginning an Examination, Continued

Form 8038-G

| Section                                      | Information/Potential Audit Questions  |
|--|--|
| Part I — Reporting Authority                 | Name and address of issuer, name of issue and date of issue. Date of issue is important to know for applying bond law.   |
| Part II — Type of Issue                      | Identifies general purpose of bond issue and issue price.  |
| Part III — Description of Obligations        | Description of obligations includes yield on bonds and final maturity date. This section can be reviewed to reveal any unusual debt service pattern example, principal and interest on bonds are payable at maturity date.   |
| Part IV — Uses of Original Proceeds of Issue | Expenditure of bond proceeds including issuance costs, proceeds allocated to a reasonably required reserve or replacement of (4R) fund, proceeds used to refund prior issues. Issuance costs are not limited for governmental bonds, but should be analyzed if high. A 4R fund would require a rebate calculation if 5 years have passed from the date of issue and any refunded bonds may impact the bonds under examination. |
| Part V — Description of Refunded Bonds       | Description of refunded bonds identifies related bond issue(s) to analyze during examination for potential impact on bonds under examination.  |
| Part VI — Miscellaneous                      | Information concerning state volume cap, pooled financings which indicate loans of bond proceeds that should be analyzed and election to pay penalty in lieu of rebate indicates Form 8038-T has been filed.   |

*Continued on next page*

## Beginning an Examination, Continued

---

**Summary of  
Bond  
Information  
Returns**

Reviewing bond information returns can:

- Provide insight into the bonds issued,
- Allow the agent to categorize the bonds and plan audit tests based on the applicable IRC section and information on the return, AND
- Formulate questions to ask the issuer or other knowledgeable persons.

---

**Case Study**

Analyze Form 8038.

Discuss disclosure concerns based on review of Form 8038.

---

## Setting the Appointment

---

- Introduction** As indicated earlier, tax-exempt bond examinations can begin several different ways. The two most common are:
- Issuer examination — Form 8038 or 8038-G assigned, AND
  - Conduit borrower examination — bond issue(s) selected as a result of conduit borrower examination
- 

- Issuer Examination** In an issuer examination where Form 8038 or 8038-G has been assigned, the agent should:
- Review Form 8038 or 8038-G,
  - Contact the issuer, AND
  - Send letter notifying issuer of examination.
- 

**Sample Contact Letter** A sample letter notifying issuer of examination is shown in **IRM Exhibit 7.6.2.5-1 Sample Contact Letter, Examination Guidelines for Municipal Financing Arrangements.**

---

**Disclosure of Examination** It is likely that the government official who signed Form 8038 is no longer in that position. In that case, the agent should attempt to contact the person currently in that position — mayor, director of finance, county commissioner, etc.

If that person is not available, IRM 7.12.2.3.3 Publicity and Limitations of EP/EO Material, provides that returns and return information of a state or local government may be disclosed to any person legally authorized to act for the state or local government.

---

- Initial Goals in Examination** The goals in setting the appointment are to:
- Contact a responsible official and notify of examination,
  - Gain access to the bond transcript, AND
  - Review the bond transcript as a starting point for the examination.

The bond transcript was discussed in Module A.

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*Continued on next page*

## Setting the Appointment, Continued

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**Conduit  
Borrower  
Examination**

In a conduit borrower examination, a bond examination may begin:

- As a result of information developed in the conduit borrower examination that could affect tax-exempt bond issue(s), OR
- As a result of analysis of information in possession of the conduit borrower related to bond issue(s) — bond transcript, official statement and selection of one or more issue(s) for examination.

This scenario will most likely occur in a CEP examination of a hospital or university system where there may be one or more bond issues.

The agent can either review the bond information in possession of the conduit borrower and determine whether an issuer examination is merited or contact the issuer immediately and establish a separate issuer examination.

---

**References**

See “Issuer examination” above to start an issuer exam.

See Section 2 of this module for disclosure implications involving conduit borrowers

---

**Case Study**

Send out letter of examination.

---

## Obtaining Information

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### **Bond Transcript**

Module A introduced the various documents that can be found in the bond transcript. The bond transcript is the agent's first source of information in the bond examination. Refer to Module A for more information.

---

### **Steps to Follow After Review of the Bond Transcript**

After reviewing key documents in the bond transcript and Form 8038, the agent should have more insight into the bond issue and can plan the rest of the examination. The agent should:

- Issue a detailed information document request (IDR),
  - Prepare an audit plan or checklist, AND
  - Schedule interviews if appropriate.
- 

### **Case Study**

Review the bond transcript, noting important items.

### **Use of Individual Document Request ("IDR")**

Use an IDR to request documents from the party in possession of the records:

- issuer;
  - conduit borrower;
  - trustee,
  - bond counsel,
  - underwriter,
  - developer,
  - financial consultant,
  - credit enhancer,
  - feasibility consultant, and
  - counsel for a number of these named here.
- 

*Continued on next page*

## Obtaining Information, Continued

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### **Third Party Requests for Information or Documents**

If information/documents cannot be obtained from one of the above parties with an IDR — go to a third party and request the necessary information/documents.

Examples of third parties that the agent may contact:

- Suppliers,
  - Government agencies,
  - Other party to a contract or agreement, AND
  - Buyer or seller of bond financed asset.
- 

### **Other Sources**

The agent may go to other sources for information:

- Examination division — current or prior examination of taxable conduit borrower, or copy of Form 1120,
  - EP/EO division — current or prior examination of exempt conduit borrower,
  - Service Center - for copy of return if unavailable elsewhere.
  - IDRS - for a copy of a BRTVU.
-

# Initial Information

---

**Information Document Request**

The IDR is issued to the issuer or conduit borrower if a conduit borrower examination is being conducted.

The conduit borrower will generally have most of the information relating to the bond issue. However, the agent should keep in mind the disclosure rules when dealing with the conduit borrower. See Section 2 of this module for additional information.

The information in the detailed IDR can be requested at the beginning of the examination, but it is generally more advantageous to review the bond transcript first. The information in the IDR can include:

- Tour of bond financed facilities,
- Interviews if appropriate,
- Contracts and agreements involving persons using bond financed facilities,
- Trustee monthly/quarterly statements relating to receipt and disbursement of bond proceeds for project purposes and any other purposes of the bond issue,
- Backup documentation for expenditure of bond proceeds; requisition forms, invoices, etc. Note: This may be too voluminous to ask for up-front, and the agent may want to request documentation for only certain expenditures after reviewing trustee statements,

---

**Information Document Request (continued)**

- Information concerning investment of bond proceeds in reserve funds and any other funds,
- Rebate calculation if appropriate,
- Detail concerning bond issuance costs (private activity bonds), AND
- For refunding bonds: copy of bond transcript or official statement for refunded bonds.

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*Continued on next page*

## Initial Information, Continued

---

**Case Study** Request information from the conduit borrower using an IDR.  
Obtain the disclosure form, Form 8821 from the issuer or conduit borrower.

---

**Information in Possession of Trustee May Require Summons** In certain examinations, the agent may be directed to a trustee who has possession of vital information concerning the bond issue. The trustee may require a summons before releasing any information.

Summons procedures are discussed later in this module.

---

**Follow-up IDRs** After reviewing the information requested in the detailed IDR, follow-up IDRs can be issued if appropriate.

---

**Audit Plan/Checklist** It is suggested that the agent prepare an audit plan or checklist after reviewing the bond transcript and categorizing the bond.

The audit plan or checklist should address:

- Review of bond transcript,
  - Current status of bonds — outstanding, refunded, defaulted,
  - Tour of facilities if appropriate,
  - Interviews if appropriate,
  - Review of any contracts or agreements involving bond financed facilities,
  - Expenditure of bond proceeds for intended purpose,
- 

*Continued on next page*

## Initial Information, Continued

---

### Audit Plan/Checklist (continued)

- Test applicable IRC sections:
  - 141 private activity
  - 145 qualified 501(c)(3)
  - 144 qualified small issue,
- Other requirements applicable to private activity bonds — IRC section 147 ex. 147(f) public approval, 147(g) limit on issuance costs,
- Arbitrage and rebate requirements IRC section 148, AND
- If bonds refunded a prior issue, comments concerning any tests of refunded bonds.

---

### Interviews

In-depth interviews may or may not be helpful in the initial stages of an examination. It is suggested to review the bond transcript before asking any substantive questions.

Basic questions involving the current status of the bonds and whether terms of the bonds have changed significantly could be asked up-front to determine if the examination should be modified.

For an issuer examination, often the government officials who were originally involved with the bond issue are no longer in office. Their successors may have limited knowledge concerning the issue.

If a conduit borrower is involved, the conduit borrower may provide more information concerning the project and expenditure and investment of bond proceeds.

The agent may also be referred to the bond counsel, trustee or financial advisor by the issuer. The agent can talk to these parties, but should be aware of disclosure rules.

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*Continued on next page*

## Initial Information, Continued

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**Depth and  
Scope of  
Examination**

The depth and scope of an examination should be sufficient enough to confirm that the bonds under examination are in compliance with the Code and Regulations based on the date of issue.

The examination should confirm that:

- Bonds were issued for an exempt purpose,
- Bond proceeds were spent for the intended purpose,
- Private activity limitations were met,
- Each major category of expenditure complies with the Code and Regulations — new money, reimbursement, refunding, etc.,
- Rebate requirements have been met, AND
- If the bonds under examination refunded a prior issue, does the refunded bond qualify for exempt status?

---

**Problem**

Prepare an audit plan or checklist.  
Do the yield calculation.

---

## Use of the Summons

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**When to Use** Use of the summons depends on both each agent's individual audit techniques and local procedures.

---

**Issuer, Conduit Borrower, Trustee** In the event that any of these parties do not comply with your IDR and the requested data is not obtainable from other sources — a summons can be issued.

In most cases this is the last resort. But a summons is a very useful tool available to the revenue agent and should not be neglected.

---

**Third Parties** Similar to the above parties, if requests are made of third parties and they do not comply — a summons can be issued.

Here, too, in most cases this is a last resort.

**(See Exhibit O-7 for Form 2039 and agent's affidavit)**

---

**Restructuring and Reform Act of 1998** Congress enacted section 3415 of the RRA of 1998. This new section affected IRC section 7609.

---

**Background** Prior law defined certain persons other than the taxpayer under investigation as “third party recordkeepers”. These included banks, attorneys, accountants, and other enumerated persons who kept records of transactions in a capacity as a recordkeeper. Under prior law, whenever the Service served a summons on these third-party recordkeepers both the taxpayer and the other person named in the description of records sought by the summons were entitled to be notified of the summons. The noticees had the right to intervene in any enforcement proceeding regarding that summons as well as the right to bring a motion to quash the summons within 20 days of notification.

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## Use of the Summons, Continued

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### Changes

The RRA of 1998 results in the following changes:

- Notice requirement applies to ALL third parties, not just third party recordkeepers
  - Notification requirements apply to summons for testimony as well as records
  - Clarification is made that information may be obtained through informal (non-summons) procedures under IRC sections 7601 and 7602.
- 

### Impact on Bond Program

Third party notice requirements do not apply to issuers or bondholders

All other summons issued must now meet the notification requirements.

---

### Serving the Summons - Restructuring and Reform Act of 1998

Congress enacted section 3416 of the RRA of 1998. This section affected IRC section 7603.

---

### Background

Under prior law, a summons had to be served either by handing it to the person to whom it was directed or leaving it at the person's usual place of abode.

Service to third-party recordkeepers also had to be made personally.

---

### Mailing Summons

The new law allows an additional option for service of summons to third-party recordkeepers:

- Personal service of the summons as under prior law
  - Service by registered or certified mail (new)
- 

*Continued on next page*

## Use of the Summons, Continued

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**Effect on Bond Program** This is advantageous to revenue agents, because many third-party recordkeepers are out-of-town entities. Now the revenue agent can mail summonses to them.

---

**Effective Date** Effective dates for both Act sections 3415 and 3416 is the date of enactment, July 22, 1998.

---

**Request for a Summons** At times the party that has the information sought by the agent will request that a summons be issued before the documents will be released.

Consideration should be given to the Neece vs. IRS, 922 F.2d 573 (10th Circuit 1990) decision. Here the bank voluntarily gave the agent financial information of one of its depositors. The court held that the IRS should have gone through third party summons procedures, even if the bank voluntarily gave the information. The taxpayer was not afforded all their rights without the summons procedures.

---

**District Counsel** Before a summons is to be issued, consultation with the District Counsel bond liaison is necessary.

---

**Exercise** You issue an IDR to the issuer requesting invoices to support amounts paid out of the project fund. According to the bond transcript this was supposed to be for a new computer. The issuer does not respond to your request.

- What are your options?
  - What is your next step?
  - Who do you contact?
- 

*Continued on next page*

## Use of the Summons, Continued

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### Case Study

Review the summary of the tour of the bond-financed facilities.

Determine other information that should be requested from the issuer or conduit borrower.

Review the additional information distributed to you. What implications does this have for the bonds?

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# Use of Bond Proceeds Schedule

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**Introduction** The “Use of Bond Proceeds Schedule” is prepared by the issuer, conduit borrower, trustee or agent from the trustee fund statements.

---

**Trustee Fund Statements** These statements:

- Provide the detail of the use of funds,
- Can be obtained from issuer, conduit borrower or trustee (in that order), AND
- Are similar to private foundation trust statements.

---

**Purpose of Bond Proceeds Schedule** The “Use of Bond Proceeds Schedule” is used to show the flow of funds to determine if requirements are met for:

- Arbitrage spending,
- Rebate spending,
- Reserve fund,
- Costs of issuance fund, AND
- Bona fide debt service fund.

It also shows the amount of earnings received on various fund accounts.

---

**Project Fund** The project fund can also be called the:

- Construction fund, OR
- Capital expenditure fund.

To determine if the user has met the spending requirements, review:

- resolution to draw funds, template in bond transcript,
  - specific draws on fund, for project purposes,
  - invoices, usually attached to draw requests, AND
  - contracts and agreements.
- 

**Reasonably Required Reserve and Replacement Fund ("4R")** The reserve fund:

- Is normally 10% of the gross proceeds of an issue,
- Has normally no activity, other than recorded earnings, AND
- Will usually have its requirements and limitations set out in the bond transcript.

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*Continued on next page*

## Use of Bond Proceeds Schedule, Continued

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**Costs of Issuance Fund ("COI")**

The Costs of Issuance Fund is limited to 2% of proceeds-use price available to public. Normally this is the price less any original issue discount.

Conduit borrower can use its own funds to exceed the 2% limitation.

Review conduit borrower's invoices for amounts paid.

The requirements and limitations are found in the bond transcript.

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**Bona Fide Debt Service Fund ("BFDSF")**

This fund is also called the "Bond Fund." It makes debt service payments from periodic deposits from the user of the proceeds.

The requirements and limitations are found in the bond transcript.

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**Illustration**

Use of bond proceeds schedule — **See Exhibit O-8.**

---

**Case Study**

Use the information that you have received from your instructor to determine if the bonds meet the private business tests. Use your computers for computations.

---

## Assistance from Others

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### District Counsel Bond Liaison

District counsel has a specific person designated to be a bond liaison between the field and headquarters. This person is available to help with technical questions, technical advice procedures and closing agreements. Keep this person involved in your cases.

Each agent should contact their key district bond coordinator or group manager to find out who is their District Counsel bond liaison.

---

### Headquarters Exempt Organizations Bond Focus Group

The Exempt Organizations Bond Focus Group is another key contact point for revenue agents conducting bond examinations. Contact a member of this group whenever help is needed with a technical question, technical advice, procedures, and closing agreements.

---

### Field Service Advice ("FSA")

Difficult questions should be addressed to your District Counsel bond liaison. If necessary, that person will seek assistance from Chief Counsel in the National Office by use of the FSA. Normally, the FSA will take 90 days after receipt to be completed.

The FSA is a tool available to the agent. It can:

- Provide guidance in developing issues, AND
- Be a prelude to a technical advice.

However, FSAs cannot be cited in any technical advice.

Beginning in 1999, FSAs (along with all other Chief Counsel Advice documents) will be made available for public inspection. (See **Announcement 99-4, 1999-3 I.R.B. 1, attached as Exhibit O-10.**)

---

### Engineer Economist

Request the assistance of an IRS engineer or economist for questions about:

- Economic life of bond financed-assets,
  - Feasibility of bond projects, OR
  - Valuation of real/personal property.
-

## Change Case

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### **Closing Conference**

Similar to other change cases, the results of the examination should be communicated to the issuer at a closing conference. Local procedures will dictate who is present at this meeting. As with all meetings, the issuer and the agent will always be present. But the following parties may also attend with proper power of attorney (POA) or disclosure waiver (D/W).

- Conduit borrower — with D/W,
  - Trustee — with D/W,
  - Bond counsel — with D/W or POA,
  - Any other interested party with proper D/W or POA, AND
  - Agent's group manager, local procedures apply.
- 

### **Closing Agreement - Agreed Case**

If taxpayer agrees to the changes, a closing agreement can be entered into between the issuer and the Commissioner.

See Section 4 of this module for specific procedures regarding closing agreements.

---

### **Other Agreed Change Cases**

Certain agreed change cases may be closed without a closing agreement:

- IRC section 150(b) cases,
  - denial of claim for refund,
  - adjustment to claim for refund ,
  - certain other adjustments to arbitrage, AND
  - certain other adjustments to rebate.
- 

### **Technical Advice**

Technical Advice is not mandatory. It can be requested by the District or the issuer.

It should be requested when:

- there is a lack of uniformity regarding the disposition of an issue, OR
- an issue is unusual or complex enough to warrant consideration by Headquarters.

Follow the procedures of Rev. Proc. 99-2, 1998-1, I.R.B. 155 (or a later release which supercedes this revenue procedure.)

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*Continued on next page*

## Change Case, Continued

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|   |   |
|---|---|
| <b>Appeals</b>                              | Issuer can request an appeal in writing of an adverse determination by the District that interest on a bond issue is not excludable from gross income under IRC section 103.  |
| <b>Restructuring and Reform Act of 1998</b> | Congress enacted section 3105 of the RRA of 1998.   |
| <b>Effective Date</b>                       | The effective date of the RRA provision is July 22, 1998.   |
| <b>Revenue Procedure</b>                    | A copy of Rev. Proc. 99-35, 1999-41 I.R.B. 501 which contains the proposed revenue procedure for administrative appeal of adverse determinations of tax exempt status of bonds is attached as <b>Exhibit O-10</b> .   |
| <b>Local Procedures</b>                     | Local procedures should always be followed in processing cases to Appeals.  |
| <b>Bond Tech Advice (T/A) Procedures</b>    | <p>Bond T/A procedures are the same as other T/A procedures with the following differences:</p> <ul style="list-style-type: none"><li>• District Counsel bond liaison should be involved prior to beginning T/A procedures,</li><li>• Use Rev. Proc. 99-2, 1998-1 I.R.B. 155 (or any comparable later dated revenue procedure),</li><li>• Key district review sends the T/A to chief counsel in the national office, AND</li><li>• In some cases, prior to a T/A request, the use of a Field Service Advice could be sent by District Counsel to get advice on the issue in question.</li></ul> |

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*Continued on next page*

## Change Case, Continued

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### Results of T/A Sent to N.O.

The possible outcomes of Tech Advice requests sent to the national office are:

- Case results in a favorable decision for the issuer, which would become a no-change case, OR
  - Case results in an unfavorable decision for the issuer, which would allow for:
    - A closing agreement,
    - Issuer's written request for an appeal, OR
    - Taxing the bondholders (see Section 5 of this module), if the closing agreement is not accepted by the issuer.
- 

### Exercise

You have just completed the examination of a IRC section 144(a) bond. The information you have compiled indicates that the \$10 million limitation has been exceeded. You are going to hold a closing meeting with the issuer to discuss your findings.

- Who should be present at this meeting?
  - What disclosure concerns, if any, would you have?
  - What are the different possible outcomes of the meeting?
-

## No-Change Case

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### No-Change Letter

The no-change letter is used to close out the exam when there are no-changes to the bond issue under examination.

Note: The same bond can be opened **again** with another examination and could affect the bondholders for all open years.

**See IRM Exhibit 7.6.2.5-2 Sample No Change Letter, Examination Guidelines for Municipal Financing Arrangements,** for a sample no-change letter.

---

### Sending the Letter

For purposes of the bond case, the issuer is the taxpayer. Therefore, the no-change letter will be sent only to the issuer.

All other parties, such as the conduit borrower, trustee, or bond counsel involved in the bond examination are considered third parties and will not receive their own letter.

Exception — bond counsel would receive a POA copy of the issuer's letter with a valid POA.

---

# Closing Procedures

---

**Normal Closing Procedures** Bond examinations are similar to EO closings.

Use forms:

- 5599, *EO Examined Closing Record*
- 3198, *Special Handling Notice*
- 5772, *EP/EO Workpaper Summary*
- 5773, *EP/EO Workpaper Summary Continuation Sheet*
- 5464, *Case chronology record*

Usually activity code 397 will be used. Special compliance initiatives will use a different activity code.

Use correct project code for bonds:

- 017, Non-EO bond exam
- 018, Non-EO bond compliance activities
- 050, EO compliance activities
- 053, Bond compliance initiative
- 056, Related returns (i.e. 990, 1120)
- 076, EO bond exam
- 103, Focus group
- 110, Small-issue capital expenditures
- Additional project codes as prescribed by headquarters.
- When determining the priority of project codes, CEP time takes priority over bond time.

---

**NOTE** Time spent on bonds is reported on CEMIS in the CEP narrative. The District Office receives credit for bond time spent on CEP cases even though the CEP project code is used.

---

**Local Procedures** Consider all local procedures when closing a bond case.

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**Problem** Pre-closing meeting.

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## Section 4

# Closing Agreements

### Overview

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**Purpose** This section identifies the parties involved, the purpose, and the steps in the closing agreement process.

---

**Objectives** At the end of this lesson the student will be able to:

- Identify the parties to the closing agreement
- Follow the proper steps in the closing agreement process.
- Compute the correct closing agreement amount.

---

**In This Section** This section contains the following topics:

| <b>Topic</b>                  | <b>See Page</b> |
|-------------------------------|-----------------|
| Overview                      | O-52            |
| Introduction                  | O-53            |
| The Closing Agreement Process | O-55            |

---

# Introduction

---

**Parties Involved**

The parties to the closing agreement (C/A) are:

- The issuer (as the taxpayer, the issuer must be a party to the closing agreement), and
- The IRS.

Any other party involved in the bond transaction can be a party to the C/A, with proper disclosure consent.

C/As are **not** entered into with individual bondholders.

---

**Purpose**

The primary purpose of a C/A is to ensure consistency among districts, issuers, and taxpayers.

It is a method for closing an agreed change case.

A closing agreement:

- Allows the interest on the bonds to remain tax-exempt, AND
  - Prevents bondholders from being taxed on the interest they receive.
- 

**Steps in Proposed Exam Guidelines for Municipal Financing Arrangements**

IRM 7.6.2.5.6 Exempt Organizations Examination Procedures, Chapter 5, Examination Guidelines for Municipal Financing Arrangements, outlines the steps and sample forms to:

- obtain concurrence from District Counsel and headquarters,
  - negotiate the terms of the agreement,
  - compute the tax amount, with input from District Counsel and headquarters, AND
  - make use of the standard C/A, disclosure consent, and letter to the issuer.
- 

**Communication**

At all times open communication should be maintained with your district counsel bond liaison.

Headquarters will also have to be informed of the C/A from its beginning and if any changes are proposed.

As with any case, good communications with the issuer will enhance the prospects of smoother processing of the C/A.

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*Continued on next page*

## Introduction, Continued

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### Local Requirements

All local requirements and operating procedures **must be** taken into account when processing C/A.

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# The Closing Agreement Process

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## Determine that You Have an Issue

Fully develop the case to the point that you have determined there is an issue that can be resolved with a C/A.

Discuss the issue with District Counsel to get their concurrence before proceeding with the C/A. District Counsel will give the agent:

- the “go ahead”,
  - additional sources to research, OR
  - reasons they believe agent does not have a good case.
- 

## Send Information to Headquarters

Draft a memo to headquarters containing:

- facts,
- law,
- analysis, AND
- closing agreement amount.

Memo is sent to: EO bond group CP:E:EO:T:4

Include with the memo:

- Completed C/A and disclosure consent, AND
- Completed copy of the issuer letter proposing a C/A.

**See IRM 7.6.2.5.6 Exempt Organizations Examination Procedures, Chapter 5, Examination Guidelines for Municipal Financing Arrangements, Closing Agreement Procedures.**

---

## Closing Agreement Amount

Discuss the closing agreement amount with District Counsel.

There are a number of alternatives for computing the closing agreement amount, these include:

- total taxpayer exposure,
- arbitrage profits, OR
- another basis.

When computing the closing agreement amount, consideration should be given to whether or not the bonds can be redeemed early.

**(See Rev. Proc. 97-15, 1997-1 C.B. 635 (Exhibit L-1) for more information on calculating the closing agreement amount.)**

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## The Closing Agreement Process, Continued

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**Total Taxpayer Exposure** Taxpayer exposure is the amount of tax the U.S. Treasury could collect if bondholders paid tax on the interest they have earned and will earn on the bonds.

Calculate the bondholder's interest:

- determine interest paid to bondholders for all open years,
- determine interest due for all future years, AND
- keep information by interest payment dates.

Information can usually be found in the debt service schedule in the official statement or bond transcript.

Calculate the tax rate:

- use highest individual rate,
- use a set 28 percent rate,
- use 50/50 blend of all the highest individual rates (28, 31, 36, and 39.6 percents) with highest corporate rate (35 percent) which equals 34.33percent,
- choose one of the above rates or select a similar alternative, OR
- consult with District Counsel and headquarters to determine rate to use.

Calculate total taxpayer exposure:

- for all open years, multiply the bondholder's interest by the chosen tax rate;
- for all future years:
  - (1) multiply the bondholder's interest by the chosen tax rate,
  - (2) then using a present value basis, discount this amount using the
    - (a) bond yield as the discount rate, OR
    - (b) Applicable Federal Rate (AFR) as the discount rate;
- total the above amounts for all years.

Also consider any penalties and interest.

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*Continued on next page*

## The Closing Agreement Process, Continued

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**Illustration** Calculation of closing agreement amount based on taxpayer exposure — See **Figure O-1**.

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**Arbitrage Profits** Calculate the closing agreement amount based on the amount of arbitrage profits rebatable to the United States under IRC section 148(f).

Also consider any penalties and interest.

If taxpayer can correct non-payment of rebate by meeting the requirements of IRC section 148(f)(7), penalty in lieu of loss of tax exemption, then the issuer will be treated as if it had made a full, timely payment.

**Keep in mind** — there may be more than one issue involved. If taxpayer exposure exceeds the amount of rebate due, than an amount greater than the amount described in IRC section 148 (f)(7) may be required to enter into a C/A.

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**Other Basis** Besides the two alternatives above, other closing agreement amounts can be calculated based on the specific circumstances of each bond case. These other situations should be discussed with the District Counsel bond liaison and headquarters.

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**Standard C/A, Consent to Disclosure and Issuer Letter in the Proposed Exam Guidelines for Municipal Financing Arrangements** **IRM Exhibit 7.6.2.5-3 Model Closing Agreement and IRM Exhibit 7.6.2.5-4 Consent to Disclose Tax Information, Examination Guidelines for Municipal Financing Agreements** contain model closing agreement language and sample consent to disclose tax information.

In order to maintain a uniform approach to the C/A program, these two exhibits **must be used**. Any deviation should be discussed with headquarters before undertaking any changes.

Prepare both the C/A and disclosure consent with the specific case information.

Prepare closing agreement proposal letter to the issuer.

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*Continued on next page*

## The Closing Agreement Process, Continued

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### Headquarters Concurrence

Headquarters receives the package containing:

- memo,
- C/A,
- consent to disclose,
- issuer letter proposing the C/A, AND
- proposed closing agreement amount within a given range.

After obtaining Headquarters concurrence, the agent:

- may have to make specific changes,
- can contact the issuer and begin negotiations,
- should take into account relevant facts that would influence the amount acceptable in a C/A, AND
- will have a closing agreement amount range to be used when negotiating.

---

### Letter to the Issuer

- Letter is sent to the issuer
- Form 886-A is also sent with the:
  - facts,
  - law, AND
  - analysis.

Letter states that the preliminary determination is that the bonds do not meet the requirements of the IRC. It also states that there is the possibility of a C/A. The issuer is given 30 days to communicate their decision to the agent.

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*Continued on next page*

## The Closing Agreement Process, Continued

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### Negotiations and Signing

The Key District is responsible for the negotiations and signing of the C/A, for any case it has under examination.

- Issuer **must** be a party to the negotiations and signing.
- Any other party may also participate in the negotiations and signing, with proper disclosure consents.
  - Form 8821 can be obtained from the issuer
  - Form 8821 can also be obtained from the other participants — if their records are part of the negotiations. **See Chief Counsel's "Disclosure Guide for Tax-Exempt Bond Examinations."**
- If the agreed amount is within the range agreed upon between the district and Headquarters, the C/A can be finalized and signed by the issuer.
- Issuer **must** also sign the **separate** consent to disclose.

This is not a valid C/A until signed by the Commissioner's representative.

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### Example

You have gotten approval from headquarters to start negotiations on the C/A. You have calculated the closing agreement amount to be \$100,000. Due to certain hazards in the case, both the district and Headquarters agreed that an appropriate range is between \$90,000-\$100,000.

Along with you at the meeting are your group manager, the issuer, bond counsel and the conduit borrower. Bond counsel has a power of attorney from the issuer and the conduit borrower. In addition, you had earlier secured a Form 8821 from the issuer allowing the conduit borrower to answer questions and provide records to you during the examination. The conduit borrower's records that are not normally open to the issuer were used to document the issue at hand. You now have secured a Form 8821 from the conduit borrower allowing those records to be presented to the issuer during the negotiations.

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*Continued on next page*

## The Closing Agreement Process, Continued

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### Example (continued)

The meeting discussed the issue and what caused the bonds to violate the IRC. This was shown by using the conduit borrower's records. The issuer, conduit borrower, and bond counsel agreed that there was a problem and offered a closing agreement amount of \$50,000. You explained that this was unacceptable and your only option was to send the case in for technical advice and request the bondholder's names. You informed those present that if you are upheld in the technical advice, your only option is to tax the bondholders.

Since the parties already agreed to your issue, they then came up with their own calculations and determine that the total should only be \$94,500. After discussion with your manager it is decided to accept this offer, since it is within the agreed-upon range.

The issuer signs the C/A and the consent to disclose.

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### Payment

Payment **must** be secured or the agreement is null and void.

In accordance with the Proposed Exam Guidelines, payment is to be made at the time the agreement is signed.

Local procedures **must** be taken into account here.

Payment **must** be in **full**.

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### C/A Processing

The next step is to have the Commissioner's representative sign the C/A for the IRS. These procedures are dictated by local operating procedures. **Check local procedures** for this process.

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### Case Study

Discuss the steps in the closing agreement process as they apply to the case study.

Use your computer to compute the closing agreement based on taxpayer exposure.

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*Continued on next page*



**Figure O-1: Calculation of Closing Agreement Amount — Based on Taxpayer Exposure**

| 1       | 2         | 3     | 4        | 5          | 6          | 7             | 8              | 9                 | 10         |
|---------|-----------|-------|----------|------------|------------|---------------|----------------|-------------------|------------|
| Date    | Principal | Rate  | Interest | Ind. Rate* | Corp. Rate | Blend Rate ** | Tax Blend Rate | 7.64 *** Discount | Total      |
| 11/1/95 | 1,700,000 | 5.50% | 46,750   | 33.65      | 35.00%     | 34.33%        | 16,046.94      |                   | 16,046.94  |
| 5/1/95  | 1,700,000 | 5.50% | 46,750   | 33.65      | 35.00%     | 34.33%        | 16,046.94      |                   | 16,046.94  |
| 11/1/96 | 1,700,000 | 5.50% | 46,750   | 33.65      | 35.00%     | 34.33%        | 16,046.94      |                   | 16,046.94  |
| 5/1/97  | 1,700,000 | 5.50% | 46,750   | 33.65      | 35.00%     | 34.33%        | 16,046.94      | 0.863             | 13,848.51  |
| 11/1/97 | 1,700,000 | 5.50% | 46,750   | 33.65      | 35.00%     | 34.33%        | 16,046.94      | 0.863             | 13,848.51  |
| 5/1/98  | 1,700,000 | 5.50% | 46,750   | 33.65      | 35.00%     | 34.33%        | 16,046.94      | 0.802             | 12,869.64  |
| 11/1/98 | 1,700,000 | 5.50% | 46,750   | 33.65      | 35.00%     | 34.33%        | 16,046.94      | 0.802             | 12,869.64  |
| 5/1/99  | 1,700,000 | 5.50% | 46,750   | 33.65      | 35.00%     | 34.33%        | 16,046.94      | 0.745             | 11,954.97  |
| 11/1/99 | 1,700,000 | 5.50% | 46,750   | 33.65      | 35.00%     | 34.33%        | 16,046.94      | 0.745             | 11,954.97  |
| 5/1/00  | 1,700,000 | 5.50% | 46,750   | 33.65      | 35.00%     | 34.33%        | 16,046.94      | 0.692             | 11,104.48  |
| 11/1/00 | 1,700,000 | 5.50% | 46,750   | 33.65      | 35.00%     | 34.33%        | 16,046.94      | 0.692             | 11,104.48  |
| 5/1/01  | 1,700,000 | 5.50% | 46,750   | 33.65      | 35.00%     | 34.33%        | 16,046.94      | 0.643             | 10,318.18  |
| 11/1/01 | 1,700,000 | 5.50% | 46,750   | 33.65      | 35.00%     | 34.33%        | 16,046.94      | 0.643             | 10,318.18  |
| 5/1/02  | 1,700,000 | 5.50% | 46,750   | 33.65      | 35.00%     | 34.33%        | 16,046.94      | 0.597             | 9,580.02   |
| 11/1/02 | 1,700,000 | 5.50% | 46,750   | 33.65      | 35.00%     | 34.33%        | 16,046.94      | 0.597             | 9,580.02   |
| 5/1/03  | 1,700,000 | 5.50% | 46,750   | 33.65      | 35.00%     | 34.33%        | 16,046.94      | 0.555             | 8,906.05   |
| 11/1/03 | 1,700,000 | 5.50% | 46,750   | 33.65      | 35.00%     | 34.33%        | 16,046.94      | 0.555             | 8,906.05   |
|         |           |       | 794,750  |            |            |               | 272,797.98     |                   | 205,304.52 |

\* Individual tax rate was calculated using equal weighted average of 28%, 31%, 36% and 39.6% tax brackets.

\*\* Blend rate is average of individual rate and corporate rate. (50/50)

\*\*\* Yield

Column 1 — Debt service payment dates  
 Column 2 — Outstanding principal at debt service dates  
 Column 3 — Coupon interest rate  
 Column 4 — Interest payment (Col. 2 × Col. 3)  
 Column 5 — Blend of individual tax rates (see \*)

Column 6 — Corporate tax rate  
 Column 7 — Blend of corporate and individual rates (see \*\*)  
 Column 8 — Tax based on interest paid (Col. 4 × Col. 7)  
 Column 9 — Present value using bond yield as discount rate and time from payment date  
 Column 10 — Tax amount (Col. 8 × Col. 9)



## Section 5

### Securing Bondholders' Names

#### Overview

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**Purpose** This section discusses the purpose and procedures for:

- securing bondholders' names, AND
- issuing a John Doe Summons

---

**Objectives** At the end of this lesson the student will be able to:

- Identify the proper steps that should be taken to secure bondholders' names.
- Prepare and obtain approval for a John Doe Summons

---

**In This Section** This section contains the following topics:

| <b>Topic</b>                | <b>See Page</b> |
|-----------------------------|-----------------|
| Overview                    | O-62            |
| Introduction                | O-63            |
| John Doe Summons Procedures | O-64            |

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# Introduction

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|  |   |
|--|---|
| <b>Purpose</b>   | <p>Bondholders' names are secured for the purpose of taxing the bondholders.</p> <p>Securing bondholders' names can be a long process. Therefore, the names may be requested long before taxing the bondholders is to be attempted.</p>   |
| <b>Steps in Exam Guidelines for Municipal Financing Arrangements</b> | <p>IRM 7.6.2.5.5.8 Examination Guidelines for Municipal Financing Arrangements, outlines the steps and the letter to be used:</p> <ul style="list-style-type: none"><li>• Make formal request of issuer</li><li>• Prepare letter requesting bondholders' names</li><li>• Make request of trustee, if issuer does not timely provide the names</li><li>• Summons the bondholders' names, possibly using a John Doe Summons</li></ul>                   |
| <b>When to Begin?</b>  | <p>Obtaining bondholders' names can take considerable time. The agent may begin as soon as a preliminary determination has been reached and both district counsel and headquarters concurs with the agent's determination.</p> <p>Start the process:</p> <ul style="list-style-type: none"><li>• When technical advice is being sought</li><li>• Possibly when discussing a closing agreement</li><li>• When appeals review is being sought</li></ul> |
| <b>Exercise</b>  | <p>You have just asked the issuer for a list of all the bondholder's names.</p> <ul style="list-style-type: none"><li>• What problems will you run into?</li><li>• What concerns will the issuer have?</li><li>• How long will this all take?</li></ul>   |

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# John Doe Summons Procedures

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|                          |  |
|--------------------------|--|
| <b>Purpose</b>           | A John Doe summons is necessary when securing information, such as bondholders' names, in regard to unnamed parties.   |
| <b>District Counsel</b>  | <p>District Counsel <b>must</b> be involved in all John Doe summons procedures. District Counsel involvement begins when it is first determined that a John Doe summons is needed and, ends with either enforcement or a decision is made to cease summons activity.</p> <p>District Counsel will guide the agent through the necessary steps required in the procedure.</p> |
| <b>Forms Preparation</b> | <p>The forms that are prepared by the agent:</p> <ul style="list-style-type: none"><li>• Form 2039, <i>IRS Summons</i></li><li>• Possible attachment to summons, if all information required on summons does not fit on Form 2039</li><li>• Affidavit of agent</li></ul>   |
| <b>Illustration</b>      | Form 2039 and agent's affidavit — <b>See Exhibit O-7.</b>  |

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# Section 6

## Defaulted Bond

### Overview

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**Purpose** This section discusses causes for default and procedures to deal with a defaulted bond.

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**Objectives** At the end of this lesson, the student will be able to:

1. Identify the causes of default.
2. Apply appropriate procedures to deal with a defaulted bond.

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**In This Section** This section contains the following topics:

| Topic        | See Page |
|--------------|----------|
| Overview     | O-65     |
| Introduction | O-66     |

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# Introduction

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## What Causes Default?

The bond indenture has written language describing what circumstances will cause the bonds to go into default. Some examples of default:

- Ratio of debt to equity is exceeded
  - Total amount of debt is exceeded
  - Non-payment of certain expenses
  - Non-payment of debt service
- 

## Default Procedures

Agent should determine the cause of default and its effect on the bonds under examination.

- If issuer is still paying debt service on bond and there is no change in the activities in regard to the bond (other than oversight by a consultant etc.), exam is treated no different.
- If default causes debt service to be reduced or discontinued, bond may require redemption.

**Note:** If debt service is discontinued to bondholder there would be no tax due since no interest was paid to the them. This should be taken into account when determining which bonds to examine.

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## Problems with Defaulted Bonds

The biggest problem an agent runs into with defaulted bonds is the lack of cooperation from the issuer, trustee, conduit borrower or bond counsel. Some or all of these parties are to blame for the default and will be concerned about their liability to the bondholders. This can delay responses to requests for information/documents and the shifting of responsibility among these parties.

An agent should be aware of these potential problems before opening a defaulted bond case. However, a bond in default may not be known going into a case and can only be found out after the case is opened

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*Continued on next page*

## Introduction, Continued

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**Example**

The issuer has taken on more debt than the bond indenture allows. The issuer has not gotten behind in any debt service payment. The bondholders have been paid on time for interest and any principal payments that were due. But due to the higher than allowed debt the bonds are technically in default. The remedy put forth by the trustee is to have an independent consultant oversee the operations of the issuer. The consultant will remain in this capacity until the debt is reduced to an acceptable level and then for six months beyond reaching this level.

As far as the agent is concerned there is no effect on the bond examination. As long as the issuer is in compliance with the IRC (arbitrage, rebate, etc.), the fact that they are in default does not change the examination.

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## Summary

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### **Review of Module O**

Module O discussed audit techniques relative to bond examinations. Although they are similar to examinations of exempt organizations, there are some significant differences, such as:

- you may need to contact other parties in order to get necessary records,
- because of the contact with other parties, you will need to be much more conscious of disclosure concerns,
- resolution of issues requires contact with National Office personnel and District Counsel, AND
- you may need to issue a summons to obtain some records from third parties.

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### **Preview of Tax- Exempt Bonds, Phase II**

Tax-Exempt Bonds, Phase II continues our study of the federal taxation of municipal bonds by focusing on more complex technical areas. Some of the topics included in Phase II are:

- Computing the yield on bonds with unusual features,
- Valuing and computing the yield on investments,
- Applying the general allocation and accounting rules,
- Understanding advance refundings,
- Understanding pooled financings,
- Applying the appropriate regulations to an issue, and
- Determining if a bond has been reissued.

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END OF MODULE O

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