

July 7, 2006

IRS LAUNCHES TAX-EXEMPT BOND AUDIT INITIATIVE

AT A GLANCE

The Issue:

The Internal Revenue Service's (IRS) Office of Tax-Exempt Bonds is preparing to launch an audit initiative focusing on compliance with requirements that must be met when a 501(c)(3) organization is a borrower under a tax-exempt bond financing. Approximately two-thirds of the audits are expected to target hospitals and other health care facilities. IRS officials have stated that organizations that have borrowed funds using tax-exempt bonds should strongly consider conducting internal compliance checks in advance of this audit initiative. **Organizations that voluntarily come forward to resolve compliance problems typically are treated much more favorably by the IRS than organizations where non-compliance is discovered by the IRS in the audit process.** Since audit letters will be sent out as early as August, it is crucial that organizations that may be affected by this initiative conduct compliance checks as soon as possible.

Our Take:

This is another in the series of questionnaires, examinations and audits of tax-exempt entities that the IRS is conducting, and hospitals again will comprise the majority of those targeted. In this case, hospitals can be proactive by conducting their own internal compliance checks to determine whether there are problems and take steps to resolve them before the IRS audit begins.

What You Can Do:

Please review this advisory and share it with your senior management and legal counsel to determine whether you could be the target of this IRS audit and, if so, whether you should conduct an internal compliance check.

Further Questions:

If you have questions, please contact Melinda Hatton, vice president and chief Washington counsel, at mhatton@aha.org or (202) 626-2336, or Maureen Mudron, Washington counsel, at mmudron@aha.org or (202) 626-2301.

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BACKGROUND

Under Section 145 of the Internal Revenue Code, 501(c)(3) organizations are eligible to use tax-exempt bond financing to finance facilities to be used to further the organization's tax-exempt purpose. In order for the interest on such bonds to remain exempt from federal income taxation, the borrower must comply with a number of requirements, including restrictions on earning arbitrage profits on the bond proceeds prior to expenditure and limitations on the amount of "private-business use" of the financed facilities, including use by the 501(c)(3) organization in an unrelated trade or business. These requirements generally are applicable throughout the period during which the bonds are outstanding, and failure to meet them could result in the interest on the bonds becoming taxable on a retroactive basis. Therefore ongoing compliance monitoring is essential.

Qualified 501(c)(3) bonds are issued by state or local government issuers, with the proceeds loaned by the governmental issuer to the 501(c)(3) borrower. If the Internal Revenue Service (IRS) determines that there is a violation of the tax law requirements, it typically will attempt to negotiate a closing agreement with the issuer to preserve the tax-exempt status of the bonds. This agreement usually is conditioned upon a settlement payment to the IRS. The settlement amount often is based on the taxes the bondholders would have paid if the interest were taxable (subject to applicable statutes of limitations). If a closing agreement cannot be reached, the IRS may elect to tax the actual bondholders.

AT ISSUE

The IRS audit initiative will be aimed at determining the levels of post-issuance non-compliance by 501(c)(3) borrowers in tax-exempt bond financings. The first phase of the initiative will focus on qualified 501(c)(3) bonds issued in 1997 and 1998. The primary area of focus will be potential non-qualifying private use of bond-financed facilities, which will include examinations of:

- Sales of facilities or equipment;
- Leases;
- Management contracts;
- Food service contracts;
- Parking service contracts;
- Research contracts;
- Naming rights contracts; and
- Employee contracts, including physician contracts.

Since use of bond-financed facilities in an unrelated trade or business of a 501(c)(3) borrower is treated as a non-qualifying use under the tax-exempt bond rules, these audits also will involve determining whether any of the borrower's activities should be treated as unrelated trades or businesses. In addition, private-use issues will be examined, possibly leading to questions regarding private inurement and private benefit, which ultimately could result in an examination of whether the borrower should continue to qualify as a 501(c)(3) organization. Examination of the unrelated-business income tax, private inurement and private benefit issues may involve coordination between the Office of Tax-Exempt Bonds and the Exempt Organizations division of the IRS.

In addition, the IRS will examine the investment of bond proceeds prior to expenditure in order to determine compliance with the applicable arbitrage and rebate provisions.

NEXT STEPS

IRS officials suggested that 501(c)(3) organizations with outstanding tax-exempt bonds should consider performing compliance self-assessments. If an organization is found to be non-compliant, it may be possible for the borrower to self-correct the problem or approach the IRS about entering into a voluntary closing agreement to settle the issue (usually involving a payment to the IRS). IRS officials stated that a borrower is generally treated much more favorably by the agency in setting the terms of any settlement if the borrower has voluntarily approached the IRS to resolve a noncompliance issue, rather than waiting until the noncompliance is discovered by the IRS in the course of an audit. Since the IRS will send out audit letters as early as August, it is important that hospitals begin performing compliance checks as soon as possible.