

# THE BOND BUYER

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## IRS: New Forms Will Bring Audits Plans to Check Some Bond Issues Used by Nonprofits

BY LYNN HUME

WASHINGTON — The Internal Revenue Service plans to audit certain bond issues used by nonprofit organizations based on reviews of the bond-related information they file with the agency, IRS officials and tax lawyers said.

Cliff Gannett, the IRS' acting director of government entities, and Steve Chamberlin, manager of compliance and program management for the tax-exempt bond office, spoke at recent conferences about the planned reviews of the Form 990, Schedule Ks.

Hospitals, universities, museums, charities and other nonprofits must file these forms with the IRS every year if they financed projects with 501(c)(3) bonds sold by governmental issuers after 2002 and the bonds are still outstanding.

The disclosure of the IRS audit plans for these bonds has led lawyers to warn nonprofits that they must be careful to provide accurate information on their Schedule Ks and be ready to defend it.

"The nonprofit sector needs to be aware that their Schedule K reporting information will now be subject to audits and they need to properly and accurately complete their forms and be able to defend all of the information therein," said Ed Oswald, a partner at

Orrick, Herrington & Sutcliffe here and a former Treasury Department official.

"The nature of some of the questions require a significant level of tax expertise and borrowers may need to rely on outside professionals."

Gannett talked about the Schedule K reviews this week at The Bond Buyer's second annual 501(c)(3) conference for health care, higher education and nonprofit institutions. Chamberlin discussed them at the National Association of Bond Lawyers' Bond Attorneys' Workshop last week in San Antonio.

"During the fiscal year we're going to be dedicating more staff resources to Schedule Ks than in past years," Chamberlin explained Tuesday. "If we see things that raise questions or cause concerns, then we'll look at that and see if we want to go out and get more information, which may result in targeted audits."

Gannett said the effort will be "a plus for both the IRS and charities [because] we're better using our resources and we'll lessen the burdens on those that are continuing to monitor their post-issuance compliance and are complying with tax law requirements."

"We think that now we'll be able to better target issues" for audit, he said.



*"The questions require a significant level of tax expertise," says Ed Oswald of Orrick Herrington.*

Gannett said the IRS already has about 25 to 30 audits of 501(c)(3) bonds underway, but that none of these stemmed from the information provided on the Schedule Ks.

The IRS developed its Form 990 Schedule K to obtain more information on bonds used by nonprofits. For the 2008 tax year, the IRS required organizations that financed projects with more than \$100,000 of bonds through

conduit deals to fill out Part I of the Schedule K by listing any bonds issued after 2002 that were still outstanding.

But the IRS gave nonprofits until the 2009 tax year to fill out the parts II-IV of Schedule K, which ask about the use of proceeds, the amount of private business use, and arbitrage issues, including whether the issuer entered into a qualified hedge with respect to the bonds or invested the proceeds in a guaranteed investment contract.

The IRS added a Part V in the 2010 Schedule K so that borrowers can explain their responses or provide supplemental information.

Under the federal tax code, nonprofits can only finance projects with tax-exempt bonds if 95% of the bond proceeds are used for their charitable purposes and related non-private purposes.

Both Oswald and Mike Solet, a partner at Mintz, Levin, Cohn, Ferris, Glovsky and Popeo PC in Boston, said the questions in Part III on Schedule K, which ask about the percentage of financed property used for private business or unrelated trade or business activities, are among the trickiest.

“They are math questions. You need a diamond cutter’s precision here,” said Oswald.

Solet said nonprofit borrowers may respond to those questions with high percentages that appear to raise red flags, but that don’t really pose compliance problems because the 95% private and unrelated business-use ceiling is calculated over the life of the bonds rather than in any given tax year.

A college, for example, could lease

space to a private entity for a very short period of time with the intention of reclaiming use of the space for itself afterward. In one tax year, its business use might be high, but it would not be high over the life of the bonds, Solet said.

Another example, he said, is if a nonprofit’s facility was managed by a private company under a very short-term contract for a fixed payment.

If the management contract were of a short enough duration and the payment scheme was fixed in a certain way, it might not be treated as private use under a safe harbor provided in IRS guidance, he said.

In each case, the nonprofit borrower might want to explain the situation in Part V on the form, Solet said. ■



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