

C. TAX EXEMPT BONDS COMPLIANCE INITIATIVE: QUALIFIED SMALL ISSUE BONDS

by
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1. Introduction

Tax Exempt Bonds has conducted a qualified small issue bond examination compliance initiative. This article summarizes its results.

2. Objective of Initiative

The initiative was designed to accomplish two goals. The first was to measure the level of compliance of a statistical sampling of qualified small issue bonds with the applicable provisions of the Internal Revenue Code. The second was to determine whether the interest paid on the bonds continues to be excludable from gross income of the respective bondholders thereof under I.R.C. § 103.

The examinations also measured whether recipients properly used bond proceeds as well as whether there were violations of the \$10 million or \$40 million capital expenditure limitations under I.R.C. §§ 144(a)(4) and (10)(A) respectively. In addition, the examinations also determined whether users of bond proceeds were in compliance with other Income Tax Provisions such as depreciation allowance under I.R.C. § 268(g)(5).

3. Initiative Design

A statistical sampling of Forms 8038 of qualified small issue bonds filed in 1991 and 1992 identified one hundred six returns for examination. Of these, two were excluded, leaving a final sampling of one hundred four cases. Qualified small issue bonds with an issue price of less than \$1,000,000 were excluded from the sampling.

For purposes of this study, a qualified small issue bond is one defined in I.R.C. § 144(a). That is, any bond issued as part of an issue the aggregate authorized face amount of which is \$1,000,000 or less and 95% or more of the net proceeds of which are to be used:

- (A) for the acquisition, construction, reconstruction or improvement of land or property of a character subject to the allowance for depreciation, or
- (B) to redeem part or all of a prior issue which was issued for purposes described in (A) above.

At the election of the Issuer, \$10,000,000 can be substituted for the \$1,000,000 limit.

Field examinations were conducted of the returns sampled and the results were recorded on a checksheet. Headquarters personnel provided telephone assistance, technical assistance and technical advice support when necessary.

The following represents the number of issues selected in the statistical sample by issue price:

Greater than 999,999 and less than 2,000,000	28
Greater than 1,999,999 and less than 3,000,000	18
Greater than 2,999,999 and less than 4,000,000	16
Greater than 3,999,999 and less than 5,000,000	15
Greater than 4,999,999 and less than 6,000,000	6
Greater than 5,999,999 and less than 7,000,000	7
Greater than 6,999,999 and less than 8,000,000	4
Greater than 7,999,999 and less than 9,000,000	2
Greater than 8,999,999 and less than 10,000,000	3
Greater than 9,999,999	5

There were seventy-seven returns of less than \$5,000,000 selected which represented 74.0% of the total sample. Sixty-one of the returns selected were refunding bonds.

The total dollar value or issue price of the bonds selected was \$407,128,935.

4. Initiative Results

Eighty of the examinations, or 76.9%, resulted in no change. Twenty-four of the examinations, 23.1%, resulted in some type of change. Of the twenty-four change cases, there were four cases in which technical advice was requested regarding whether bonds are taxable. In addition, one examination where a proposed adverse determination and an adverse technical advice had been issued was forwarded to Appeals. For purposes of this analysis, these are considered change cases.

The twenty-four change cases are broken down as follows:

Closing Agreements	12
Bonds declared taxable	1
Changes to other returns	11

The changes to other returns are discrepancy adjustments made to the returns of conduit borrowers for depreciation allowance. One examination where the bonds were declared

taxable resulted in a closing agreement in Examination Division with regard to the taxability of a bondholder. The issues involved in the closing agreements included:

Activity conducted is not manufacturing;
The 2% issuance cost limitation was exceeded;
The \$10 million cap was exceeded; and
The \$40 million cap was exceeded.

While returns of less than \$5,000,000 represented 74.0%, they also represented 79.2% of the change cases. Nineteen of the change cases were returns of less than \$5,000,000.

As previously mentioned, sixty-one of the cases identified in the sample were refunding cases. Of these, fifty-four resulted in no change. These represented 68% of the no change cases.

In contrast, forty-three of the examinations were of new issues. Seventeen of these, or 39.5%, resulted in an examination change.

5. Conclusions

The high degree of noncompliance suggests that qualified small issue bonds continue to be an area of emphasis in the Tax Exempt Bonds annual workplan. Correspondingly, the qualified small issue bonds market segment was incorporated as a priority item into both the FY 2000 and 2001 workplans.