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IRS Interest in Advance Refundings Grows

By Kevin B. Scott

The IRS recently sent out a questionnaire (Form 14246) to 269 issuers of tax-exempt bonds requesting information on advance refundings that took place between July 1, 2009 and June 30, 2010. Hopefully you are not among the recipients of the questionnaire.

An advance refunding occurs when an issuer refunds bonds prior to their first call date, before the bonds are currently refundable. The issuer typically issues tax-exempt bonds and deposits the proceeds in an escrow account, from which the debt service on the refunded bonds is paid until the first call date, at which time the bonds are refunded with the amount remaining in the escrow fund.

Advance refundings have been out of favor lately because issuers have not been able to earn sufficient interest on the escrow investments to make the refunding economical. In certain interest rate climates, however, advance refundings can be very attractive. Advance refundings are technically difficult from a tax compliance standpoint, and it is no wonder the IRS is interested in them, although the timing is curious given the lower than normal activity.

Perhaps more important than the substantive inquiry into the technicalities of an advance refunding is how the questionnaire evidences the IRS' continued scrutiny of the tax-exempt market generally. Clearly, the IRS is interested in how some of the decisions related to tax-exempt bonds are made. One suspects that the IRS is concerned that some issuers may not have the resources to independently evaluate strategies relating to advance refundings, variable rate debt, interest rate swaps and investment contracts and, as such, are at the mercy of market participants who have a clear interest in seeing a transaction take place. As the marketplace has become more complex over the past decade, this issue has become increasingly important.

It seems the IRS believes at least part of the solution rests with "written procedures." In fact, the term "written procedures" is used 12 times in this short questionnaire. Record keeping also appears prominently in the document. In this sense, the questionnaire is consistent with the questions asked by the IRS in Schedule K to Form 990, which was recently introduced. The IRS has a growing interest in whether issuers have procedures in place to monitor post-issuance compliance with the requirements of tax-exempt bonds. The IRS must realize that, while issuers may have sufficient professional assistance during the issuance of the bonds, there is a risk that no one is minding the store once the closing occurs and the transaction bible is placed on the shelf.

While efforts like this questionnaire and Schedule K to Form 990 evidence the IRS' continued scrutiny of the tax-exempt market, they also provide valuable insight that can benefit mindful issuers and beneficiaries of tax-exempt debt.

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