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Federal Tax Record Retention Guidelines for Tax-Exempt Single-Family Mortgage Revenue Bonds/Programs

The Internal Revenue Code of 1986 (the "Code") requires that every governmental entity that issues tax-exempt single-family mortgage revenue bonds (MRBs) must retain certain records for federal tax purposes. If the Internal Revenue Service audits a bond issue it will normally request that certain records be provided to it and may ask for backup documents. The following is a summary of the various tax rules with respect to record retention, based on the type or source of those records. In addition, the following summarizes the rules applicable to how records can be maintained, for how long they should be maintained, and whether the bond issuer can utilize third parties to maintain records. It should be noted that the IRS has recently added thousands of audit agents to its enforcement personnel. Therefore, it is difficult to predict how this new generation of enforcers will apply new audit techniques and the need for taxpayer disclosure of backup materials.

Bond Issuance Documents
Basic records of the bond issuance transaction should be retained. Most, if not all, should be in the bond closing transcript/bound volume. These would include:

- the authorizing bond resolution
- the trust indenture/general resolution
- the official statement
- closing certificate directions
- tax/arbitrage certificate and appendices (which should include yield calculations), proof of TEFRA notice and hearing and governor's (or other official's) approval
- any yield verification, and
- bond and tax counsel opinions.

Bond-Related Operating Information
Records relating to the administration of the bond issue need to be retained. These include:

- documents evidencing the expenditure of the bond proceeds
- documents pertaining to the investments of bond proceeds (including the purchase and sale of securities) and mortgage loan receipts
- yield calculations for the investments
- actual investment income received
- rebate calculations and proof of timely rebate payments, as well as IRS Form 8038-T, and
- documentation demonstrating compliance with the 42 months bond expenditure rule, and the 10-year anti-recycling (bond redemption) rule.

A popular request that is made by IRS agents who are auditing tax-exempt bonds is for the issuer to provide copies of arbitrage rebate calculations as well as the Form 8038-T submitted with rebate payments.

Program Documents

The forms of program documents should be retained, particularly the form of lender origination agreement and any mortgage purchase/program guide. In past audits the IRS has often reviewed the form of such documents to make sure that such documents contain the requisite tax code requirements for meeting the MRB program requirements. In addition, an issuer should retain documents evidencing that an amount at least equal to 20% of the bond proceeds (or such lesser amount as is permitted by the Code) was available for financing targeted area residences, and documents evidencing that the availability of such financing was published.

If an issuer received, from HUD and the Treasury Department, designations of "areas of chronic economic distress" or "ACEDs," those letter designations should be retained forever. ACEDs are a type of Targeted Area and as such are exceptions to various tax program rules. Most ACED designations were issued in the 1980s (although some are still being issued) and remain valid because the IRS has no present procedure to revoke such designations. The IRS could require that an issuer provide such designation letters in the case of an audit; anecdotal information is that HUD and the Treasury may not be able to locate its ACED letter files if an issuer requested copies.

Individual Mortgage-Related Documents

Certain documents with respect to each mortgage that is financed by a bond issue also need to be retained. These include:

- the Borrower Certificate (or comparable documents whereby the borrower certifies to facts required by the Code) and evidence supporting the Code certifications (e.g., income information, first-time homebuyer and purchase price evidence)
- the actual Note, but the mortgage/trust deed need not be retained, and
- documents evidencing that each mortgagor received proper notification of potential recapture in the event of early prepayment of the mortgage loan.

It is noted that IRS agents rarely ask for mortgage documentation. However, on such rare occasions an IRS agent will randomly pick a few mortgage loans and ask for the documentation that will prove compliance with the income limitation, the purchase price limitation, the principal residence requirement, and the three-year (first time homebuyer) requirement.

Method of Information Retention

Records may be retained in physical form. Records may also be retained through electronic storage systems. Such electronic storage systems must ensure an accurate and complete transfer of the hard copy records to the electronic storage system and contain a retrieval system that indexes, stores, retrieves and reproduces all transferred information. This system must include reasonable controls and quality assurances that (a) ensure the integrity, accuracy and reliability of the program, (b) prevent and detect the unauthorized creation of, addition to, alteration of, or deterioration of electronically stored records, (c) regular inspections and evaluations are conducted and (d) reproduced hard copies of electronically stored records exhibit a high degree of legibility and readability. The information in the system must be cross referenced with the issuer's records in a manner that provides an audit trail to

Housing Finance Agency Group

John Wagner
(402) 231-8811

Michelle Adams
(404) 222-4646

Adam Baird
(509) 343-4473

Jeffrey Blumenfeld
(215) 299-4317

Mitchell Bragin
(202) 828-8450

Larry Carlile
(303) 292-7783

Sisera Daniel
(202) 828-2327

Jim Hathaway
(501) 975-3137

Karilyn Kober
(402) 231-8770

Steve Likes
(402) 661-8648

Erika Lynch
(402) 231-8722

Fred Marienthal
(303) 292-7817

John McGill
(402) 231-8974

Drew Page
(402) 661-8631

Patti Peterson
(402) 231-8785

Leslie Powell
(404) 222-4639

Dawn Roth
(402) 231-8772

the source documents. The issuer must maintain and be able to provide to the IRS, upon request, within 10 days, a complete description of the records requested by the IRS and provide the IRS with the resources necessary to locate, retrieve, read and reproduce any electronically stored books and records. An electronic system may not be subject, in whole or in part, to any agreement that would limit the IRS's access to use of the system. In recent audits the IRS has requested that all requested documents be provided in electronic format.

Length of Records Retention

Records relating to a bond issue and the mortgages it has financed should be retained for a minimum of three years after all of the bonds have been fully paid off, and we recommend retention for at least four years as a safe harbor. With respect to refunding bonds, the tax status of the refunding issue depends upon the tax-exempt status of the bonds being refunded. As a result, not only must the material records of the refunded bonds (as described above for a bond issue) be retained, but all the above documents related to the refunded bonds should also be retained until the refunding bonds are fully paid, plus four years. However, there is one exception—because arbitrage compliance (including arbitrage rebate) is specific to each separate bond issue, once a bond issue has been completely paid off (e.g., via refunding), the arbitrage documentation that relates to that bond issue can be disposed of in three or four years. Such arbitrage information will not be relevant to the tax exemption of the refunding bonds.

Third Party Record Retention

The record retention requirements that are described above can be retained electronically by a third party. Third party electronic record retention system requirements are described above. The IRS permits an issuer to use a third party to retain records if the third party has a contractual requirement to do so with the issuer. For example, a trustee often retains bond payment and investment records for an issuer pursuant to the bond resolution/trust indenture. However, if the third party makes an error in retaining certain records, the issuer will bear responsibility and potential liability for the failure to retain the necessary records. So an issuer should make sure that the third party is an organization that is stable and will continue in existence, and the third party should contractually agree to return the records to the issuer if the third party determines to cease to exist.

If you have any questions, please contact one of the attorneys listed on the left in Kutak Rock's Housing Finance Agency Practice Group. You may also visit us at www.KutakRock.com.