

TAXING ISSUES

The Jones Hall Municipal Finance Tax Newsletter

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What's New in Washington – IRS Restructuring and Reform Act of 1998

After months of hearings in which witnesses behind screens testified about IRS audit abuses, the Internal Revenue Service Restructuring and Reform Act of 1998 (the "Act") was enacted. While the Act deals mostly with IRS audit procedures concerning individual taxpayers, it does contain one provision regarding tax-exempt bonds. The Act directs the IRS to modify its administrative procedures to permit an issuer to appeal to a senior officer in the IRS Office of Appeals an auditor's determination of taxability of the bonds. The intent of this provision is to provide an appeal to a presumably more experienced Appeals agent in the event an inexperienced IRS auditor makes a mistake.

It is unclear what benefits, if any, issuers will realize from this provision. In my capacity as a director on the Governing Board of the National Association of Bond Lawyers (NABL), I am serving on a committee which will submit comments to, and discuss this provision with, the IRS. As this project progresses I will keep you informed of its significance to tax-exempt bond issuers.

Currently, IRS audit procedures require examining agents to request guidance, when needed, in the form of a Technical Advice Memorandum (TAM) from the National Office of the IRS in Washington, DC. Agents are supposed to request a TAM when they are unsure about the correct application of the law as it relates to tax-exempt bonds. The most knowledgeable and experienced IRS personnel with expertise in tax-exempt finance are generally located in the IRS National Office. It is doubtful that Appeals officers outside the National Office will be as knowledgeable in tax-exempt finance matters as National Office personnel. However, an agent is not required to request a TAM if the agent believes that the law is clear, and, therefore, this appeal right may be useful in such cases.

This provision was enacted as a compromise to a proposal made by Senator Orrin Hatch which would have given issuers the right to challenge, in Tax Court, an IRS TAM declaring the bonds taxable. The "Hatch Bill" would also have given bondholders a right to intervene in the Tax Court litigation. Because of concerns by mutual funds holding tax-exempt bonds regarding the duties and liabilities attached to this right to intervene on behalf of bondholders in a Tax Court action, the Hatch Bill was dropped and this provision was enacted.

IRS Enforcement Program – Will My Bonds Be Audited?

During the past five years, the IRS has actively developed a nationwide program to audit tax-exempt obligations. Tax-exempt bond audits are handled by four IRS Key District offices located in Baltimore, Brooklyn, Dallas, and Los Angeles. Currently, 38 IRS agents, 28 of whom are full-time, are engaged in auditing tax-exempt bonds. According to the IRS, there are approximately 300 active tax-exempt bond audits under way at any given time. An IRS official has stated that, as of March, 1998, 195 tax-exempt bond audits had been completed of which 114 (or about 58 percent) resulted in no change and no payments being made to the IRS. The other 42 percent of audits closed with some type of payment or settlement being made between the issuers (or conduit borrowers) and the IRS. Note that not all of the bonds included in this 42 percent were found to have issues regarding taxability. According to the IRS, a large portion (probably 50 percent) of these issues involved minor problems such as improper accelerated depreciation being taken on assets financed with tax-exempt private activity bond proceeds (only straight-line depreciation is allowed). Apparently, problems (or perceived problems by the IRS) relating to tax-exemption were found in less than 21 percent of the bonds audited. Taking into account the complex tax rules applicable to tax-exempt bonds, issuers should be congratulated for their diligence in tax compliance.

Targeted Audits and Random Audits

Until recently, most IRS audits have targeted specific types of transactions. These targeted audits have included: (i) small issue private activity bonds (the \$10,000,000 limitation on issue size and capital expenditures), (ii) yield burning (overpayment for escrow securities and excessive broker fees on guaranteed investment contracts), (iii) back-loaded debt (“window” interest only refundings where debt service on the refunding bonds is paid in later years freeing up revenues in earlier years that is used to pay principal on the refunded bonds and avoid transferred proceeds), (iv) refunding escrow portfolio restructurings (“pre-natal” profits are made on trading the escrow securities during the period beginning on the date of the purchase agreement and ending on the date of delivery of the escrow securities), (v) reimbursement bonds (using bond proceeds to reimburse an issuer for previously paid expenditures), (vi) two percent costs of issuance limitations (costs of issuing private activity bonds paid with proceeds of the bonds may not exceed 2% of the proceeds of the bonds), and (vii) abusive 501(c)(3) nonprofit group transactions (e.g., a for-profit owner sells a nursing home facility to a dormant not-for-profit corporation at an inflated value).

The IRS has announced that, in addition to targeted audits, it will also begin a program of random audits. Bonds will be audited even if there is no reason to believe that there is anything amiss. The purpose of these random audits is to assure across-the-board compliance with tax rules on all types of tax-exempt financings. What should you do if your bond is audited? First, don’t panic. The odds of there being a significant problem with your bond are not very high (“cowboys” excepted). Second, contact your tax counsel for advice. And third, do not volunteer any more information than the IRS agent asks for. It appears that the IRS has an effective tax-exempt bond audit program so, as the sergeant on Hill Street Blues used to say “Lets be careful out there”.

QZABs Anyone?

The Taxpayer Relief Act of 1997, authorized a new type of municipal obligation called “qualified zone academy bonds” or “QZABs”. These obligations are intended to allow needy public schools to issue bonds without interest cost. Holders of QZABs receive a Federal income tax credit equal to 110 percent of the long-term applicable Federal rate (AFR) compounded annually for the month in which the QZABs are issued (the rate for August is 6.30 percent), multiplied by the outstanding principal amount of QZABs held. This tax credit is supposed to be sufficient to allow the QZABs to be issued at par without any interest coupon (the amount of the credit is also treated as taxable income to the holder). Only a bank, insurance company or corporation actively engaged in the business of lending money, is eligible for the credit and therefore the market for these bonds is limited to these entities.

QZABs may be used by a “qualified zone academy” to finance (i) rehabilitation or repairing of public school facilities (however, not new construction), (ii) equipment, (iii) development of course materials, and (iv) training teachers and other school personnel. A qualified zone academy is a public school (or program within a public school) below the postsecondary level supervised by an eligible local education agency (e.g., a school district) that (i) is designed in cooperation with business to enhance the academic curriculum, increase graduation and employment rates, and prepare students for college and the workforce, (ii) has the same academic curriculum as other schools in the district, (iii) has a comprehensive education plan approved by the district, and (iv) is located in an empowerment zone or enterprise community or it is reasonably expected that at least 35 percent of the students at the school will participate in the school lunch program under the National School Lunch Act. Generally, because empowerment zones and enterprise communities are relatively rare, most qualifying schools will meet the school lunch program requirement.

An additional requirement is that the school district have written commitments (as of the date of closing) from private entities to make qualified contributions with respect to the school equal to at least 10 percent of the proceeds of the bonds. Qualified contributions include (i) equipment, (ii) technical assistance in developing curriculum or training teachers, (iii) services of employees as

volunteer mentors, (iv) internships, field trips or other similar outside educational opportunities, and (v) any other property or service specified by the district.

Volume and Maturity Limits

QZABs are not tax-exempt obligations, and are authorized to be issued only in calendar years 1998 and 1999. The maturity of a QZAB is limited to the period equal to 50 percent of the present value (as of the date of issue) of the repayment obligation on the bonds discounted at 110 percent of the long-term AFR compounded semi-annually (this results in an 11 year maximum maturity based on the current applicable AFR). QZABs are subject to an annual national volume limitation of \$400,000,000 of which California is allocated \$56,360,000 for calendar year 1998. The California Department of Education allocates QZAB volume limitation to school districts within the State. To the best of my knowledge, no QZABs have yet been issued in California. Jones Hall is acting as bond counsel with respect to a number of QZAB transactions and it appears that there are financial institutions willing to buy these bonds. However, the credit rate may be too low for these bonds to be sold at par and therefore they may be sold at a discount (the credit quality of the issuer will also affect the sales price).

The New Private Activity Bond Regulations - Reimbursing Equity Contributions

Although the private activity bond regulations are not that new anymore (they were released in January, 1997), issues of particular importance to California issuers continue to come up in "real life" applications. One issue is the use of both bond proceeds and non-bond proceeds (equity) to finance a single piece of property or a single project. Payments allocated to the bonds, rather than the equity, will be treated as private payments and may cause the bonds to be private activity bonds. The regulations require that an official intent resolution be adopted in order to allocate payments received from the property to the equity, rather than to the bond proceeds. For example, assume that a city purchases a \$1,250,000 parcel of land using \$1,000,000 of bond proceeds and \$250,000 of general fund moneys. The city then sells the land to a private developer for \$250,000. In order to allocate the \$250,000 to the equity contribution and not to the bonds, the "equity allocation rule" must be met. Under this rule the issuer must (i) no later than 60 days after making the expenditure (e.g., purchasing the land) adopt an "official intent" resolution to reimburse the equity contribution (with proceeds of the expected land sale), and (ii) the private payment (i.e., the land sale proceeds) must occur no later than 18 months after the later of the date the expenditure is made (i.e., the land is purchased) or the date the project is placed in service (in the case of raw land, the date it is used for its intended use).

A simple way to comply with the equity allocation rule is to adopt an "official intent" resolution on or before the bond closing stating the intent to use payments with respect to the property to reimburse the equity. If the equity allocation rule is not complied with, any payments received with respect to the property are allocated between the bonds and the equity on the basis of the relative amount of funding provided by each (e.g., if the property was financed 60% with bonds, then 60% of the payments are allocated to the bonds). Such a pro-rata allocation of payments may cause the bonds to meet the private security or payment test and therefore be treated as private activity bonds.

A Final Thought - "The wages of sin are death, but by the time taxes are taken out, it's just sort of a tired feeling." Paula Poundstone.

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