Bond Case Briefs

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IRS Focuses on Tax Exempt Financings Involving Developers: Orrick

For a number of years, the IRS Office of Tax-Exempt Bonds ("TEB") has expressed concerns about potential tax abuses that may exist in what it has characterized as "developer-driven deals" involving the use of tax-exempt bonds. TEB has generally used this term to describe tax increment financings, assessment and special tax bonds, and PILOT (payment in lieu of tax) bonds, and has also used this nomenclature to challenge the tax exemption of certain financings issued by special governmental districts such as community development districts. While it is entirely appropriate for TEB to focus on topics and bond issues like these, TEB often sees abuses and technical problems where none exist. Based on audit activity in recent years, it appears that TEB has adopted an approach of identifying tax-exempt bond transactions with significant private developer involvement and advancing the view that interest on such bonds is taxable, even when those transactions meet all applicable tax requirements and also satisfy the public and tax policies behind those requirements. Simply stated, TEB seems to take the view that developers benefit too much from these transactions for the bonds to qualify for tax-exemption regardless of the supporting legal authority, clear and specific provisions of the Internal Revenue Code ("Code") and applicable Treasury Regulations notwithstanding.

State, city, county and other local governmental entities that issue municipal bonds, investors and market professionals are increasingly concerned about these attacks, often based on novel arguments by the IRS that are inconsistent with established tax law and traditional types of financing practices by municipal governments. An additional concern is that there seems to be confusion within TEB as to the different tax rules that apply to these financing structures. It is important for market participants to be aware of TEB's posture regarding these transactions, and we believe it is useful at this juncture to clearly set forth the federal tax law requirements that apply to these financings in order to bring clarity to the marketplace, governmental issuers, legal experts and even the regulators.

Basic Principles of Tax-Exempt Financing

Since the first federal income tax was enacted, interest on obligations of states and local governments has been excluded from tax. In the 1930s and 1940s, the Internal Revenue Service ("IRS") asserted that interest on assessment bonds issued by local governments did not qualify for this exemption because private property owners that were obligated to pay the assessments (and not the issuing municipalities) were the real obligors on the bonds. The courts uniformly rejected those early IRS attempts. See, e.g., *Commissioner v. Pontarelli*, 97 F.2d 793, 1938 (Acq.); *The Riverview State Bank v. Commissioner,* 1 T.C. 1147, 1943 (Acq.); *Independent Gravel Company v. Commission*, 56 T.C. 698, 1971; Rev. Rul. 56-159, 1956 C.B. 609.

In response to IRS' concerns that these judicial decisions unduly expanded the availability of tax-exempt bonds for private businesses, in 1968 and again in 1986 Congress revised the Code to provide specific limits on the tax-exemption for municipal bonds that finance facilities for private persons. But Congress recognized that tax-exempt municipal bonds should continue to be allowed as a tool to promote certain traditional economic development purposes. Thus, even if an issue of municipal bonds is used to solely to finance property that is to be owned and used by a private person, Congress has allowed the bonds to be tax-exempt so long as principal and interest on the bonds is not payable from or secured by property used by any private person. For example, Congress made clear that municipal bonds that are secured by and payable solely from generally applicable taxes are to be tax-exempt even if all bond proceeds are used to fund a grant to a private business to induce it to locate a new factory within the boundaries of the issuer.

Traditional Financing Structures for Economic Development

Fostering local economic development, usually real estate and infrastructure development or grants to assist local business development, is one of the oldest and most important uses of municipal bonds. It is an important and well-established function of state and local governments. In many jurisdictions, it is perhaps more important than ever before given the pressing needs for economic growth and infrastructure development. While many borrowing structures are used, most of the municipal bonds issued for these purposes are either some form of assessment bond or tax increment bond. For example, assessment bonds were authorized by statute as early as 1915. In Texas, special districts trace their roots back to 1917 and public improvement district bonds ("PIDs"), secured and payable from assessments, were authorized in 1987. Tax increment bond financings ("TIFs") are authorized by statute in 49 States. They began in California around 1950 and in Texas around 1989.

Assessment bonds, including PID bonds in Texas, are paid from assessments or special taxes (as opposed to general ad valorem property taxes) levied on parcels of land that benefit from the local infrastructure facilities financed by the bonds. For general federal income tax purposes, assessment bond proceeds are treated as being loaned to the property owner or owners who are obligated to pay the future assessments. Tax increment or TIF bonds are different as they are bonds payable from future incremental ad valorem property or sales taxes, including PILOTs. In many cases, the incremental tax payments are derived from a wide array of property owners or other taxpayers. However, in some cases, the incremental tax payments are attributable to a specific developer or business enterprise. Regardless of the source of the incremental tax payments, such tax payments are "taxes of general applicability," and the obligation to pay generally applicable taxes is fundamentally different than the obligation to repay a loan.

Quite different tax requirements apply to assessment bonds as compared to tax increment bonds. This is one area where there seems to be confusion within TEB.

Overview of Tax Requirements

Generally, except in the case of assessment bonds (and certain specified qualified private activity bonds), proceeds of tax-exempt bonds cannot be loaned to a private developer ("private loans"). Such private loans, with the exceptions noted below, violate the private loan bond restrictions in the Code. In addition, generally tax-exempt bonds cannot be issued if both (i) the assets financed by the proceeds are used by a private party ("private use") and (ii) the bonds are paid with, or secured by, payments or assets provided by a private party ("private payments"). As is true in many areas of the tax law, a number of exceptions and rules of special application result in specific definitions of private loans, private use and private payments.

Assessment Bonds

As noted above, for tax purposes, the proceeds of assessment bonds are treated as loaned to the assessed (for the most part, private) property owners. Section 141(c) of the Code sets forth a special exception to the private loan prohibition that allows the proceeds of assessment bonds to be loaned to private parties. This exception from taxable private loan status requires (i) an assessment regime to be established under state law, (ii) the requirements of that regime to be applied on an equal basis among assessed property owners and (iii) the bond proceeds to be used to finance "essential governmental function" (e.g., governmentally owned and publicly used) improvements. Bonds that meet these special requirements, relating to State and local governmental procedures and control, do not violate the private loan bond prohibition.

While assessment payments from business property owners, are deemed to be private payments, there is no private use of the bond financed assets as they are owned by local governments and used by the general public. Policy-wise, Congress has determined that this type of development financing is consistent with the general purposes of tax-exempt financing, even though it is often the real estate developer who is the initial beneficiary of the bond proceeds and uses the bond proceeds to pay for the infrastructure costs or is reimbursed with the bond proceeds for those costs. In other words, the tax rules essentially allow for private payments in this context, so long as the bonds finance public infrastructure, even though it is a private developer that uses the proceeds to pay, or get reimbursed for, its costs of providing the infrastructure.

Tax Increment Bonds

By comparison, tax increment financing, or TIF bonds have no special statutory rule relating to private loans, but also have no special limitation requiring bond proceeds to finance public infrastructure; i.e., the essential governmental function requirement discussed above does not apply to TIF bonds. Tax increment bonds qualify as tax-exempt because there is no creation of a private loan and because the bonds are not repaid from private payments or secured by privately-owned property. As the proceeds of tax increment bonds typically will be used by, or granted to, a private developer, these bonds avoid taxable private activity bond status by being secured and payable only from taxes of general applicability (ad valorem property taxes, general sales taxes, hotel occupancy taxes, etc.).

As is true for assessment bonds, long-standing principles and specific rules in the Treasury Regulations set forth the requirements for tax increment bonds to bear tax-exempt interest. These include rules dealing with the ability of a governmental entity to make grants of bond proceeds, rules for determining when bonds are secured by and payable from generally applicable taxes, including PILOTs, and a special rule relating to avoiding private loan status when a private party receiving a grant of bond proceeds is obligated to pay the generally applicable taxes that will repay the bonds. Given the long history of these types of financings and the regulatory effort put into framing how these transactions are compatible with tax-exempt financing, it is clear that these types of financings are an appropriate use of tax-exempt bonds. Yet TEB is proceeding against some of these transactions on a variety of theories that undermine or ignore the existing statute and regulations.

Are All TIF and Assessment Bonds Developer Driven?

In a number of recent bond audits, TEB is not applying the law to the facts in cases involving tax-exempt assessment bonds and tax increment bonds. Almost every real estate development transaction starts with an agreement, often called a "development agreement," between the developer and the local agency/issuer. The development agreement describes in some detail the facilities the developer is required to install or construct and how costs of those facilities will be paid or reimbursed to the developer. This is true in most assessment district transactions where, for example, the developer is obligated to construct specified infrastructure to accommodate future residential development. Similarly, in tax increment deals, the development agreement will specify the facilities (typically to be privately owned by the developer) that will be funded, in part, by the grant of the future tax increment. In both types of transactions, the development agreement will obligate the local agency/issuer to pay or reimburse the developer for all or a portion of the developer's costs either from future assessments or from future tax increment revenues. If bonds are issued instead, the specified assessments or tax increments will be used to pay debt service on the bonds. This is a standard and common type of tax-exempt financing transaction.

In at least one current audit, TEB has taken the position that where the developer had the right to receive future ad valorem property tax increment revenue as reimbursement for its infrastructure costs, the use of those revenues to pay debt service on tax increment bonds instead is to be treated as private payments. This position was taken by TEB despite the only source of debt service on the bonds being the future ad valorem property taxes. Apparently, TEB is of the view that a right by the developer to receive these tax payments which precedes the issuance of bonds, taints the property tax revenue stream and converts the generally applicable taxes into private payments when bonds are later issued. This TEB position has the potential to call into question the tax-exempt status of literally thousands of municipal bond transactions completed all over the country and to undermine a standard financing structure for tax increment bonds. Indeed, in many, if not most tax increment financings, the development agreement precedes the bond issuance, and specifies that the developer has the right to be reimbursed either from bond proceeds or from future tax increment payments.

Equally troubling is the TEB position being taken in an audit regarding the private loan financing test. The developer had been granted the right to receive future tax increment payments expected to be derived by a city from increases in ad valorem property taxes throughout a large redevelopment district. The city's grant was required to be allocated by the developer to the costs of its commercial project located within the redevelopment district. With the city's cooperation, approval and consent, a conduit issuer issued the tax increment bonds the proceeds of which were used by the developer for the specified purposes. The bonds were secured and payable only from the same future tax increment grant payments, the bond proceeds were paid to the developer, and the city retained the tax increment payments originally promised to the developer but not needed to repay the bonds (e.g., the excess debt service coverage). This is, in substance, the same as the city issuing the bonds. For reasons that are not at all clear, TEB has taken the position that the bond proceeds were treated as if loaned to the developer even though the developer has no payment obligation with respect to the bonds or right to any of the city retained tax increment payments.

Another recent example of TEB's antipathy towards developer driven tax-exempt bond deals is the well-publicized audits involving Florida Community Development Districts and the question of what constitutes a "political subdivision." In those cases, the IRS examined a type of assessment bond transaction where it did not like the perceived developer benefit. TEB's challenge, however, was one in which it stretched to find a problem and did so, contrary to century-old precedent regarding the definition of a "political subdivision." In connection with this enforcement matter, the IRS literally created a new definition of "political subdivision" and attempted to apply it retroactively to reach a negative conclusion as to the tax-exempt status of the bonds. While those audits were resolved on other grounds, and the IRS has more or less withdrawn this position regarding political subdivisions, the case again demonstrates the degree to which TEB will stretch or ignore existing law to reach, apparently, a pre-conceived result.

In yet another well-publicized example, TEB has concluded that bonds secured and payable from PILOTs issued to finance a public school are taxable. In that case, TEB again strained to conclude there was a private loan problem based on PILOTs to be made by a developer on an unrelated project. To be sure, the recent history of tax rules relating to PILOT transactions is complicated.

However, the bonds in question were issued under prior tax rules applicable to PILOTs and the bonds were structured to comply with those prior requirements as well as with the IRS analysis set forth in a pair of high profile private letter rulings applying those prior rules. TEB's analysis apparently ignores the tax law that was in place at the time the bonds were issued and that actually applies to the bonds. Those same TEB arguments would have applied equally to the transactions approved in the two favorable private letter rulings.

Conclusion

Tax-exempt bond financing for economic and infrastructure development is an important and regularly used tool for local governments throughout the country. It can be easy to characterize any individual transaction as providing some sort of benefit to a private developer; after all, a grant of bond proceeds (or a loan in the assessment bond context) is essentially a contribution or benefit provided by the local government to a commercial enterprise. However, that is true in virtually every such transaction, and, in fact, that is the point, to provide benefit to the private developer. Fostering economic development requires the government to provide incentives to private business interests. The tax law has developed, and Congress has expressly permitted, specific rules for when tax-exempt bond financing is allowed in this context. The examples described above, indicate a willingness by TEB to ignore State and local decision making, long standing municipal bond structures and existing law and to look for new ways to attack development and infrastructure transactions. This is an inappropriate and disruptive path for TEB to be pursuing.

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