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IRS Audits Spell Potential Trouble for Dozens of Jail Bond Deals in Border States.

The Internal Revenue Service is auditing dozens of tax-exempt bond-financed jails, particularly in border states, and suggesting in some cases that, if the jails hold significant amounts of federal inmates, the bonds are no longer tax-exempt and are instead taxable private-activity bonds, sources said Thursday.

Many of these jails were built by state or local governments with tax-exempt bonds or certificates of participation, primarily to hold state and local inmates. But when the jails have additional space or nearby federal facilities are full, the local governments take inmates from U.S. Citizenship and Immigration Service or the U.S. Marshals Service. The federal government typically pays more to house its inmates than state and local governments, the sources said.

Under the federal tax laws and rules that apply to private-activity bonds, state and local governments are considered to be governments but the federal government is a nongovernmental or private entity. Tax-exempt bonds are private-activity bonds if more than 10% of the proceeds are for private use and more than 10% of the payments for debt service are from private parties. But PABs are not tax-exempt unless they are issued for "qualified" purposes and a jail is not considered to be a qualified purpose.

This week, U.S. Bank N.A. filed event notices for two separate issuers that financed jails saying the IRS had indicated the tax-exempt bonds or COPs were not tax-exempt. The bank was trustee for both sets of bonds.

One notice said the Burnet County, Tex., Public Facility Corp. has received four letters from the IRS, the first on Dec. 12, 2011 and the most recent on April 12 of this year, seeking information about $35.38 million of project revenue bonds that were issued in 2008 to build a jail.

The bank said that, in the most recent IRS letter, the issuer was asked to provide information "regarding a preliminary conclusion by the IRS that the … bonds … violate certain Internal Revenue Code rules that cause [them] to be taxable." The notice said the issuer is cooperating with the IRS and that "it is unknown at this time what the outcome of the IRS examination will be."

Bill Neve, president of the Burnet County Public Facility Corp., said the county built the 586-bed jail to hold county prisoners but provided for some extra space so it wouldn't have to expand the jail during the next 20 years or so. The IRS is concerned about the number of federal prisoners in the jail, many of whom were housed for less than 100 days, he said.

The PAB rules contain an exception for short-term private use and define that to be less than 100 days. But Neve and other sources indicated that if the IRS thinks there is a significant number of federal inmates, it does not take that exemption into account.

U.S. Bank, NA also issued an event notice stating that the IRS sent the Village of Epps, La., a Notice of Proposed Issue on July 30 "indicating that [$10.3 million of certificates of participation] may not be qualified or exemption from federal income taxation."

The COPs, part of a total $13.65 million issue, were sold in May 2003 and were used to finance the acquisition and improvement of a 592-bed, 48445 square foot detention facility on 10 acres of land in West Carroll Parish, La., according to the official statement.

Epps essentially purchased the detention facility from the corporation through a lease with an option to buy, but the corporation manages the facility. The lease is put into a trust and COP holders get interest payments from the rental payments. Epps' rental payments under the lease, along with other money held by the trustee, support the debt service payments on the COPs, according to the OS. The detention facility was inspected and approved to house U.S. Marshals Service inmates at the time of issuance, the OS said.

The trustee bank said in the event notice that the IRS "suggests that the COPs may be characterized as 'private-activity bonds' under the Internal Revenue Code" and asked Epps to respond by Aug. 30.

Once the IRS sends a Notice of Proposed Issue, which is a preliminary determination that bonds are taxable, the issuer has 30 days to appeal to the IRS' internal administrative appeals office, sources said.