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IRS May Make New Jersey Authority's Municipal Bonds Taxable Because of Total Return Swap.

Aug 5 (Reuters) – The Internal Revenue Service has taken a major step toward declaring millions of dollars of revenue bonds issued by the New Jersey Health Care Facilities Financing Authority in violation of U.S. tax law, which could make the interest paid by the debt taxable.

The authority said on Monday it has requested a 90-day extension to evaluate settlement possibilities and to look into seeking advice from the IRS and appealing any determination.

For nearly three years, the tax agency has investigated whether "total return swaps" and other post-issuance transactions associated with bonds sold in 1993 and 1994 led to arbitrage. In a total return swap, an issuer pays a counterparty using the returns on its bonds in exchange for set payments.

At the end of July, the IRS issued notices of "proposed adverse determination" for bonds sold for a loan to the Deborah Heart and Lung Center and a loan to the Jersey Shore Medical Center. It gave the authority 30 days to request a review of the determination.

The IRS contends "that the transactions utilized an abusive arbitrage device, 'creating additional arbitrage investment opportunities for the borrower,'' Mark Hopkins, the authority's executive director, said in a statement.

The tax exemption for municipal bond interest is considered the chief selling point for the debt and often allows issuers to pay buyers lower interest rates. Most issuers in the $3.7 trillion U.S. municipal bond market work with the IRS to prevent their interest payments from being taxed.

The authority "intends to take whatever steps it deems prudent to prevent the bonds from becoming taxable," said Hopkins. "The NJHCFFA is not aware of any other issues of its bonds that are under similar examination by the IRS."

For the Deborah debt sale, the swaps occurred in 2004, according to a notice posted by the non-profit cardiac organization that was dated August 1. Of the $37.41 million in bonds originally issued, $17.61 million is still outstanding, the notice said.

For the Jersey Shore Medical Center, $87.49 million in bonds were issued, according to a November filing from the Meridian Hospitals Corporation, which includes the center. It said that $16.56 million was outstanding.

Hopkins said lawyers for the authority and hospitals had provided detailed responses to the IRS on two separate occasions, disputing its "purported facts, assumptions and conclusions."