[Bond Case Briefs]

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[IRS Conducting Targeted Audit of Troubled Wayne County Jail Bonds.]

WASHINGTON – The Internal Revenue Service is conducting a targeted audit of $200 million of recovery zone economic development bonds issued in 2010 by the Wayne County Building Authority in Michigan to finance a jail facility that was never completed.

The county disclosed the audit in an event notice posted on the Municipal Securities Rulemaking Board's EMMA system on Sept. 9 in the "Other Event-Based Disclosures," rather than the "Communication from the Internal Revenue Service" or "Adverse Tax Opinion or Event Affecting Tax-Exempt Status" categories of event notices. The IRS audit notice is the latest in a series of headaches for the county tied to the abandoned jail site in downtown Detroit, the county seat.

The authority received the audit notice from the IRS on July 28. The Service said it decided to audit the bonds "because of information we received from external sources or developed internally that causes a concern" that the bonds may fail one or more of the bond provisions in the federal tax code. Bond lawyers have said that language like this is an indication that the audit is targeted.

If the IRS determines that the authority's bond issue violates any tax requirements, the federal subsidy payments the authority receives for the bonds could be at risk. The authority could lose part or all of the subsidy payments, and those losses could be retroactive to the issue date, or prospective, or both. A loss of the subsidy payments "could materially adversely impact the county's ability to pay debt service with respect to the Series 2010 jail facilities bonds or other obligations of the county," the county said.

The authority receives subsidy payments equal to 45% of the interest costs, minus any reductions due to sequestration. As of the date of the event notice, the authority has received about $36.88 million from the Treasury. The event notice said that the county and the authority are currently unable to determine if the audit will lead to the loss of the subsidy payments.

The county said it has hired Miller Canfield to handle the IRS review. A spokesman also said the county is not aware of the information the IRS says it received that suggest the bonds may not be compliant.

"Nothing has come to our attention which suggests that bond usage was non-compliant," county spokesman James Canning said in a statement. "The full amount of authorized bonds have not been spent and are being held in the project fund," said Canning. "Wayne County is cooperating with the IRS and believes that it is in full compliance with all tax requirements."

The county's building authority floated the $200 million bond issue in 2010 to consolidate three aging jail facilities into one adjacent to the Frank Murphy Hall of Justice in downtown Detroit. The bonds were structured as RZEDBs, carrying the county's limited-tax general obligation pledge. RZEDBs are federally taxable, direct-pay bonds whose available project proceeds have to be spent on purposes that promote development or other economic activities in recovery zones.

Wayne broke ground on the $300 million, 2,000-bed project in 2011 and halted it by the summer of 2013 as the estimated cost climbed to $390 million. The site has since sat vacant, with County Executive Warren Evans saying the cash-strapped county does not have the money to finish the project and cannot borrow the money without paying a hefty penalty. The county has the authority to issue another $100 million of bonds to complete the project.

Meanwhile, in 2014, the county's former chief financial officer and two others connected to the project were indicted by a grand jury for misconduct in office and willful neglect of duty tied to the jail financing.

Michigan Gov. Rick Snyder declared Wayne to be in a financial emergency in July, and the county is currently operating under a consent agreement with the state. As part of the decree, Wayne is required to present the state with a plan for the jail by Jan. 31. Officials are reportedly trying to sell the site to a local businessman.

Wayne is paying $14 million annually for the abandoned project, with debt service structured as cash rental payments from the building authority to the county, as well as an additional $3 million in storage costs.

Some of the bonds matured in 2014, and others mature in 2015, 2016, 2025 and 2040. Bonds maturing after 2021 have an optional redemption starting in December 2020. The bonds are also subject to an extraordinary optional redemption due to sequestration cuts to subsidy payments, but not due to any actions of the building authority.

The bulk of the $200 million of taxable bonds — $143.33 million — feature a 2040 maturity and a 10% coupon. The bonds were yielding 11.5% in Wednesday trading, according to EMMA. That's down from 12.3% on July 15 trading and up from a 7.5% to 8% yield in January.

Fitch Ratings has warned that the jail debt could be particularly vulnerable to cuts or default because it is not subject to abatement or appropriation and the project is politically controversial.

"Debt service comprises a relatively small share of governmental spending, but Fitch believes the jail debt could be vulnerable given the failure to complete the project," Fitch said in a March 2015 ratings commentary.

JP Morgan was the senior manager on the original deal. Government Finance Associates Inc. was the county's financial advisor, and Miller, Canfield, Paddock and Stone, PLC was bond counsel, according to the official statement for the bonds.

THE BOND BUYER

BY NAOMI JAGODA and CAITLIN DEVITT

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