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D.C. And IRS In Muni Bond Tax Dispute Tied To Oyster School P3.

WASHINGTON – The Internal Revenue Service is preliminarily challenging the tax-exempt status of bonds issued by the District of Columbia as part of a much lauded public-private partnership to build a new elementary school.

The district, which issued $11 million of bonds in late 1999 for the James F. Oyster Elementary School P3, disclosed the IRS stance in a material event notice recently posted on the Municipal Securities Rulemaking Board's website.

The district said it had received a Notice of Proposed Issue (Form 5701-TEB) from an IRS examiner in February regarding $8.73 million of the bonds that are still outstanding. The IRS sends NOPIs to issuers when it believes tax laws have been violated. A NOPI contains the issues, facts, law and TEB examiner's preliminary position that the bonds are not tax-exempt.

The district said in the event notice that it "is currently discussing its options with respect to the notice and its counsel."

Mark Scott, former head of the IRS TEB office who now has a private practice focused on representing whistleblowers, recently tweeted that the Oyster School P3 "is a tax scam … that cost district residents millions in tax dollars."

He called the transaction a "PPP disaster" and asked whether this is the kind of project Mayor Muriel Bowser's new P3 office wants to support. Bowser launched an Office of Public-Private Partnerships in November of last year "to build collaborations between private sector businesses and [the district government] to support large-scale projects such as infrastructure development and enhancements."

The office is headed up by Seth Miller Gabriel who wrote in an Internet post last October that he'd been taking government officials on tours of P3 projects, including the Oyster school. "Could a PILOT structure, similar to the one used to save the Oyster School, also be the answer to the DC General Hospital-shelter (or temporary housing around the country)?" Gabriel asked in the post.

Scott, who is looking into the Oyster P3 for a client under the whistleblower program, claims the bonds are actually taxable private-activity bonds because the district made an indirect private loan to the developer, LCOR New Oyster School LLC (LCOR).

Asked about the dispute with the IRS and Scott's statements, the District sent the following email to The Bond Buyer on Wednesday: "The District confirms that it has responded to an IRS inquiry regarding bonds issued in connection with the construction of the District's James F. Oyster Elementary School. The developer received no proceeds from the bond sale. One hundred percent of the bond proceeds were used to build a new public school and the developer has no right to use any school property. All property tax-related payments made by the developer to the District are dedicated to pay debt service on the bonds that funded the school's construction."

The email continued: “The District is confident that the bonds comply with federal tax law. The District has responded to the IRS preliminary findings.”

According to descriptions of the Oyster school P3 in the official statement for the bonds and documents from district officials and staff, some of which were obtained by Scott through Freedom of Information Act requests, the district issued roughly $11 million in revenue bonds. The proceeds were used by the developer to finance the demolishment of an old school and the design and construction of a new Oyster Elementary School within two years.

The 32-year bonds are to be entirely repaid by payments-in-lieu of taxes to be made by the developer.

The school was built on .79 of an acre, owned by the district. But the district transferred to the developer .88 of an acre next to the school on which the developer constructed a 210-unit luxury apartment complex with an estimated value, at the time of the OS, of $23 million. The district would have no financial interest in the apartment project.

But the developer was exempted from paying property taxes on the property for the apartment complex in return for making PILOTS to the district for debt service.

At the time of the bond offering, the district estimated the value of the land for the apartment building to be between $3.2 million and $3.76 million and estimated that $6.6 million of property taxes would be abated, after taking into account the cost of capital for the revenue bond financing, assuming a 6% yield on the bonds.

The yields on each of two sets of term bonds maturing in 2015 and 2021 was 6.65% and 6 3/8%, respectively, according to the OS.

Scott contends that what really happened in the transaction was that the district made an indirect loan to the developer of between $3.2 million and $3.76 million and then allowed the developer to pay for it with PILOTS, based on a tax-exempt rate.

The district contends that the bonds proceeds were allocated to financing the school project. But Scott says the transaction is abusive and that the IRS commissioner should reallocate the $3.2 million to $3.76 million of bond proceeds as a loan to the developer.

Under federal tax laws, bonds are PABs if more than the lesser of 5% or $5 million of the bond proceeds are used directly or indirectly to make or finance loans to private parties. If a PAB-financed project doesn’t fall within a specified category, the bonds are not “qualified” and therefore not tax-exempt.

In this case, 5% of the $11 million of bond proceeds would be $550,000 and that amount would be less than $5 million for purposes of the private-loan test. Scott says $3.2 million to $3.76 million of the bond proceeds that should be allocated as a loan to the developer is roughly one third of the bond issue and substantially in excess of the private-loan 5% limitation.

Scott claims the bonds are PABs and taxable since they meet the private loan test for PABS and do not fall within a “qualified” category of projects that can be financed with tax-exempts.

Gabriel said he was not aware of the dispute. Ed Oswald, a partner with Orrick, Herrington, & Sutcliffe who is representing the district in the dispute with the IRS, could not be reached for comment.

The Bond Buyer

By Lynn Hume

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