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Scott: IRS Should Go After Developer, Lawyers in DC Bond Deal.

WASHINGTON - The District of Columbia is appealing the Internal Revenue Service's finding that some of its bonds are taxable, at the same time a former IRS official is urging the agency to go after the developer and bond counsel in the transaction.

Mark Scott, the former head of the IRS' tax-exempt bond office who now represents whistleblowers in private practice, said both the developer, LCOR New Oyster School LLC, and the bond counsel should have known the bonds did not comply with the federal tax requirements at the time they were issued.

DC issued the \$11 million of PILOT revenue bonds in 1999 as part of a much-lauded public-private partnership to build the James F. Oyster Elementary School. The bonds were used to finance construction of the school and were to be entirely repaid by payments-in-lieu of taxes (PILOTS) to be made by LCOR. The school was built on .79 of an acre.

As part of the deal, D.C. sold LCOR about .88 of an acre next to the school, estimated to be worth roughly \$3.7 million, on which the developer constructed a 211-unit luxury residential apartment complex. The district had no financial interest in the apartment building, but exempted LCOR from paying property taxes on the building's land in return for LCOR's making PILOTS to the district for debt service on the bonds.

Scott claims the bonds are actually taxable private activity bonds. He says that D.C., in essence, made an indirect loan to LCOR of about \$3.7 million and then allowed the developer to pay for it with the PILOTS, based on a tax-exempt rate. Scott contends the bonds fall under the federal anti-abuse rule for private activity bonds and that, under that rule, the IRS commissioner can reallocate the \$3.7 million value of the property as a loan to the developer.

Under tax requirements, bonds are PABs if they involve a private loan that is the lesser of 5% or \$5 million. Five percent of \$11 million of bonds would be \$550,000. The bonds would be taxable because luxury apartment complexes do not fall into one of the qualified categories of projects that can be financed with tax-exempt PABs.

The IRS apparently agreed with Scott and on Feb. 2, it sent D.C. a Proposed Adverse Determination that its bonds were taxable.

On Monday, D.C. filed an appeal of that determination with the IRS' Office of Appeals. It announced the appeal in a notice filed on the Municipal Securities Rulemaking Board's EMMA website.

Scott said he doesn't think D.C. will prevail in the appeal.

"The chance of appeals coming up with a different decision is slim because this has already been reviewed for legal sufficiency by an IRS legal review team," Scott said, based on documents he obtained from the district through a Freedom of Information Act request.

The IRS “should go after the developer here, which is taking a deduction presumably for the full amount of property taxes and part of those taxes are actually payments on the loan that should not be deductible,” said Scott. “LCOR duped D.C. and is now making millions from the Oyster P3 bond deal. Shouldn’t they pay to resolve the adverse IRS exam?” he asked.

Scott said the IRS should also go after the bond counsel, too, because it never should have given the opinion that the bonds were tax-exempt. “They should go after Hunton & Williams under Section 6700” of the Internal Revenue Code, he said.

Hunton & Williams was listed on the official statement as bond counsel. But Andrew Kintzinger, counsel at the firm, said on Thursday, “The lawyers who handled this issue left Hunton soon after the issue was completed. Since that time, we have not been involved in that matter. We understand that Ed Oswald, as The Bond Buyer has reported, is handling the audit for the District.”

Oswald, with Orrick, Herrington & Sutcliffe, is serving as tax controversy and representing the District in the IRS matter. The lawyers involved in the deal left Hunton & Williams and went to Orrick after the deal was completed, sources said.

Section 6700 allows the IRS to go after transaction participants, rather than the taxpayers, for violations of tax law requirements. But this section of the tax law does not appear to have been used in recent years.

The Bond Buyer

By Lynn Hume

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