

Bond Case Briefs

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IRS Targets Port Arthur, Texas, Bond Issuance for Hedge Bond Violation - Is Your Bond Issue at Risk? - McNeese

The Internal Revenue Service recently issued a notice of proposed adverse tax determination in what might be a harbinger of additional enforcement actions targeting alleged hedge bonds. The Port of Port Arthur Navigation District of Jefferson County, Texas, issued tax-exempt bonds — according to a continuing disclosure filing made by the Port on Aug. 23, the IRS is alleging that those bonds are taxable “hedge bonds” due to noncompliance with the requirements of the Internal Revenue Code. The Port is contesting the taxability determination.

A taxability determination under Section 149(g) of the code comes down to one thing: you issued your bonds too early. This section is intended to prevent the issuance of tax-exempt bonds earlier than is reasonably necessary to accomplish the governmental purpose of the issue. Bonds issued too early means foregone tax revenue for the federal government, a result frowned upon by the IRS.

Avoiding taxable hedge bond status is fairly straightforward — the issuer must have a reasonable anticipation at the time of issuance that it will expend at least 85% of the proceeds of the issue within three years. The 85% test is based on “reasonable expectations,” not actual results — an issuer could, in fact, fail to spend 85% of the proceeds in three years and avoid a taxability determination under the hedge bond rules.

Over the last year, the municipal bond market has seen a rapid rise in interest rates, coinciding with rapid increases in the Federal Funds Rate by the Federal Reserve to combat inflation. As rates began to rise, a municipality may have been tempted to borrow earlier than was needed to lock in a lower interest rate on its debt. Therefore, bonds issued over the last 12 to 18 months for new capital projects may be at risk of examination by the IRS.

If you issued bonds to finance new projects during this period, now is the time to check your files to ensure compliance with the hedge bond rules. Make sure your records from the time of issuance are in order to show support for having a “reasonable expectation” of spending the proceeds within three years. Meeting minutes, engineering studies and other documentation showing an imminent need to borrow for a project will be helpful evidence. If circumstances have changed since then, preserve documentation of what happened and, ideally, why it was not in the realm of possibility at the time the bonds were issued.

If your bond issue is targeted by the IRS for examination, consult with tax counsel before making any response. I have advised many clients over the years in connection with IRS examinations of tax-exempt bonds, including examinations involving application of the hedge bond rules.

by Timothy Horstmann

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McNeese Wallace & Nurick LLC

