June 14, 2011

Jefferson County Sewer Bonds Under IRS Investigation

The IRS has opened investigations into Jefferson County's sewer bonds that enjoy a tax-exempt status because they have almost landed the county into bankruptcy. The IRS has asked for information on the sewer bond sales of 2003. The purpose of the bonds was to raise money in order to pay off previous bond investors who lent part of the $3.2 billion borrowed to fix the county's sewer system. And since they were issued as tax-free bonds, the bondholders do not have to pay any taxes on any periodic interest payments.

The IRS is evaluating the tax-free status of the bonds known as the 2003 fixed rate warrants, auction rate warrants and variable demand warrants. As such, the county has cautioned that bond interest payments might 'be declared taxable and a tax liability could be assessed against the holders.

'In the past, whenever the IRS investigated the tax-free status of municipal bonds, the point of contention has always been 'yield burning', a situation where a municipality wants to refinance old debts at better rates. Yield burning is done by a bond issuer who issues new bonds and uses the money generated to buy cash-generating investments such as US Treasury bonds. This is perfectly legal and all that needs to be done is to ensure the interest the bond issuer earns does not exceed what the issuer pays to the investors of the new bonds. If the earning exceeds the new-issue payout rate, it is considered trading profit, and must be paid by the municipality to the federal government. To get around this, municipalities have bought US Treasury bonds to put into the escrow accounts from investment banks at artificially inflated prices.

This was what Jefferson County did in 2003 with the sewer bonds. The investment banks concerned were JPMorgan Chase & Co. and Merrill Lynch. In 2000, 10 Wall Street investment banks agreed to pay a combined $140 million in restitution after being accused of pocketing proceeds from inflated Treasury bonds sold to municipal issuers.

The IRS has also investigated the role of the lawyers engaged in providing legal counsel in relation to the tax-free status of the bonds. In 2003, a bond attorney was fined “a fine equal to 100 percent of the fee earned in an abusive bond transaction.”

Jefferson County is in default of its sewer bonds. This came after a $1 billion project more than tripled in costs and complex Wall Street interest rate swaps advised by JPMorgan backfired. As a result, the county is considering cutting about 700 jobs to avert what may be the largest municipality bankruptcy in US history.