

Prison Financings Under IRS Scrutiny

Prison financings have attracted significant attention from the IRS over the last few years. As reported in the press, several publicly-announced settlements with the IRS or bond redemptions have occurred because of violations of the tax requirements applicable to tax-exempt bonds issued to finance prison facilities. The problems discovered by the IRS or by the issuers themselves have involved excess “private business use” and excess “private security or payments,” which together cause state or local government bonds to become private activity bonds the interest on which (in the case of a prison financing) is taxable.

Private business use in these cases has resulted from one or both of two sources – a “non-qualifying management contract” or a contract with the federal government to house federal prisoners. First, some of the prisons were managed by private companies under management contracts that did not satisfy an applicable set of IRS rules, and as a result the private manager was treated as a private business user of the entire prison facility (assuming the manager was responsible for managing the entire facility). The rules that these management contracts must satisfy to avoid private business use are set forth in IRS Revenue Procedure 97-13, issued in 1997. Late last month, the IRS broadened these rules by the issuance of Notice 2014-67, making it somewhat easier to avoid private business use. However, the rules remain sufficiently narrow that bond counsel should always be consulted before entering into a management contract for a tax-exempt bond-financed prison, or for that matter any tax-exempt bond-financed facility, to be sure the tax rules are satisfied.

The second common source of private business use in the case of these prison financings is contracts with the federal government to house federal prisoners. While not necessarily intuitive, the federal government is treated the same as a private corporation for tax-exempt bond purposes. As a result, if the contract between the federal government and the governmental prison owner extends beyond certain time limits imposed by the tax regulations, the right of the federal government to house prisoners in the financed prison results in private business use, regardless of whether the federal government actually exercises its right to house its prisoners there (the mere contractual right of the federal government to house prisoners there creates private business use). Once these forms of private business use are found to exist, any revenues derived by the bond issuer from the prison, particularly the fees paid by the federal government to house prisoners, are treated as “private payments.” This is the case regardless of whether the revenues are used to pay debt service on the bonds that financed the prison. The resulting combination of private business use and private payments, if greater than the de minimis amounts permitted by the Internal Revenue Code, will cause any tax-exempt bonds issued to finance the prison facility to become taxable private activity bonds.

For an issuer of tax-exempt prison bonds that is considering a management contract or a contract to house federal prisoners, bond counsel should be contacted as early as possible. With proper advice, it should be possible to enter either or both of these types of contracts without jeopardizing the tax-exempt status of the bonds – but it is

necessary to satisfy the tax requirements. If an issuer finds itself in the position of having entered into either or both of these types of contracts unaware of the tax implications for its bonds, immediate action is necessary. The tax regulations provide “remedial actions” that, if taken quickly enough after a private business use contract is entered, can preserve the tax-exempt status of the bonds and generally require no interaction with the IRS.

If those remedial actions are not available because, for example, too much time has passed since the tax problem arose, a second, albeit less desirable, remedy is available under the IRS’s Voluntary Closing Agreement Program (VCAP). The issuer can request a closing agreement with the IRS, under which the issuer will be required to make some payment to the IRS (generally calculated under a set of guidelines issued by the IRS), and in exchange the IRS will agree not to declare interest on the bonds taxable as a result of the tax violations described in the closing agreement. While this may not sound like a very attractive option, the policy of the IRS is to require a lower payment – potentially significantly lower – under VCAP than if the violation is discovered upon an audit of the bonds.

In summary, before entering into a management contract for a tax-exempt bond-financed prison (or any tax-exempt bond-financed facility) and before entering into a contract with the federal government to house its prisoners in such a facility, consult with bond counsel to ensure compliance with the tax rules. If it is discovered that such a contract already exists and it violates the tax rules, consider the options of the remedial action rules and, if necessary, the IRS’s VCAP program. The latter probably will not be cost-free, but the cost will likely be significantly less than the price that would be paid upon an audit of the bonds.

Recent Decisions of Interest

Public Records. Dismissal of an action to compel school board members to release emails was not in error where the complaint did not allege that the board members improperly met in person and there was no pending rule or resolution before the board at the time the emails were exchanged. Accordingly, the emails’ contents were not a meeting about official business subject to public disclosure under Section 121.22 of the Ohio Revised Code. *White v. King*, 2014-Ohio-3896 (Ohio App. 5th Dist.).

Real Property Taxes. A county auditor is required to verify the income information provided by an applicant for a reduction of real property taxes under Section 323.152 of the Ohio Revised Code even when the applicant is not required to file an Ohio income tax return. A county auditor is not required to use the web-based income verification system provided by the Tax Commissioner to verify the income information; instead, a county auditor may complete the income verification using any reasonable means. A county auditor is not required to separately verify on an annual basis the income of a person who receives the reduction of real property taxes. *2014 Op. Att’y General No. 2014-037*.

Health Insurance Premiums. A board of county commissioners that purchases group healthcare insurance for county employees and their spouses pursuant to Section 305.171 of the Ohio Revised Code may set premium rates on the basis of the use of tobacco, provided that (i) the board of county commissioners must have a reasonable basis for making that distinction and (ii) all similarly situated county personnel must pay the same insurance premium and receive equal benefits under the policy of group healthcare insurance. *2014 Op. Att’y General No. 2014-034.*

Sanitary Rates. A board of county commissioners is not permitted to waive sanitary rates for properties that are capable of, but are not currently, being served by a county sewer district established pursuant to Chapter 6117 of the Ohio Revised Code. When a board of county commissioners fixes sanitary rates pursuant to Section 6117.02(A) of the Ohio Revised Code, the board reasonably may distinguish between properties that are served by a county sewer district and properties that are capable of, but are not currently, being served by a county sewer district and may impose lower sanitary rates on the latter type of properties. *2014 Op. Att’y General No. 2014-031.*

Public Records. To determine whether personal email addresses document the organization, functions, policies, decisions, procedures, operations, or other activities of a public entity and, accordingly, must be disclosed under Section 149.43 of the Ohio Revised Code, a public entity must determine whether disclosure of the email addresses would facilitate the public’s ability to monitor the functions of the public entity in performing its statutory duties, and whether the public entity actually used the email addresses in making decisions or in performing its functions. *2014 Op. Att’y General No. 2014-029.*

Use of Tax Levy Proceeds. A board of township trustees may not expend revenues generated from taxes levied pursuant to Sections 5705.19(I) and 5705.19(J) of the Ohio Revised Code (for the fire and police departments, respectively) to pay legal expenses incurred to address collective bargaining issues involving township police officers, road workers, firefighters, and emergency medical technicians. *2014 Op. Att’y General No. 2014-028.*

Purchase of Alcoholic Beverages by Public Entity. The Auditor of State will continue to issue findings for recovery when public funds are used to purchase alcoholic beverages, except when the alcoholic beverages are purchased for resale and the following conditions are satisfied: (1) the political subdivision obtained a valid permit from the Ohio Division of Liquor Control; (2) the political subdivision complied with the permit; (3) the political subdivision purchased the alcoholic beverages solely for resale to the public; (4) the expenditure is reasonable; and (5) the proceeds are applied as required by any applicable statute or controlling law (e.g., municipal charter or ordinance). *Auditor of State Bulletin 2014-003.*

Legislation of Interest

Amended Substitute House Bill No. 492 (effective September 17, 2014). This Bill, among many other things, expressly authorizes municipal corporations to award job creation and job retention municipal income tax credits even if a corresponding state tax credit has not been awarded and modifies certain State tax credit programs.

Substitute Senate Bill No. 287 (effective September 4, 2014). This Bill amends Revised Code Chapter 135 (the Uniform Depository Act) to modify the types of obligations eligible for investment of interim and, with respect to a county, inactive moneys, including investments in obligations of governmental entities.

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