Client Alert

CURRENT ISSUES RELEVANT TO OUR CLIENTS SEPTEMBER 2012

Chapman and Cutler LLP
Attorneys at Law · Focused on Finance®

Public Finance Tax Update

In this issue:

1. Treasury Report Highlights Increased Bond Examination Activity by the IRS
2. Possible Cuts to Federal Subsidies for Build America Bonds and Tax Credit Bonds
3. Management of Electric Transmission and Distribution System Does Not Result in Private Business Use

Treasury Report Highlights Increased Bond Examination Activity by the IRS

The U.S. Treasury recently released a report from the Treasury Inspector General for Tax Administration (the *"Treasury Report"*) that states that the Internal Revenue Service (the *"IRS"*) more than doubled the number of bond examinations conducted per year from the number of examinations it conducted during previous reporting periods. The Treasury Report, which covers IRS enforcement activities of the Tax Exempt Bonds Office (the *"TEB"*) from FY 2005 to FY 2010, also shows that the TEB assessed more than $84 million of additional amounts for noncompliance based on bond examinations for such fiscal years. TEB assessed such amounts while also decreasing the amount of time TEB staff spends on each examination from more than 100 staff days to approximately eight staff days per examination.

The Treasury Report also shows that although the number of bond examinations has increased, most of the examinations did not uncover any tax violations. On average for the reporting period, 58 percent of bond issues examined by TEB were compliant and the compliance rate increased to 70 percent when arbitrage refund claims were removed from the calculation.

TEB is also conducting fewer examinations to identify bond promoters involved in misconduct. The number of TEB misconduct investigations decreased from 21 investigations in FY 2005 to two investigations in FY 2010. TEB believes the reason for the decrease can be attributed to the suspension of eight investigations in FY 2006 and 2007 that TEB plans to reactivate in the future, and that highly public criminal prosecutions have created a deterrent effect. The previous report prepared by the Treasury covered enforcement activities from FY 2002 through FY 2004.

The entire Treasury Report is available at: http://www.treasury.gov/tigta/auditreports/2012reports/201210087fr.pdf

Possible Cuts to Federal Subsidies for Build America Bonds and Tax Credit Bonds

On September 14, 2012, the Office of Management and Budget sent a report (the *"Report"*) to Congressional lawmakers discussing major cuts that will have to be made in federal payments to issuers of Build America Bonds and other direct-pay bonds if Congress is forced to make $1.2 trillion in across-the-board cuts to the federal fiscal 2013 budget under the Congressionally mandated sequestration process.

In August 2011, bipartisan majorities in both the House and Senate voted for the threat of sequestration as a mechanism to force Congress to act on deficit reduction. The specter of harmful across-the-board cuts to defense and nondefense programs was intended to drive both sides to compromise. The sequestration itself was never intended to be implemented. It is important to note that Congress can take action to avoid sequestration by passing a comprehensive and balanced deficit reduction package.

The estimates and classifications in the Report are preliminary. If sequestration were to occur, the actual results would differ based on changes in law and ongoing legal, budgetary, and technical analysis. The percentage cuts in the Report reflect the requirements of the laws that the Report is applying. With the single exception of military personnel accounts, the Obama administration cannot choose which programs to exempt, or what percentage cuts to apply. These matters are dictated by a detailed statutory scheme.

The Report shows that payments authorized for direct-pay bonds would be cut 7.6 percent, totaling $255 million for Build America Bonds (BABS), $62 million for qualified school construction bonds (QSCBs), $3 million for qualified zone academy bonds (QZABs), and $2 million for qualified energy conservation bonds (QECBs). It is possible that cuts may also be made to New Clean Renewable Energy Bonds but the Report shows no cuts to them at this time. The amounts authorized prior to the sequestration for fiscal year 2013 were: $3.351 billion for BABs; $820 million for QSCBs; $38 million for QZABs; and $32 million for QECBs.

The Report provides preliminary estimates of the sequestration's impact on more than 1,200 budget accounts.

The Report is for fiscal year 2013. The fiscal year is the accounting period for the federal government which begins on October 1 and ends on September 30. The fiscal year is designated by the calendar year in which it ends; for example, fiscal year 2013 begins on October 1, 2012 and ends on September 30, 2013. The failure of Congress triggers automatic reductions in discretionary appropriations and direct spending to achieve the deficit reduction that Congress was supposed to achieve. Absent further congressional action, the Report states that the first of these reductions will be implemented on January 2, 2013, by a sequestration of non-exempt discretionary appropriations and non-exempt direct spending. Accordingly, it appears that the sequester's cuts take place over nine months, rather than twelve, because the 2013 fiscal year will have already started by January 2, 2013.

Management of Electric Transmission and Distribution System Does Not Result in Private Business Use

In Private Letter Ruling 201228029, the IRS determined that a management agreement pursuant to which a non-governmental operator managed a governmental electric transmission and distribution system did not result in private business use. Although the management agreement did not satisfy the requirements of Revenue Procedure 97-13 (*"Rev. Proc. 97-13"*), which sets forth the safe harbors for management contracts that do not create private business use, the IRS nevertheless determined that, based on all the facts and circumstances, the agreement did not create private business use.

A governmental electric company entered into a management agreement with a non-governmental operator for the management of the electric company's transmission and distribution system. The agreement has a ten-year term, is not subject to renewal or extension and may be immediately terminated prior to the end of the term by either party due to specified events of default. None of the voting power of the governing body of the electric company is vested in the operator and its directors, officers, shareholders and employees, there are no overlapping board members between the operator and the electric company and the electric company is not a related party to the operator.

Under the agreement the operator gets paid (i) a fixed direct fee, which is a yearly stated dollar amount, payable in 12 monthly installments, but subject to a reduction if the manager reduces its credit support to the electric company and subject to a yearly adjustment based on the Consumer Price Index, (ii) an incentive compensation component, which is not based on gross revenues or net profits, but rather is measured against certain performance goals outlined in the agreement and is subject to a downward adjustment if the operator fails to achieve stated minimum levels of performance specified in the agreement and (iii) reimbursement of expenditures incurred by the operator (without any mark up or profit, other than a mark up associated with an affiliate's direct expenses in accordance with Federal Energy Regulatory Commission sanctioned cost allocation methods) in the course of providing services, including wages, salaries, benefits and other labor costs of the general workforce, costs incurred by the operator for supplies, costs of capital improvements, subcontractor costs, taxes and other similar costs and excluding amounts paid by the operator to or for senior management employed by the operator. With respect to the fixed direct fee, the fixed component assumes a certain dollar amount of credit support provided by the operator to the electric company. The credit support can be reduced at the electric company's sole discretion in certain dollar increments, which triggers a reduction in the annual fixed direct fee at a stated rate. The incentive compensation component is based on certain performance metrics. A failure to meet certain performance metrics can result in various reductions in the incentive compensation, including a reduction of 50 percent of the incentive fee or a 100 percent reduction in the event minimum performance levels are not achieved for any two years of a consecutive three-year period. Poor performance with respect to certain performance metrics related to customer satisfaction and service interruptions can also result in a forfeiture of the entire incentive compensation component for the year as well as a penalty payment to be paid from the operator to the electric company equal to a certain percent of the fixed direct fee for the year.

The IRS determined that, although the agreement did not meet all the requirements of Rev. Proc. 97-13 that would allow it to be treated as a management contract that does not result in private business use under Rev. Proc. 97-13, the agreement did not create private business use. First, the IRS noted that the fixed direct fee did not meet the definition of a periodic fixed fee in Rev. Proc. 97-13, because it is subject to adjustments based on reduced credit support as well as reductions because of poor performance, and such adjustments are not specified, objective and external with the meaning of Rev. Proc. 97-13. However, the IRS determined that the fixed direct fee component did not cause the agreement to result in private business use of the electric system because the adjustments are not based on a change in net profits.

The IRS also concluded that the incentive compensation component does not cause the agreement to result in private business use of the electric system because, although the fee provides incentives to reduce expenses, none of the performance categories are based on gross revenues or net profits of the electric system. In addition, the IRS concluded that the reimbursements of the pass-through expenditures do not cause the agreement to result in private business use. While the IRS noted that certain charges from affiliates that were reimbursable may include a markup authorized by the Federal Energy Regulatory Commission, the IRS determined that such markup will not be based on a share of the electric system's net profits. Last, the IRS noted that neither the length of the agreement nor any relationship between the operator and the electric company will result in private business use of the electric system, because the agreement will not exceed the 20-year term allowed under Rev. Proc. 97-13 and the operator will not have any role or relationship with the electric company that will substantially limit the electric company's ability to exercise its rights under the agreement.

If you would like to discuss any of the issues addressed in this Client Alert, please contact Jeffrey D. Berry at (312) 845-3713 or berry@chapman.com; David J. Cholst at (312) 845-3862 or cholst@chapman.com; Anthony R. Rosso at (312) 845-3913 or rosso@chapman.com; or Brent L. Feller at (312) 845-3822 or feller@chapman.com. To learn more about Chapman, please visit us online at chapman.com