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Vernon City Tax-exempt Bond under IRS Probe

The city of Vernon issued \$419 million worth of tax-exempt bonds in 2009 which has come under IRS investigation. This has now become the third major tax investigation of the city over the past one year. In its audit notification to the city, the IRS said that it had received information that “causes a concern that the debt issuance may fail one or more provisions” of the Internal Revenue code. There has been no official comment from the IRS on the matter and city officials say they have not been briefed about the details of the audit.

Vernon’s troubles are not limited to tax issues. Recently, three top city officials have been convicted of corruption and the state legislature is contemplating disincorporation of the city. In addition, the city has suffered huge financial losses over investments in its power business. The city racked up a \$130-million loss in net assets and nearly half a billion dollars in debt between 2005 and 2010.

Although no official details of the audit has been released by the IRS, most legal experts say that the violation is probably due to the city’s use of the bond proceeds. Federal law allows local governments to issue tax-exempt bonds for certain types of ‘qualified purposes’ like big infrastructure developments and construction projects. But Vernon issued its bonds in 2009 to fund a supply of natural gas the city had bought 3 years earlier.

If the purpose for which the bonds were issued is deemed in violation of the Inland Revenue code then the city could be liable for millions of dollars in unpaid taxes. Tax experts interpreted the wording of the IRS audit notification as a red flag, indicating that

the city has been targeted for investigation and that the city did not receive the notification at random.

However, Vernon city officials believe they have not violated any federal law and that they are fully cooperating with any IRS investigation.

Vernon's government has an operating budget of more than \$300 million. Most of its revenue comes from the Light & Power Department, which sells electricity to about 1,800 companies in the city. Vernon built a power plant and between 2003 and 2009 financed it with more than \$1 billion in bonds. In 2006, Vernon offered the \$419 million bond issue to purchase 15 years' supply of natural gas for its new power plant. But unfortunately, the deal turned awry. Natural gas prices has fallen as low as \$3 from above \$10 a unit since 2006. And the derivative trades Vernon used to try to lower its interest rates backfired after the financial meltdown of 2008.

In 2006 itself, Vernon sold the power plant to a private company but the city still had to pay for the natural gas. Most of the proceeds from the 2009 bonds were used to redeem the outstanding debt on the original natural gas purchase.