



Memorandum

TO: SUCCESSOR AGENCY
BOARD

FROM: Julia H. Cooper

**SUBJECT: RECOGNITION OF
SUCCESSOR AGENCY
ARBITRAGE REBATE
LIABILITY**

DATE: October 24, 2019

Approved

Date

10/24/19

REPLACEMENT

REASON FOR REPLACEMENT

Negotiations are ongoing with the Internal Revenue Service (IRS). There were legal limitations that required counsels for both the City and the IRS to conduct further research. This replacement memo has captured this new information and staff's recommendation has been updated accordingly.

RECOMMENDATION

Adopt a resolution of the Successor Agency to the Redevelopment Agency Board:

- (a) Recognizing the additional arbitrage rebate liability, penalties and interest (rebate liability) due with respect to the Redevelopment Agency of the City of San Jose Merged Area Tax Allocation Bonds Series 1999 (1999 Bonds) in the amount of \$171,593.84 plus penalties (\$85,796.92) plus interest, as calculated by the IRS, from March 9, 2018 to July 15, 2020 for a total estimated payment amount of approximately \$300,000;
- (b) Proceeding with necessary approvals from the Oversight Board and California Department of Finance to have the arbitrage rebate liability recognized as an enforceable obligation; and
- (c) Authorizing the Executive Officer, Chief Financial Officer and Successor Agency General Counsel to continue discussions with the IRS to resolve the matter and pay the amount of rebate liability, including execution of documents related to such payment.

OUTCOME

Adoption of the resolution recognizing the additional arbitrage rebate liability, authorizing proceeding with necessary approvals from the Redevelopment Dissolution Countywide Oversight Board of Santa Clara County (Oversight Board) and the State Department of Finance

of the State of California (DOF), and authorizing continued discussions with the IRS to resolve the matter will assist in proceeding with payment of the additional arbitrage rebate due on the 1999 Bonds.

BACKGROUND

Following dissolution of the Former Redevelopment Agency, the Finance Director was appointed as the Chief Financial Officer for the Successor Agency and the Successor Agency hired BLX Group (BLX), a nationally recognized rebate calculation service provider to perform arbitrage¹ rebate calculations on all outstanding Redevelopment Agency bonds to determine to calculate the amount of rebate, if any, was owed to the IRS. This work effort was completed to ensure compliance with IRS tax regulations. The result of this work effort was the determination that rebate was due on the \$59,000,000 Merged Area Redevelopment Project Revenue Bonds 1996 Series A and 1996 Series B (the 1996 Bonds) and \$240,000,000 Merged Area Redevelopment Project Tax Allocation Bonds Series 1999 (the 1999 Bonds). The amount of rebate, late interest and penalties owed for the 1996 Bonds and 1999 Bonds was determined to be \$10,140.44 and \$3,878,837.60, respectively.

Due to the financial condition of the Successor Agency in 2017 and requirements under State law governing the dissolution of redevelopment agencies (the Dissolution Law), the Successor Agency was unable to make the late rebate payments until the Successor Agency issued the 2017 Refunding Bonds. Pursuant to IRS procedures for late rebate payments, on December 22, 2017, the Successor Agency used proceeds of the 2017 Refunding Bonds to pay the late rebate payments with interest and penalties in the amounts determined by BLX in its rebate calculation reports.

On July 8, 2019, the IRS initiated audits of both the Redevelopment Agency of the City of San Jose Merged Area Project Revenue Bonds Series 1996 Series A and 1996 Series B (the 1996 Bonds) and the 1999 Bonds. The audit letters asked for general information about each of these Bonds and asked questions about the methodology used to compute the amount of the late rebate payment on the 1996 Bonds and the 1999 Bonds. The bond counsel firm, Jones Hall, under a retainer agreement with the Successor Agency, is representing the Successor Agency before the IRS in this matter.

¹ Under IRS rules, if proceeds of tax-exempt bonds are invested at a yield higher than the yield on the bonds, earnings in excess (Excess Earnings) of amounts that would have been earned had the proceeds been invested at the bond yield (Bond Yield) must be paid (rebated) to the Federal government. The Internal Revenue Code refers to these excess earnings as arbitrage.

ANALYSIS

The IRS has determined that no additional rebate, penalty, or interest is due on the 1996 Bonds. However, during the audit the IRS asserted that the methodology used to compute the 2017 Final Rebate Payment for the 1999 Bonds was incorrectly calculated resulting in an under payment of rebate in the amount of approximately \$172,600. With penalties and interest (through July 15, 2020) the total amount owed increases to approximately \$279,000. The Successor Agency disagreed that the 2017 Final Rebate Payment was insufficient and maintained that the methodology used to compute the 2017 Final Rebate Payment was correct and no additional rebate amounts are due.

The ongoing discussions with the IRS to reach resolution in this matter have been fluid. At this point the IRS usual procedures do not create a mechanism to allow for a delayed payment by the Successor Agency and payment of the rebate liability due must be made at the time the settlement agreement is effective. The Successor Agency's ability to enter into new obligations, such as a settlement agreement with the IRS is restricted by State law governing the dissolution of redevelopment agencies (Dissolution Law). Under the Dissolution Law, the Successor Agency cannot enter into agreements unless it is first approved by the Oversight Board and the DOF. Additionally, the Successor Agency cannot make payments unless the payment is on the Recognized Payment Obligation Schedule (ROPS) that relate to enforceable obligations of the former redevelopment agency or that are approved by the Oversight Board and the DOF.

Bond Counsel and staff continue to work through issues with the IRS, including deferral of payment of the rebate liability to provide staff with the opportunity to seek the necessary approvals required under the Dissolution Law. Accordingly, staff is seeking authorization from the Successor Agency Board to proceed with the approval processes under the Dissolution Law to recognize the full amount of the rebate liability plus penalties and interest, through July 15, 2020 (approximately \$279,000) for placement on the FY 2020-21 ROPS.

Additionally, exploration continues on the ability to pay the additional amounts due from other loaned sources. However, the Dissolution Law does not permit the amount to be loaned to the Successor Agency in advance of recognizing the enforceable obligation, so the risk exists that any funds loaned to the Successor Agency in advance of FY 2020-21 ROPS approval and the start of the new fiscal year on July 1, 2020 could not be repaid.

EVALUATION AND FOLLOW-UP

This memorandum will not require any follow-up with the Successor Agency Board.

PUBLIC OUTREACH

This memorandum will be posted on the City's website for the October 29, 2019 City Council/Successor Agency meeting.

COORDINATION

This memorandum has been coordinated with the City Attorney's Office as general counsel to the Successor Agency.

COMMISSION RECOMMENDATION/INPUT

This recommendation has not been heard by any commission.

FISCAL/POLICY ALIGNMENT

Recognizing the additional arbitrage rebate liability, including penalties and interest due to the IRS and working on a resolution to make the payment is consistent with the Council approved *Guiding Principles for Budget and Financial Management* for the Successor Agency to meet its legal commitments and requirements with respect to the 1999 Bonds.

COST SUMMARY/IMPLICATIONS

The Additional Rebate Amount estimated at \$279,043.78, with a not to exceed payment of \$300,000.00 will be added to the Recognized Obligation Payment Schedule for FY 2020-21 for Oversight Board approval in January 2020 and submission to DOF for their review and approval. After securing approvals, the Successor Agency will be able to make the payment to the IRS in July 2020 from disbursement of Redevelopment Agency Property Tax Trust Fund (RPTTF) by the Santa Clara County Auditor-Controller.

CEQA

Not a Project, File No. PP17-004, Government Funding Mechanism or Fiscal Activity with no commitment to a specific project which may result in a potentially significant physical impact on the environment.

/s/

JULIA H. COOPER
Chief Financial Officer

For questions, please contact Julia H. Cooper, Director of Finance for the City of San José/Successor Agency Chief Financial Officer at 408-535-7011.