

## Probe's QZAB Requests Hint At Possible Arbitrage Abuses

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WASHINGTON — In their wide-ranging inquiries of the municipal market, the Justice Department and the Securities Exchange Commission requested documentation on investments and derivatives associated with qualified zone academy bonds because many QZAB deals have allegedly contained abusive arbitrage devices, source's suggested yesterday. QZABs are used by municipal issuers to finance repairs and renovations, develop curricula, train teachers, or update technological equipment at existing school facilities. The taxable tax-credit bond program was created in 1997, and Congress has authorized the issuance of \$400 million of QZABs each year since 1998. Though the tax-credit bonds were created to help needy schools, problems have cropped

up because QZABs are not subject to the arbitrage rebate and yield restrictions that apply to tax-exempt debt, according to sources familiar with the Justice and SEC investigations. A large number of industry firms were subpoenaed last week in those probes, which are examining alleged collusion in the bidding for and prices of investment contracts and derivatives.

Specifically, there appear to be many questionable contributions by deal participants and significant pricing problems with the financial products in which QZAB proceeds are invested, one industry source said yesterday.

When issuers sell QZABs, they are required to secure a private partner willing to contribute cash, in-kind services, or materials having an "acceptable present fair market value" — as of the date of issuance —

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of not less than 10% of the net present value of the amount of money borrowed. Issuers typically invest proceeds in a guaranteed investment contract or another investment vehicle that earns interest until the funds are needed for projects.

But since QZABs are not subject to the tax code's arbitrage regulations, "you could do the worst arbitrage scam [imaginable] because there is no rebate requirement; no mandate that the money has to be spent," and the 10% contributions can be bogus, one source said.

"Because of the ability to arbitrage the stuff, people have been out there pushing for the deals to get done," another source said.

Companies can overvalue the computers or software they donate to the school, and the Department of Education has warned bond counsel, financial advisers, and school superintendents and financial officers of "serious" concerns about, deal participants misusing the 10% match provision "by valuing a contribution above fair market value or not requiring the match partner to set up an academic program in the school district," which is also required.

The Internal Revenue Service's tax-exempt bond office handles examina-

tions of most municipal bond transactions but does not normally deal with QZABs because the bonds are required to be held by banks, insurance companies, or corporations actively engaged in the business of lending money. Those taxpayers fall under the umbrella of the IRS' large and mid-sized business division, not the tax-exempt and government entities division, which encompasses the TEB office.

TEB and LMSB officials met in 2001 to discuss jurisdictional issues and abuses seen in the QZAB sector. It was determined that since the taxpayers in question were banks and financial institutions — which received tax deductions or credits for their participation in the deals — LMSB was the proper place for the enforcement side.

"It would have been difficult to examine and we would have had to really craft some new way to issue summonses because there are no information returns [for QZABs]," said former TEB director W. Mark Scott, now a partner with Vinson & Elkins LLP here. "We had some discussions on it and decided that LMSB should handle it until such time that there was an information return for QZABs."

It is not clear whether LMSB officials have examined any such deals since then, and they did not return inquiries through the IRS' main press office yesterday.

One industry source that works with QZAB issuers said the picture is clouded by differences in state laws. Texas, for example, requires three bids for a guaranteed investment contract for QZAB proceeds, while other states use forward delivery agreements and do not use GICs at all, the source said.

Another individual familiar with QZAB issuers and the lawmaking process said he had not heard much on the issue of arbitrage abuses in the sector, but pointed to proposed legislative restrictions for the bonds that are a "critical issue."

"In terms of third parties making a profit out of this; the banking and the proceeds; that I've never heard of. I thought it was just an issue of school districts taking advantage of the delay in spending that money, then being able to lessen their debt by being strategic in the market."

Congressional leaders such as Senate Finance Committee chairman Charles Grassley, R-Iowa, are said to be aware of some of the concerns related to QZABs. Several restrictions on the bonds have been proposed in the past year but have not been enacted, including requirements that issuers reasonably expect to spend 95% of proceeds within five years; enter into binding contracts with third parties to spend at least 10% of proceeds within six

months of the bonds' issue date; and redeem bonds within 90 days if they fail, to spend 95% of the proceeds within the five-year period.

Those particular restrictions — and a two-year extension of the QZAB program, which expired last year and must be reauthorized annually — were wrapped into the so-called "tax extenders" bill that has languished on Capitol Hill for more than a year.

Previously included in tax reconciliation legislation and the so-called "trifecta" bill, which would have increased the minimum wage and permanently extended estate tax relief, the tax extenders may be passed as a stand-alone bill when the lame-duck Congress convenes next month. They could also be attached to different legislation, as the "trifecta" appears to be dead in the water.