

Federal, State and Local Governments Newsletter

Volume 1

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FEDERAL



STATE



LOCAL



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MANY STATE
AGENCIES WERE
UNAWARE OF
REQUIREMENTS TO
REPORT
REIMBURSEMENTS AS
TAXABLE INCOME.

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Attn: Lou Leslie,

Operations Manager

1111 Constitution Avenue NW

Washington, DC 20224

MESSAGE FROM THE EDITOR

STEWART ROULEAU, FSLG SENIOR ANALYST

In the March issue of the FSLG Newsletter, Charles Peterson, Director of Government Entities (GE), spoke about Commissioner Mark W. Everson's effort to rebalance compliance and outreach activities. He pointed out some general areas of increased emphasis for GE, including abusive schemes, information returns, and employee fringe benefits.

Listed below are illustrations of common problems we are encountering in some of the areas that we are focusing compliance efforts.

Travel and Meal Allowances. A state auditor recently determined that nearly every agency was allowing reimbursements for meals that exceed Federal per diem allowances, and these were not being reported or accounted for as required by Federal tax law or state policy. The report indicated that many state agencies were unaware of requirements to report reimbursements as taxable income on employee Forms W-2.

Automobile Use. We recently discovered situations in which municipal policy allows widespread use of government-owned vehicles for commuting or other personal purposes. In many cases, employers are unaware that this creates a taxable fringe benefit.

Federal Agency Information Reporting. A recent GAO report determined that for 2000 and 2001, Federal agencies did not file information returns in 152,000 cases in which they were required. These represent \$25 billion in Federal payments to vendors and contractors.

Consideration for Volunteers. In this issue, we address this topic in detail in the article "Taxation of Benefits for Volunteers." Many governments have established policies to provide benefits, such as tax abatements, to certain workers considered to be volunteers. In general, compensation in any form that is contingent upon services provided is taxable income, regardless of the worker status as "volunteers." This includes expense allowances that do not meet the accountable plan rules.

Your FSLG Specialist is available to assist you in answering your questions about these and other topics. A directory of Specialists may be found in this publication. More information, including our Fringe Benefits Tax Guide, is available on our web site at www.irs.gov/govts.

SALE IN – LEASE OUT (SILO) TRANSACTIONS

BY MARLYCE LUITJENS, FSLG SPECIALIST (MIDWEST)

Your government entity may be approached about entering into a leasing transaction known as a “SILO” arrangement that may offer up-front cash benefits to enter into a long-term lease of your infrastructure. Although the up-front cash benefit is enticing and may help alleviate budget shortfalls, you should know that the Internal Revenue Service disallows depreciation and interest expense deductions claimed by taxpayers entering into SILOs. Lease-in lease-out (LILO) transactions that have many features found in the SILO transactions are “listed transactions,” meaning that they are abusive tax avoidance transactions.

To help you to understand how these transactions work, and why you should carefully evaluate participating in them, we are providing some background information.

What Is a SILO?

A SILO is a “sale-in/lease-out” arrangement between a for-profit corporation and a tax-exempt entity (Domestic or Foreign), such as a municipality or other state or local governmental unit. The objective of the transaction is to provide the for-profit corporation with tax deductions that the governmental unit cannot use because it is tax-exempt and an up-front benefit to the tax-exempt entity for entering the transaction. The SILO transaction generally includes an investor (a U.S. corporation), a tax-exempt entity (e.g. municipality), a grantor trust (an entity set up for the benefit of the investor), one or more foreign lenders, deposit taker(s) and financial advisors/arrangers (promoters) that assist the investor and/or the tax-exempt entity.

In a typical SILO transaction, the tax-exempt entity leases its property, such as a highway, subway, bridge, or water plant, to a U.S. corporation. The U.S. corporation treats the arrangement as a purchase of the property for Federal tax purposes. The U.S. corporation simultaneously leases the property back to the government entity for a shorter period of time. Although the parties structure the transaction in the same form as in a LILO transaction, since the length of the lease exceeds the useful life of the property, the transaction is treated as a sale and leaseback for tax purposes. The SILO employs the same fundamental contractual arrangements as the LILO arrangement, but typically involves a service contract provision instead of the put or renewal option found in LILOs. Please note that the service contract provision serves the same function as the put option, that is, it guarantees a fixed return to the corporation. The property generates tax deductions, mainly depreciation and interest expense, for the U.S. corporation. There are other SILOs that may be referred to as QTE (qualified technological equipment) leases.

Example of a SILO Transaction

A municipality leases its wastewater treatment plant (the “plant”) to a U.S. corporation for a 99-year lease period and receives an immediate lease payment of \$100 million for the property that will cover the 99-year lease term. This 99-year term is normally longer than the useful life of the plant or a nominal cost to renew the lease is granted

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THE
INTERNAL REVENUE
SERVICE
IS TAKING STEPS
TO COMBAT
ABUSIVE TAX SHELTERS
AND TRANSACTIONS.

to the investor such that the total term will be longer than the life of the asset. The municipality immediately leases the plant back from the corporation for a period of 30 years; this 30-year period usually ends at the first date on which the tax-exempt entity may exercise its buyout option. The transaction results in no change in the municipality's use or operation of, or beneficial interest in, the plant. The municipality retains the legal title to the plant and all ownership responsibilities, continues to operate the plant, delivers services, sets the user fee rates, collects the user fees, makes upgrade and expansion decisions and pays for such changes. The U.S. corporation treats the lease as a purchase for Federal tax purposes and deducts the interest expense and depreciation expense from its gross rental income. Generally, deductions exceed the rental income and offset other income of the investor.

At the onset of the contractual arrangement, the municipality receives the \$100 million purported purchase price from the corporation. The funds for the \$100 million are provided by an equity investment by the U.S. corporation (approximately 15-20% of the \$100 million) and the remainder as a nonrecourse borrowing by the Trust. However, the municipality has an immediate right to an unrestricted use of only \$3 million of the \$100 million payment received from the corporation. The \$3 million is in essence an accommodation fee received by the municipality for entering into the long-term lease transaction with the U.S. corporation that provides the corporation the Federal income tax benefits of the interest expense deduction and the depreciation expense deduction at the corporate tax rate of 35 percent over the term of the lease. A portion of the remaining \$97 million is invested in U.S. Federal government-backed securities or other highly rated securities by the municipality. The municipality takes the majority of the \$97 million in an amount equal to the nonrecourse loan amount and deposits it into a deposit account held at an affiliate of the foreign lender or by the foreign lender itself. These two accounts are pledged as security for the municipality's obligations to the U.S. corporation and to the foreign lender, respectively.

The \$97 million deposit amount defeases both the municipality's rent obligations under the leaseback and the buyout option. The deposit account pledged to the foreign lender represents substantially all the funds necessary for the municipality to pay rent due under the leaseback, and the securities pledged to the U.S. corporation allow the municipality to exercise its buyout option at the end of the leaseback term. Thus, without any further cost or expenditure, the municipality may use the plant for the entire leaseback term and reacquire all rights to the plant at the end of the term.

Upon the expiration of the leaseback term, the municipality has the option to purchase the plant back from the U.S. corporation for a predetermined price. Typically, the highly-rated securities pledged to the U.S. corporation by the municipality will mature on the buyout date in the amount needed to fund the buyout price. If the municipality does not exercise the buyout option, the corporation has several alternatives: (1) Take possession of the plant, (2) Require the municipality to locate a third party to enter into a service contract, or (3) Compel the tax-exempt entity to

enter into the service contract. Under alternative (2), if the municipality fails to locate a third party, the municipality will be in default unless it enters into the service contract. The result of all of these arrangements for the disposition of the plant, at the end of the leaseback term, is that the municipality will exercise the buyout option because all the funds needed by the tax-exempt entity to exercise that option are available to that entity through the purchase of the highly-rated securities (known as the equity defeasance). In addition, given the nature of property such as a wastewater treatment plant, it is unlikely that the municipality will allow the property to be operated by a private corporation because of practical considerations, such as immunity from liability and employment agreements, and other political constraints.

SILO and LILO Transactions– Legal Considerations

The Internal Revenue Service is taking steps to combat abusive tax shelters and transactions. Tax shelters that are determined to be abusive are identified as “listed transactions.” Listed transactions require disclosure by participating corporations, individuals, partnerships, and trusts, in accordance with Treasury Regulations 1.6011-4T. You can view this list at www.irs.gov. Link to Businesses, Corporations, Abusive Tax Shelters and Transactions, and Listed Abusive Tax Shelters and Transactions for the following revenue ruling and coordinated issue paper:

Revenue Ruling 2002-69 - Lease In / Lease Out or LILO Transactions
Coordinated Issue Paper - Losses Claimed and Income to be Reported from Lease In / Lease Out Transactions

For a more in-depth analysis of the LILO transaction, the Coordinated Issue Paper, “Losses Claimed and Income to be Reported from Lease In/Lease Out Transactions”, provides citations, regulations, and court cases regarding LILO transactions and can be viewed at the web site indicated above. For your reference and further information on LILOs, the web site also contains Revenue Ruling 2002-69 – Lease In / Lease Out or LILO Transactions.

Pending Administration proposals and Congressional legislation address SILO transactions and contain provisions intended to statutorily restrict these arrangements or the tax benefits available from them. If your government entity is considering an agreement of this type, you should be aware of these legislative developments.

COMMENTS OR SUGGESTIONS?

We welcome
your comments
and
your suggestions
for information
you would like
to see in this newsletter.

Please
contact us
through our website at
www.irs.gov/govts.

TAXATION OF BENEFITS FOR VOLUNTEERS

BY DENISE Y. BOWEN, FSLG TAX LAW SPECIALIST

Introduction

In recent years, many states and local governments have created laws that provide incentives to emergency response volunteers in the form of relief from certain taxes. For example, in 1999, Connecticut adopted a law enabling local governments to give property tax relief to persons who volunteer their services as emergency responders. Subsequently, a number of municipalities created programs to provide partial property tax abatements or exemptions for residents of the municipality that volunteer their services as emergency medical technicians, ambulance drivers or firefighters. A similar law was also passed in New York authorizing local governments to grant a 10% property tax deduction to certain emergency volunteers with at least 5 years experience.

These state and local law provisions raise questions about the proper tax treatment of these benefits. The Office of Chief Counsel (CC) has concluded in several Chief Counsel Advice (CCA) memoranda that a local property tax abatement provided to volunteers in exchange for services is a taxable event under §61 of the Internal Revenue Code (IRC) as compensation for services (CCA is legal advice prepared by the national office component of the Office of Chief Counsel which is distributed to field employees of the IRS or the Office of Chief Counsel). In response to an inquiry on a similar volunteer case in Massachusetts, a CCA was issued on two occasions concluding that property tax abatements in exchange for volunteer services must be included in compensation for Federal income tax purposes. Shortly thereafter, CC issued another CCA concluding that the partial abatements and exemptions of property taxes under the Connecticut programs are includible in the gross income of the recipients.

The employment tax consequences of receiving property tax abatements or exemptions in exchange for services are significant. Because the workers in question are most likely employees, the amounts that they earn under the program will constitute wages that are subject to income tax withholding and social security and Medicare (FICA) taxes. The amount of wages will be equal to the value of the property tax liability forgiven. An employer is required to withhold and pay both the employer and employee portions of the FICA tax, even though the wages are paid in noncash payments. An employer is also required to deduct and withhold the income tax required to be withheld even though the wages are paid in noncash payments. If the employer pays the employee's FICA tax obligation or the income tax required to be withheld without receiving reimbursement from the employee, the amount of those payments will also constitute additional income to the employee under section §61 and wages for federal employment tax purposes. This article explains the legal basis for the taxability of these abatements and responds to questions that have been raised about possible exceptions from income and FICA taxation.

THERE IS NO
APPLICABLE
EXCLUSION UNDER
WHICH A PROPERTY TAX
ABATEMENT CAN
BE EXCLUDED
FROM A VOLUNTEER'S
INCOME.

I Basis for Taxation

Section 61(a) of the IRC defines gross income as all income from whatever source derived, including compensation for services. Unless an exclusion applies, gross income includes income realized in any form, whether in money, property or services. There is no applicable exclusion under which a property tax abatement can be excluded from a volunteer's income.

FICA taxes are imposed on both the employer and employee with respect to wages paid by employers to employees for employment. Specific exclusions from wages and employment are provided. The wage exclusions do not apply to this set of facts and are not considered for purposes of this article. There are several potentially applicable employment exclusions. However, the following application of the law and the facts concludes that the services performed by volunteers including volunteer firefighters do not meet the requirements for exclusion from either employment or income.

II Exclusion from Income

The only exclusion to the income recognition rules that requires examination in this case is the administrative exclusion for "general welfare" payments made by governmental entities. However, because property tax abatements constitute compensation for services performed by the volunteers the exception is inapplicable.

The IRS has consistently ruled that federal payments made under statutorily created social benefit programs for the promotion of the general welfare are nontaxable. The general welfare exception applies only to governmental payments out of a welfare fund based upon the recipients' identified need, and not where made as compensation for services. In response to the inquiry in the Connecticut case CC stated:

The services requirement makes the general welfare exception inapplicable to property tax reductions. Similarly, the requirement of services can change all or a portion of a scholarship that is otherwise excludable from income under §117, into taxable income to the scholarship recipient. This same analysis can be applied to the evaluation of whether the property tax abatements or exemptions meet the requirements for exclusion from income.

CC also noted that because volunteers provide services to municipalities and the municipalities benefit from the services, the abatements and exemptions cannot be treated as a rebate.

Whether a volunteer firefighter is an employee or independent contractor will determine whether the employer is required to withhold FICA and Federal income taxes. If the firefighter is an employee, the amounts earned under the program will constitute wages subject to the withholding and payment of FICA and income taxes.

III Worker Status

When making a worker status determination, the primary inquiry is whether the worker is

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an independent contractor or an employee under the common law standard. Generally, when workers are employees, the entity that employs them must withhold and pay FICA taxes. When a worker is an independent contractor, the government entity may have information reporting responsibilities, but is not required to withhold, report and pay FICA or income taxes on behalf of the worker.

If the relationship of an employer and employee exists, the designation or description of the parties as anything other than that of employer and employee is immaterial. Thus, if an employer-employee relationship exists, the fact that a worker is described as a volunteer is irrelevant.

In general, volunteers performing services for a state or local government will likely be employees under the direction and control of the government entity for which they are employed. Guidance for determining worker status is found in the Employment Tax Regulations (the Regulations) at §§31.3121(d)-1 and 31.3401(c)-1 for FICA and for income tax withholding, respectively. Information is also available in IRS Publications 15-A and 963 and at www.irs.gov/govts. If a government entity would like the IRS to make a determination whether a worker (or class of workers) is an employee, it can file Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding.

IV Exclusion from Employment

For purposes of the FICA, § 3121(b)(7) generally excludes from the term “employment” services performed by state and local government employees. Section 3121(b)(7)(F) effective for services performed after July 1, 1991, limits the general exclusion contained in § 3121(b)(7), and excludes from employment only the services of an employee who is a member of a retirement system maintained by a public employer. The rules for determining whether an employee is a “member of a retirement system” are set forth in § 31.3121(b)(7)-2 of the Regulations.

Whether an employee’s services are excepted from employment under § 3121(b)(7) turns on whether the employee is a qualified participant in a retirement system at the time services are performed. Although the concept of a retirement system is very broad, the system must provide a minimum benefit to an employee in order for the employee’s services to be excepted from employment. Determining whether a plan is a retirement system and whether an employee is a qualified participant in can be complex. For additional information see the Regulations § 31.3121(b)(7)-2, Rev. Proc. 91-40 1991-2 C.B. 694 and Publication 963.

Additional requirements under the Regulations apply to determine whether a part-time, seasonal or temporary employee is a “qualified participant” in a retirement system. A part-time employee for purposes of the FICA is defined as any employee who normally works 20 hours or less per week. A seasonal employee is any employee who normally works on a full-time basis less than 5 months in a year. A temporary employee, for this purpose, is any employee that performs services under a contractual arrangement with the employer for 2 years or less.

Part-time, seasonal and temporary employees are considered qualified participants in a retirement system on a given day only if the benefit relied upon to meet the minimum benefit requirement is 100 percent nonforfeitable or fully vested on that day. For example, if a part-time employee is not entitled to any benefits under a retirement system prior to the completion of 10 years of service, the nonforfeitability requirement is not met. Accordingly, those part-time employees are not qualified participants in a retirement system within the meaning of IRC § 3121(b)(7)(F), and therefore their services are not excluded from employment under IRC § 3121(b)(7).

Regardless of whether the employee is a member of a retirement system, wages paid to the employee will be subject to the Medicare portion of the FICA tax, unless the employee is eligible for the continuing employment section. In general IRC § 3121(u) provides that state and local government employees are subject to the Medicare tax unless the employee has been continuously employed with his or her employer since March 31, 1986. Additional information on the Medicare tax and the continuing employment exception can be found in IRS Publication 963, Federal-State Reference Guide, and in three Revenue Rulings, Rev. Rul. 2003-46, 2003-19 I.R.B. 878, Rev. Rul. 86-88, 1986-2 C.B. 172 and Rev. Rul. 88-36, 1988-1 C.B. 343.

Certain volunteers may assert that their services are excluded from employment under the emergency worker exclusion. Section 3121(b)(7)(F)(iii) provides that services performed by employees on a temporary basis in the case of fires, storm, snow, earthquake, flood or other similar emergency are exempt from employment, regardless of whether the employee is a qualified participant in a retirement system. This exclusion applies only to services of an employee who was hired due to an unforeseen emergency to do work in connection with that emergency on a temporary basis, for example, an individual hired to fight a major forest fire. Individuals performing services as volunteer firefighters on a regular but intermittent basis are not considered emergency workers within the meaning of § 3121(b)(7)(F)(iii).

IV Section 530 Relief

An employer may assert that it is eligible for relief under §530 of the Revenue Act of 1978 (§530). Section 530 provides relief from Federal employment tax obligations if certain requirements are met. For additional information on §530 see Publication 963 and Revenue Procedure 85-18, 1985-1 C.B. 518.

Conclusion

The performance of services in return for a benefit, including the cash value of all remuneration for services performed by an employee for his employer, is taxable under IRC §61 as compensation for services. Volunteers that receive partial property tax abatements or exemptions ultimately will have a lower property tax liability. The reduction in the property tax liability results in an in-kind payment in recognition of the services performed by the volunteer. If the volunteer is an employee, the normal FICA tax and income tax withholding rules apply to the in-kind payments.

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WAGE REPORTING FOR GOVERNMENT EMPLOYEES

BY BY GLORIA BROOKS, FSLG SPECIALIST (GULF COAST)

Introduction

Many public employees are subject to unique situations that apply to their employee wage reporting requirements. Since the early 1980s, significant changes to the application of the Social Security Act and the Internal Revenue Code have affected the responsibilities of public entities, especially state and local government employers. These changes involve a complex set of laws and regulations that provide for coverage, tax withholding and reporting requirements that do not apply to private sector employers. One of the unique reporting considerations of governmental employers is the proper reporting of wages paid to "Medicare Qualified Government Employees" (MQGE).

The term "Medicare Qualified Government Employees" originated in 1986. State and local government employees hired after March 31, 1986, are subject to mandatory Medicare coverage as a result of provisions contained in the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA '85). These MQGE employees are taxed for Medicare only when they are not covered under a Section 218 agreement or the mandatory social security coverage provisions in the Omnibus Budget Reconciliation Act of 1990 (OBRA'90). Employees who were hired prior to April 1, 1986, who are not covered by social security and Medicare under a Section 218 agreement or mandatory social security coverage, are exempt from both social security and Medicare taxes. The public sector employer may, therefore, have several employment situations that involve different wage reporting requirements for any given year.

Medicare Qualified Government Employees

Specific guidelines exist for employers of Medicare Qualified Government Employees. These employers should separately file Forms W-2 for each employee subject to Medicare only taxation for the entire year from employees who are subject to both Social Security and Medicare taxation. These Forms W-2 should be transmitted with a separate Form W-3, with "Medicare Government Employee" checked in the appropriate box of Form W-2. Magnetic media filers should segregate the MQGE employees into a separate set of employee records.

Employees Covered By Full Social Security and Medicare and MQGE

Government employers with employees who are subject to both Medicare only withholding and employees subject to withholding of both social security and Medicare taxes during one year should follow specific guidelines in filing W-2 forms. In these cases, when the employee has a continuous employment

STATE AND
LOCAL
EMPLOYEES
HIRED AFTER
MARCH 31, 1986,
ARE SUBJECT TO
MANDATORY
MEDICARE
COVERAGE.

relationship with the same employer during the year, the employer has a choice of two reporting methods for each employee:

Prepare a single Form W-2 – The employer may prepare a single Form W-2 for the employee with the total annual wages in Box 1 (Wages, tips, other compensation), Box 3 (social security wages) and Box 5 (Medicare wages) should show the total wages subject to each tax during the year.

Prepare separate Forms W-2 – The employer may use a separate Form W-2 for each withholding category. One Form W-2 should report wages subject only to Medicare taxes, and a second Form W-2 should report wages subject to both social security and Medicare taxes. When you use this option, you must segregate Forms W-2 and report with a separate Form W-3 for each of the two categories. The Forms W-2 containing Medicare only tax must be attached to the W-3 with the “Medicare govt. emp.” box checked. The Forms W-2 containing both social security and Medicare tax must be attached to the Form W-3 with the “941” box checked.

The Social Security Administration prefers the use of a single Form W-2 to support its edit processes.

If you have questions about your Form W-2 filing requirements, contact your FSLG Specialist. If you have questions about the transmission or processing of Forms W-2 documents, contact the Social Security Administration.

FEDERAL, STATE AND LOCAL GOVERNMENTS CONTACTS

STATE	SPECIALIST	TELEPHONE NUMBER	EXT.
Alabama	Judy Nichols John Givens	(251) 340-1781 (251) 340-1761	
Alaska	Gary Petersen	(907) 456-0317	
Arkansas	Jan Germany	(501) 324-5328	253
Arizona	Kim Savage	(928) 214-3309	5
California	Gordon Parker Phyllis Garrett	(909) 388-8161 (213) 576-3765	
Colorado	Karen Porsch Chuck Sandoval	(719) 579-0839 (303) 446-1156	231
Connecticut	Phyllis Burnside	(401) 525-4205	
Delaware	Kevin Mackesey	(302) 856-3332	12
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Idaho	Karen Porsch	(719) 579-0839	231
Illinois	Ted Knapp Joyce Reinsma Janie Smith	(618) 244-3453 (312) 566-3879 (630) 493-5148	
Indiana	Valerie Hardeman	(317) 226-5305	
Iowa	David Prebeck	(515) 573-4120	
Kansas	Gary Decker Allison Jones	(316) 352-7475 (316) 352-7443	
Kentucky	Ray McLennan	(270) 442-2607	127
Louisiana	Gloria Brooks Robert Lettow	(225) 389-0358 (318) 869-6312	119
Maine	Bob Westhoven	(207) 784-6988	
Maryland	James A. Boyd	(410) 962-9258	
Massachusetts	Mark A. Costa	(617) 320-6807	
Michigan	Daniel Clifford Lori Hill	(313) 628-3109 (906) 228-7831	
Minnesota	Pat Wesley	(218) 720-5305	225
Mississippi	John Givens Robert Lettow	(251) 340-1761 (318) 869-6312	

CALENDAR OF EVENTS

We will use this calendar to keep you informed of major regional or national events in which FSLG will be participating in the coming months. We will also list local events as space allows. For more detailed information, visit www.irs.gov/govts or contact your local FSLG Specialist.

**National Association of
State Budget Officers**

**Annual Meeting
July 11-14, 2004**

Portland, Maine
Nasbo.org

**National Association of Counties
Annual Conference and Exposition
July 16-20, 2004**

Phoenix, Arizona
Naco.org

**National Association of College and
University Business Officers**

**Annual Meeting
July 17-20, 2004**

Milwaukee, Wisconsin
Nacubo.org

**National Conference of State Social
Security Administrators**

**Annual Conference
July 25-28, 2004**

Merrimack, New Hampshire
Ncsssa.org

FEDERAL, STATE AND LOCAL GOVERNMENTS CONTACTS

STATE	SPECIALIST	TELEPHONE NUMBER	EXT.
Missouri	Joe Burke	(636) 940-6389	
	Sharon Boone	(417) 841-4535	
Montana	Katherine Dees	(406) 761-1825	229
Nebraska	Thomas Goman	(402) 361-0202	
Nevada	Gordon Parker	(909) 388-8161	
New Hampshire	Bob Westhoven	(207) 784-6988	
New Jersey	Pat Regetz	(908) 301-2119	
New Mexico	Toni Holcomb	(505) 527-6900	232
New York	Martin Boswell	(315) 233-7302	
	Henry Ng	(212) 719-6600	
	Fran Reina	(315) 793-8171	
North Carolina	Clifford Brown	(803) 253-3523	
North Dakota	Al Klamon	(701) 227-0133	
	Rhonda Kingsley	(701) 239-5400	261
Ohio	Trudee Billo	(419) 522-2359	
	Amy Genter	(419) 522-2259	
Oklahoma	Pat O'Neil	(405) 297-4895	
Oregon	Marilee Basaraba	(503) 326-5030	
	Sue Ann Jansen	(503) 326-5057	
Pennsylvania	Patricia Crawley	(215) 861-1364	
	Doug Siegert	(412) 395-4871	
	Nora Bliven	(717) 291-1991	118
Rhode Island	Phyllis Burnside	(401) 525-4205	
South Carolina	Clifford Brown	(803) 253-3523	
South Dakota	Marlyce Luitjens	(605) 226-7216	231
Tennessee	Ray McLennan	(270) 442-2607	127
Texas	Oliverio Martinez	(972) 308-1180	
	Steve O'Brien	(512) 464-3120	
	Robert Jackson	(281) 721-7993	
	Susan Serrano	(512) 499-5435	
Utah	Katherine Dees	(406) 761-1825	229
Vermont	Fran Reina	(315) 793-8171	
Virginia	Eugenia Bahler	(703) 285-2350	138
	Michael Durland	(540) 887-2600	18
Washington	Clark Fletcher	(425) 489-4042	
West Virginia	Michael Durland	(540) 887-2600	18
Wisconsin	Susan Borchart	(414) 297-1672	
	Ruthann Watts	(262) 513-3520	
Wyoming	Dwayne Jacobs	(307) 672-7425	33

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TAX-EXEMPT BONDS: ABUSIVE TAX AVOIDANCE TRANSACTIONS

BY JOSEPH GRABOWSKI, SENIOR TEB ANALYST

The legislative history to the 1989 Tax Reform Act specifically provides that the terms “investment plan or arrangement” and “other plan or arrangement” include Tax Exempt Bonds (TEB) issued by state or local governments with regard to the use of those terms in section 6700 of the Internal Revenue Code. In 1993, the General Accounting Office encouraged the IRS to use the provisions of section 6700 of the Code to counter the growing use of tax-exempt bonds for improper purposes. Since the inception of the current TEB examination program, TEB agents have uncovered a significant level of arbitrage-motivated bond transactions.

Examination of abusive transactions has been identified as an examination priority/focus area in all of the TEB workplans. In 2001, a senior TEB group manager was appointed as the TEB Fraud Coordinator and he has been working closely with the fraud coordinators of the other IRS business units. This manager is also “the TEB IRC 6700 Coordinator” and is responsible for assisting other managers in the development of cases having IRC 6700 as a potential issue.

To the extent permitted by the disclosure provisions of the Internal Revenue Code, the Office of TEB works cooperatively with our counterparts at the Securities and Exchange Commission (SEC), National Association of Securities Dealers (NASD), Municipal Securities Rulemaking Board (MSRB), office of State Auditors and Treasurers and other agencies to identify abusive arbitrage-motivated transactions. TEB also researches the internet, newspapers and trade journals, such as the Bond Buyer and the Wall Street Journal, to identify potential abusive transactions.

During FY 2004, TEB is focusing on the following types of abusive tax schemes:

- Pooled financing where the issuer’s expectations to loan the proceeds of the bonds to conduit borrowers were unreasonable and most of the proceeds were not loaned. Also, payments to third parties involved in multiple financial transactions, such as GICs, and swaptions to divert arbitrage earnings to pay up-front issuance costs;
- Put options purchased by the issuer simultaneously with the purchase of escrow securities in connection with advance refunding bonds. The cost of the put option is diversion of the arbitrage earnings on the escrow securities to the seller of the put option and violates the requirements of section 148 of the Code;
- The payment of unreasonable, excessive GIC broker fees or Swap broker fees in connection with the GICs or Swaps purchased by issuers of certain bonds;

EXAMINATION OF
ABUSIVE
TRANSACTIONS HAS
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EXAMINATION
PRIORITY/FOCUS AREA
IN ALL OF THE TEB
WORKPLANS.

- Payment of more than Fair Market Value for the escrow securities acquired with proceeds of advance refunding bonds. As a result, the yield on the escrow securities is artificially reduced to meet the requirements of section 148 of the Code;
- Issuance of Tax and Revenue Anticipation Notes (TRANS) where the issuer manipulates its accounting methodology in order to issue a greater principal amount of TRANS than allowable; and
- Land based financings with inflated valuations.

For more information on abusive transaction in TEB,
visit the TEB website at
www.irs.gov/bonds.

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