

**The Tax Exempt and Government Entities  
Division Strategy for Abusive Tax Avoidance  
Transactions Needs Further Development**

**September 2004**

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**This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.**



DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

INSPECTOR GENERAL  
for TAX  
ADMINISTRATION

September 29, 2004

MEMORANDUM FOR COMMISSIONER, TAX EXEMPT AND GOVERNMENT  
ENTITIES DIVISION

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FROM: Gordon C. Milbourn III  
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Tax Exempt and Government Entities  
Division Strategy for Abusive Tax Avoidance Transactions  
Needs Further Development (Audit # 200410014)

This report presents the results of our review of the Tax Exempt and Government Entities (TE/GE) Division's Abusive Tax Avoidance Transaction (ATAT) Program. The overall objective of this review was to assess the adequacy of the TE/GE Division management's efforts to stop ATATs within the TE/GE Division's customer base.

The ATATs present a formidable compliance challenge to the Internal Revenue Service (IRS). According to the Government Accountability Office,<sup>1</sup> the United States Department of the Treasury loses up to \$18 billion a year from the ATATs. If allowed to go on unimpeded, the ATATs could undermine voluntary compliance by reducing the level of trust that responsible taxpayers have in the integrity of the tax system. IRS management determined that the variety, size, and nature of tax shelters require an organized approach to detection, deterrence, and enforcement so that the use of abusive transactions can be stopped.

In summary, TE/GE Division management has recently begun to develop a division-wide program to address ATATs within its customer segments. Prior to the division-wide program, most of the TE/GE Division functional offices independently developed their own processes to identify and address the ATATs and to communicate information about the ATATs to employees, customers, and other IRS offices. The functional offices were given the latitude to develop their own methodologies because of the belief that processes developed independently would better serve the extremely varied customer base and regulatory authority.

However, the individual processes alone do not provide TE/GE Division management with the assurance that ATATs are being identified and addressed division-wide in accordance with the IRS' and the Department of the Treasury's strategy. We

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<sup>1</sup> Formerly the General Accounting Office.

determined that the TE/GE Division needs to develop some common processes to identify and reduce the ATATs within their customer base.

We recommended the Commissioner, TE/GE Division, provide the functional offices with guidance in developing common processes to ensure a unified approach to addressing the ATATs. This should include identifying the ATATs during and outside of their normal work processing, identifying similar ATATs after known cases are identified, communicating information about known or potential ATATs to others that have a need to know, and tracking adequate management information so TE/GE Division management can evaluate the success of their program.

Management's Response: The Commissioner, TE/GE Division, agreed with our recommendations and will provide additional guidance to TE/GE Division functional offices to take better advantage of common processes. Specifically, the TE/GE Division ATAT Executive Steering Committee will review the ATAT processes in place in each of the TE/GE Division functions and identify those processes which, if uniformly applied across the TE/GE Division's entire customer base, will help identify and reduce ATATs within the TE/GE Division's jurisdiction; review existing TE/GE Division ATAT communication programs and develop guidelines to ensure consistency and best practices in communicating with employees, the other IRS operating divisions, and the TE/GE Division's client base; and adopt the use of the ATAT tracking database developed by the Deputy Commissioner for Services and Enforcement. The database will track information such as the number of ATATs identified and ATAT results from examinations and determinations. Management's complete response to the draft report is included as Appendix IV.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.

**The Tax Exempt and Government Entities Division Strategy for Abusive  
Tax Avoidance Transactions Needs Further Development**

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### Background

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Abusive Tax Avoidance Transactions (ATAT) are specific transactions or schemes that reduce tax liability by taking a tax position that is not supported by the Internal Revenue Code (I.R.C.) or manipulates the law in a way that is not consistent with its intent. During the 1970s and 1980s an explosion of tax shelters threatened not only revenue, but also general taxpayer confidence in the Federal tax system. Compared to the complexity and wide variety of the ATATs that exist today, the early tax shelters were unsophisticated and were aimed primarily at high-income individuals. The Congress recognized the danger posed by these tax shelters and enacted legislation to reduce their use.

Beginning in the 1990s, there was resurgence in the use of the ATATs. However, these transactions are more complex and sophisticated than the earlier ones and sometimes involve international banking transactions. For example, two abusive transactions that involve Tax Exempt and Government Entities (TE/GE) Division customers are the Producer Owned Reinsurance Companies (PORC) and misuse of the Corporation Sole form of organization.

- The PORCs are typically small insurance companies that meet certain criteria for tax-exempt status. Some United States retailers have established the PORCs to improperly route income earned from the sale of insurance contracts through the PORC to avoid paying taxes. These insurance companies are generally located outside the United States.
- Corporation Sole organizations are improperly used as a one-person church that routes all of an individual's personal financial activity through the church to avoid paying taxes.

The ATATs present a formidable compliance challenge to the Internal Revenue Service (IRS). According to the Government Accountability Office,<sup>1</sup> the United States Department of the Treasury loses up to \$18 billion a year from the ATATs. If allowed to go on unimpeded, the ATATs could undermine voluntary compliance by reducing the level of trust that responsible taxpayers have in the integrity of the tax system. IRS management determined

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<sup>1</sup> Formerly the General Accounting Office.

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that the variety, size, and nature of tax shelters require an organized approach to detection, deterrence, and enforcement so that the use of abusive transactions can be stopped.

In March 2002, the IRS and the Department of the Treasury developed a strategy to identify and deter promoters of abusive tax transactions. These efforts include:

- Vigorously enforcing the disclosure, registration, and list maintenance requirements under I.R.C. Sections (§) 6011,<sup>2</sup> 6111,<sup>3</sup> and 6112.<sup>4</sup>
- Identifying and notifying the public early about questionable transactions.
- Prioritizing the use of resources to identify promoters of tax shelters and abusive transactions.

In addition, the IRS implemented transaction-specific task forces to address different tax shelters.

The TE/GE Division has three primary functional offices to support the needs of its distinct customer segments.

- The **Employee Plans** (EP) function is responsible for ensuring that employee and individual retirement plans comply with the appropriate laws and regulations.
- The **Exempt Organizations** (EO) function is responsible for ensuring that organizations exempt from Federal income tax comply with the I.R.C. and related regulations.

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<sup>2</sup> 26 U.S.C. § 6011 (2003) requires that any person made liable for any taxes due as a result of income tax regulations shall file an appropriate return or form as prescribed by law with the appropriate information as requested on the return or form.

<sup>3</sup> 26 U.S.C. § 6111 (2003) requires that any tax shelter organizer shall register the tax shelter with the Secretary of the Treasury not later than the day on which the first offering for sale of interests in such tax shelter occurs.

<sup>4</sup> 26 U.S.C. § 6112 (2003) requires that any person who organizes any potentially abusive tax shelter, or sells any interest in such a shelter, shall maintain a list identifying each person who was sold an interest in such shelter and containing such other information as the Secretary of the Treasury may by regulations require.

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- The **Government Entities** (GE) function is further divided into three offices to support the needs of its three distinct customer groups:
  - The Federal, State, and Local Governments (FSLG) office is primarily responsible for tax compliance and outreach activity related to employment tax and informational reporting obligations of approximately 88,000 Federal agencies, quasi-governmental entities, state agencies, and local governments.
  - The Indian Tribal Governments (ITG) office is responsible for coordinating tax issues with 564 Federally recognized Indian Tribes and their related business entities.
  - The Tax Exempt Bonds (TEB) office is responsible for administering the Federal tax laws applicable to the tax-exempt bonds industry.

This review was performed at the TE/GE Division Headquarters Offices in Washington, D.C.; the TE/GE Division's EP, EO, and GE functional offices in Washington, D.C.; the EP Examinations Office in Baltimore, Maryland; and the EO Examinations Office in Dallas, Texas, during the period February through June 2004. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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### A Division-wide Strategy Was Started, but Further Development Is Needed to Identify and Address Abusive Tax Avoidance Transactions

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TE/GE Division management has recently begun to develop a division-wide program to address the ATATs within its customer segments. Prior to the division-wide program, most of the TE/GE Division functional offices independently developed their own processes to identify and address the ATATs and to communicate information about the ATATs to employees, customers, and other IRS offices. The functional offices were given the latitude to develop their own methodologies because of the belief that processes developed independently would better serve the extremely varied customer base and regulatory authority. However, the individual processes alone do not provide TE/GE Division management the assurance that the ATATs are

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being identified and addressed division-wide in accordance with the IRS' and the Department of the Treasury's strategy.

TE/GE Division management initially participated on a limited basis with the other three IRS operating divisions to address the ATATs. They initially thought that the IRS strategy to address the ATATs in the for-profit sector generally did not apply to addressing abuse issues raised in segments of the tax-exempt customer base. However, they have since determined that their customers' involvement in the ATATs can take two forms: the use of a TE/GE Division customer entity as a vehicle to facilitate tax avoidance by other, taxable entities, as well as the direct participation by a TE/GE Division customer entity in a tax avoidance transaction.<sup>5</sup>

The following actions have been taken to address the ATATs in the TE/GE Division customer base:

- The Commissioner, TE/GE Division, designated the Senior Technical Advisor (STA) in November 2002, as the TE/GE Division representative on the Servicewide ATAT Executive Steering Committee (ESC). In August 2003, the STA was assigned responsibility for coordinating the ATAT activities within the TE/GE Division. These responsibilities have continued to grow and currently include disseminating information to TE/GE Division functional offices, serving on the EO and EP functional ATAT committees, and coordinating and representing the TE/GE Division with other IRS operating divisions.
- The Commissioner, TE/GE Division, established the TE/GE Division ATAT ESC in February 2004. The TE/GE Division ATAT ESC provides a forum for:
  - Overseeing and sharing information regarding the various ATAT initiatives within the TE/GE Division.
  - Allowing the STA and other TE/GE Division representatives to share information from the

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<sup>5</sup> In April 2004, the Department of the Treasury and the IRS exercised their authority under the tax shelter regulations to specifically designate a tax-exempt party as a "participant" in a tax avoidance transaction.



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Servicewide Abusive Transaction (SAT) ESC meetings.

- Sharing best practices and important developments from within the TE/GE Division.
- The TE/GE Division Fiscal Year (FY) 2004 – FY 2005 Strategy and Program Plan, issued September 2003, included the following operating priorities: develop education and examination strategies to identify and counter abusive ATATs in the EP functional office, collaborate with the Department of Labor to prevent abusive retirement transactions, establish an EO functional office Fraud and Financial Transactions Unit, combat abusive tax shelters and other abusive tax schemes in the EO functional office, and develop education and examination strategies to identify and counter abusive tax schemes within the GE functional office. Some of the initiatives in this plan have not yet been implemented.
- The IRS recognized the emerging concern with the ATATs within the tax-exempt community in the FY 2005 – FY 2009 Strategic Plan, issued June 2004, which lists the following objective: *“Deter Abuse within Tax Exempt and Governmental Entities and Misuse of such Entities by Third Parties for Tax Avoidance or Other Unintended Purposes.”*

Although these are good initial steps in developing an approach to address the ATATs, we determined that the TE/GE Division needs to develop some common processes to identify and reduce the ATATs within their customer base. These include the ability to:

- Identify the ATAT indicators in their customer base during normal processing.
- Identify the ATAT indicators in other cases after known cases are first identified.
- Identify (proactively) new ATATs outside normal processing.
- Communicate the ATAT awareness to their staff, customer base, and other operating divisions.

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- Track adequate information, such as the number of ATATs identified, examinations completed, penalties applied, tax-exempt status revoked, additional listed transactions identified, etc., so TE/GE Division management can evaluate the success of the program.

Some functional offices have developed several of the needed processes; however, none of the TE/GE Division functional offices have developed processes for all of the above activities.

### **Most functional offices have some processes to identify indications of the ATATs within their customer base**

Regular work processes (e.g., examinations, determination processing) and third-party referrals represent the largest opportunity to identify indications of the ATATs in each of the TE/GE Division's functional offices. During regular processing, TE/GE Division employees with the appropriate skills<sup>6</sup> and ATAT awareness may identify instances of potential manipulation of the tax law or situations that may need further research to determine if the transactions are abusive. We determined four (the EP and EO functions and the TEB and ITG offices) of the five functional offices have some type of process in place to help identify indications of the ATATs during normal work processing and by internal and external referrals.

The following shows the processes that have been implemented in these four functional offices and any planned actions for improving the processes:

- In the EO function, employees were made aware of abusive filing characteristics during initial job training to improve their ability to identify potential ATATs during regular work processing. EO functional office management advised that training to recognize ATATs is essential since abusive organizations are generally organized and operated in a manner that appears similar to legitimate tax-exempt organizations.
  - Determination specialists review applications for exemption to determine if organizations meet the

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<sup>6</sup> Employees with the appropriate skills include determination specialists, field examination agents, and classifiers.

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requirements for recognition as exempt from Federal income tax. Touch-and-Go Procedures (TAG) were created to identify determination cases early in the process that may involve inconsistent application of tax law or abusive filings. When abusive filing characteristics are identified, the applications are routed through the employees' managers to determination coordinators, who assesses whether the case should be sent to the EO function ATAT Committee for further evaluation.

- Classifiers in the EO function Classification Unit review all internal and external referrals to determine if the issues should be examined. When indications of abusive allegations are identified, classifiers use techniques from a reference guide developed to help identify potential ATATs during the classification process. The guide provides examples of what employees should look for to determine if cases have the potential to be considered ATATs. If the cases are determined to be ATATs, they are routed directly to the EO function ATAT Committee for further evaluation.
- The EO function Field Examination agents review records of exempt organizations to determine if they merit continued exemption and to determine if the exempt organizations are liable for other taxes. The agents are trained to identify instances where tax positions are not supported by the I.R.C. If indications of abusive transactions are recognized, the agents generally contact the field coordinators and forward a copy of the case to the EO function ATAT Committee. The agents will continue to address the examination issues with guidance from the EO function ATAT Committee.

The EO function ATAT Committee, established in March 2004, serves as the central point to screen, review, and track information on abusive transactions and makes recommendations regarding how the cases should be addressed. When other IRS divisions' customers are also involved in the EO ATAT, the

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Committee coordinates with those divisions to ensure that the ATAT issues are fully addressed.

EO function management plans to strengthen their employees' ability to recognize potential ATATs by developing more in-depth, specific training for their examiners and agents on how to identify indications of current ATATs.

- In the EP function, employees were made aware of abusive filing characteristics to improve their ability to identify potential ATATs during regular work processing.
  - Determination specialists review applications of retirement plans to ensure the forms of the plans meet the qualification requirements of the I.R.C. When abusive filing characteristics are identified, the specialists contact a technical consultant if the abusive characteristics indicate a listed transaction.<sup>7</sup> Otherwise, the applications are routed to the EP function ATAT Coordinator for further guidance.
  - Referral specialists in the EP function Classification Unit review all internal and external referrals to determine if the issues should be examined. When abusive allegations are identified, they are routed to the field for examination and the EP function ATAT Coordinator is notified.
  - The EP function Examination agents review records of employee plans to determine if they are operated in accordance with the I.R.C. The agents are trained to identify instances where tax positions are not supported by the I.R.C. If indications of a listed transaction are recognized, the agent discusses the case with his or her manager, forwards pertinent case information to the EP function ATAT Coordinator, and contacts the technical consultant for the current enforcement strategy. For other abusive indicators,

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<sup>7</sup> A listed transaction is a transaction that is the same as or substantially similar to one that the IRS has determined to be a tax avoidance transaction and identified by an IRS notice or other form of published guidance.

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the agents provide pertinent information to the EP function ATAT Coordinator and continue to process the case.

The EP function ATAT Coordinator, established in March 2004, makes the initial evaluation of the ATAT referrals and is the central point of contact for the ATATs in the EP function. After evaluation by the EP function ATAT Coordinator, potential ATATs are forwarded to the Issue Development Team for further evaluation and development of recommendations to address the ATAT throughout the customer base. Based on the characteristics of the ATAT, the referral could be forwarded to the SAT ESC, the Office of Chief Counsel, or an EP function Development Team where a technical advisor could be assigned to coordinate the resolution strategy for the ATAT.

- The TEB office employees were made aware of abusive filing characteristics during formal job training to improve their ability to identify potential ATATs during regular work processing. The TEB office generally considers an abusive bond transaction to be any bond issuance that contains improprieties in the sale and use of the bond that would justify applying civil penalties under I.R.C. § 6700.<sup>8</sup> These transactions are addressed as part of the normal TEB workload. TEB management advised that several multi-million dollar penalties have been assessed against bond underwriters and counsel involved in abusive transactions.
  - All information items/referrals are forwarded to the Outreach, Planning and Review (OPR) office for consideration. The managers of the OPR and Field Operations (FO) offices have established a Classification Panel to determine the examination potential of each information item/referral. The referrals selected are forwarded to the FO office

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<sup>8</sup> 26 U.S.C. § 6700 (2003) penalizes any person who organizes or sells a plan or arrangement and makes in connection therewith a statement regarding the allowability of any deduction or credit, excludability of income, or the securing of any other tax benefit that the person knows or has reason to know is false or fraudulent as to any material matter.

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manager for further evaluation and can be surveyed<sup>9</sup> or assigned to an FO office group for examination.

- The FO office manager can initiate an I.R.C. § 6700 examination with concurrence of the Director, TEB. If the Director, TEB, determines there is a need for further consideration, the approval request is forwarded to and discussed by members of the TEB I.R.C. § 6700 Committee, which will either approve, deny, or hold (pending additional justification) the request to open an I.R.C. § 6700 examination.

Requests for I.R.C. § 6700 examinations on bond promoters not materially involved in an open examination are reviewed by the TEB I.R.C. § 6700 Coordinator (appointed in August 2002) and forwarded to the TEB Referral Committee for consideration. If a request is approved, the Director, TEB, is notified for concurrence 3 days prior to the request being forwarded to the FO office manager. During the 3-day waiting period, if the Director, TEB, determines there is a need for further consideration, the approval request will be forwarded to and discussed by members of the TEB I.R.C. § 6700 Committee.

Use of the TEB I.R.C. § 6700 Committee ensures consistent application of the I.R.C. § 6700-penalty investigations.

- Indian tribes are not subject to income tax but could be used as a third party of abusive schemes to evade/avoid taxes. ITG office management's focus regarding the ATATs has been on the development and implementation of an education and partnering effort with Indian tribes to identify promoters and disseminate information on schemes. The ITG office has concentrated its efforts on educating tribes and making them aware that they could be used to perpetrate the ATATs.

In addition, the Director, ITG, established and assigned a manager and 3 agents to the Abusive Detection and

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<sup>9</sup> A case is surveyed if it is not examined.

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Prevention Team (ADAPT) in March 2004. The team will address cases where the abusive transactions rise to the criminal level and have the potential for expansion. They have focused on addressing fraud issues, tax shelter activities, 31 U.S.C.<sup>10</sup> abuses, the use of tribal entities to avoid proper reporting and oversight of transactions, fuel excise tax and casino income abuses, per capita payment schemes, and the selling of bogus tribal memberships. The team will undertake compliance actions to remedy identified noncompliance, and will also be charged with undertaking preventative actions to reduce growth of abusive schemes.

Currently, the ITG office has little ability to detect the ATAT schemes through their limited customer data because their customers do not file income tax returns. Many abusive schemes use the tax-exempt status of organizations such as tribal governments to evade or avoid taxes on income. However, the ITG office has performed limited computer data analysis to determine if there are indications that their customers may be participating in two types of abusive schemes.

- Deferred Compensation Distributions – Distribution of income from gaming to the tribal members is taxable to the members if not distributed under appropriate circumstances. This scheme involves making distribution under fictitious circumstances to avoid the payment of taxes. The distribution is generally given in the form of a loan that does not have to be repaid. The member is instructed to purchase insurance that will repay the loan at death.
- Employee Leasing – This scheme involves the tribes entering into agreements to lease employees to avoid paying employment tax.
- The FSLG office has not implemented processes and has not applied significant resources in an effort to identify potential ATATs within their customer base; however, they did inform us of the following.

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<sup>10</sup> 31 U.S.C. (2002) refers to the part of the United States Code that relates to Money and Finance.

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- The FSLG office has direct enforcement responsibilities for employment tax issues. When employment tax issues are identified as abusive (e.g., if it is a listed transaction or by designation by the Director, GE), the FSLG office is responsible for identifying their customer's role in the scheme and examining the issue, including working with other IRS operating divisions when necessary.
- The FSLG office's responsibility for issues other than employment tax is to refer to the appropriate IRS operating division any leads identified during the course of their employment tax examinations. The FSLG office specialists are to be alert to facts that may suggest a government entity is engaged in an ATAT as an accommodation party or otherwise involved (i.e., lease-in lease-out [LILO] or sales-in lease-out [SILO] transactions).

While these transactions do generate significant tax benefits to taxable parties, the FSLG office customers do not derive any Federal income tax benefits. The FSLG office has made two referrals regarding LILO/SILO transactions. These transactions were discovered by field specialists and forwarded to the FSLG office management. The referrals were subsequently forwarded to another IRS operating division.

- The FSLG office management appointed the manager, Outreach, Planning and Review (OPR), as its ATAT Coordinator. At the time of our fieldwork, a position description outlining the responsibilities and duties of the position had not been developed.
- The FSLG office management is developing procedures for their specialists to follow if they encounter an ATAT or an emerging issue that could be considered abusive.

LILO transactions are now more prevalent than originally thought and are a widespread concern. According to a Department of the Treasury spokesperson, these transactions involve billions of dollars in assets and represent a substantial loss to the



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Department of the Treasury. The LILO transactions involve an arrangement between government entities and private companies, involving the sale or lease of public facilities such as subways, bridges, stadiums, and dams to private companies, in exchange for a fee paid by a shelter promoter. A simultaneous arrangement is made to lease the facility back to the government. This allows the private business to claim large depreciation deductions without assuming any risk of ownership.

### **Most functional offices have processes or the ability to identify similar ATATs within their customer base**

Once a potential ATAT is identified, the TE/GE Division functional offices should have processes in place to identify similar ATATs within their existing customer base and current inventory. We determined that four of the five functional offices (the EP and EO functions and the TEB and ITG offices) have developed processes or took other actions to help identify additional cases with characteristics similar to those previously identified. However, development of these processes should continue until all functional offices within the TE/GE Division have the ability to identify the ATATs with characteristics similar to those previously identified.

- The EO function uses its TAG procedures for Determinations and Field Examinations to identify similar ATATs within their customer base. After an abusive transaction is identified, alerts are issued to EO function managers to share with their specialists. Also, a spreadsheet listing abusive cases is distributed monthly.

In addition, the EO function took additional actions on several occasions after the ATATs were identified in their customer base. For instance, after determining that certain I.R.C. § 501(c)(15)<sup>11</sup> organizations (i.e., PORCs) were being used in the ATATs, the EO function established procedures to ensure that similar new

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<sup>11</sup> Under 26 U.S.C. § 501(c)(15) (2003), certain insurance companies are granted tax exemption if they do not write life insurance policies and if they do not write premiums in excess of \$350,000 for the taxable year.

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organizations that submit applications for tax-exempt status met all of the requirements before approval.

The determination process was centralized for PORC cases at their Headquarters Office and the applications were reviewed by a core group of experienced legal staff. In addition, the I.R.C. § 501(c)(15) Coordinating Committee researched the Returns Inventory and Classification System (RICS)<sup>12</sup> database and selected approximately 214 potential abusive cases for manual classification and review. The Coordinating Committee worked with representatives from other IRS operating divisions to review the 214 cases. Twenty-six of the 214 cases were opened for examination to determine if the organizations took a tax position not supported by the I.R.C., or if they manipulated the tax law in a way that is not consistent with its intent.

The EO function has established compliance teams for four other categories of organizations where abuses have been detected. The compliance teams are at various stages of addressing the issues. They include the following abusive areas:

- Donor-Advised Funds – Organizations established for the purposes of generating questionable charitable deductions, providing impermissible economic benefits to the donors and their families, and providing management fees for the promoters.
- Supporting Organizations (SO) – Organizations established to make significant tax-deductible contributions and maintain control of the money to be used for personal purposes. For example, a promoter or donor forms an SO and contributes stock to it. The SO sells the stock and invests the proceeds with what appears to be a legitimate investment company, or loans the proceeds back to the donor's family business. In reality, the promoter controls the investment company and, therefore,

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<sup>12</sup> The RICS is an IRS computer system that provides user access to return and filer information related to the filing and processing of EP, EO, and GE forms.

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maintains control of the money for personal purposes.

- Housing and Urban Development (HUD) Program – Organizations established to use proceeds from the sale of HUD Program homes to inappropriately benefit the principals of the organization instead of using the proceeds to support its exempt purpose.

One of HUD's programs is to provide homes at a discount to tax-exempt organizations. The organizations can resell the homes for a profit as long as the proceeds from the sale go back into the organization to support the tax-exempt purpose.

- Credit Counseling – Organizations that charge excessive fees to low-income customers for debt management services instead of providing education on how to manage personal finances. The organizations often charge excessive fees to the debtor that only worsen the credit problems that caused the debtor to turn to the counseling organization in the first place.

- The EP function developed a process to identify transactions similar to the existing ATATs. They query computer databases and poll the staff for open examinations or determinations that may be similar to existing employee plans or previously closed determination applications identified to be potential ATATs. For example, after the identification of a potential ATAT related to I.R.C. § 412(i),<sup>13</sup> the EP function analyzed the RICS data and identified almost 8,000 Form 5500<sup>14</sup> and Form 5500-EZ<sup>15</sup> returns that contained an I.R.C. § 412(i) indicator. Guidance in the form of an Interim Audit Guide and Examination Project Guidance was issued to agents and a sample of 30 of these cases was sent to the field for examination in March 2004.

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<sup>13</sup> 26 U.S.C. § 412(i) (2003) defines certain insurance contract plans as they relate to qualified retirement plans.

<sup>14</sup> Annual Return/Report of Employee Benefit Plan (Form 5500).

<sup>15</sup> Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan (Form 5500-EZ).

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After the S Corporation<sup>16</sup> Employee Stock Ownership Plan (ESOP)<sup>17</sup> Effective Date<sup>18</sup> abusive transaction was identified, the EP function searched the determination database and identified 20 approved plans similar to previously identified abusive plans. TE/GE Division management advised that guidance was issued to EP function determination employees, providing criteria about which ESOPs could be processed and closed, and what to look for during determination application processing. As a result, the practitioners who submitted these plans withdrew the majority of them.

In another example, after the S Corporation ESOP Management Company<sup>19</sup> issue was identified, the EP function performed a trend analysis and identified 1,275 S Corporation ESOPs with less than 10 participants. The EP functional office initiated a compliance initiative for the issue. They canvassed their examination groups and identified 31 open examinations related to this issue. Additionally, the TE/GE Division received a referral of 70 Management Company ESOPs from the Large and Mid-Sized Business Division. The compliance initiative was revised to sample the referred cases, and in conjunction with the Small Business/Self-Employed (SB/SE) Division, the highest risk cases were selected for examination. The SB/SE Division is responsible for the examinations of the U.S. Corporation Income Tax Return (Form 1120), and the EP function is responsible for examinations of the qualified plans.

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<sup>16</sup> S Corporations (formerly known as Subchapter S Corporations) are pass-through entities that are generally exempt from Federal income taxes. The shareholders, a maximum of 75, report the S Corporation's profit or loss on their individual tax returns.

<sup>17</sup> An ESOP is a type of retirement plan organized by a corporation for its employees. The contributions to this plan are invested in the corporation's stock.

<sup>18</sup> Some ESOPs that hold employer securities in an S corporation were being used for the purpose of claiming eligibility for the delayed effective date (March 14, 2001) of 26 U.S.C. § 409(p) (2003).

<sup>19</sup> When an ESOP owns an S Corporation, the profits of that corporation generally are not taxed until the ESOP makes distributions to the company's employees when they retire or leave the job. The abusive transactions move business profits of the S Corporation away from the ESOP, so that the rank-and-file employees do not benefit.

## The Tax Exempt and Government Entities Division Strategy for Abusive Tax Avoidance Transactions Needs Further Development

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Training for this issue was provided to the EP function in May 2004.

- The TEB office uses a commercial Municipal Bond database to identify information on similar types of bond issuances or information on bond issuances by the same bond counsel, promoter, or underwriter after identifying an initial abusive transaction. Use of the database allows TEB office management to focus on a particular firm or person who may be marketing abusive bond transactions or to identify other municipalities that may be participating in abusive bond transactions. The TEB office also uses summons to obtain client lists from promoters to identify the extent that the abusive transactions were marketed.

The TEB office frequently contacts the Securities and Exchange Commission (SEC) for information on investigations that may have identified potential abusive transactions.

- The ITG office performs computer data analysis of Indian tribal information to identify characteristics similar to previously identified ATATs. For example, they can use the database to search for tribes that previously had high taxable income that decreased substantially. This condition may indicate that the tribe is involved in abusive schemes.

As stated previously, the FSLG office has not yet applied any significant resources to the identification of ATATs.

### **Most functional offices do not have processes to identify ATATs outside of their normal work processing**

Most of the TE/GE Division functional offices do not have processes to proactively identify<sup>20</sup> the ATATs outside of their normal work process. The proactive identification of the ATATs is essential to help identify the ATATs that the TE/GE Division may not yet be aware of (either existing ATATs or emerging ones).

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<sup>20</sup> Proactive processes include reviewing and analyzing sources of computer data or information outside of normal work processing and coordinating with other industry groups to identify ATAT indicators.

## The Tax Exempt and Government Entities Division Strategy for Abusive Tax Avoidance Transactions Needs Further Development

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The only offices with processes to proactively identify ATATs outside of their normal work process are the TEB and ITG offices.

- The TEB office management worked with the Florida and Pennsylvania State Auditor Offices to identify abusive transactions. In addition, TEB management coordinates with other agencies and associations (e.g., the SEC, National Association of Securities Dealers, Municipal Securities Rulemaking Board); reviews trade publications and other media (e.g., The Wall Street Journal, Internet, newspapers); and monitors Lexis databases, tax returns, and examinations to proactively identify the ATATs.
- The ITG, along with other government agencies, is a member of the Indian Gaming Workgroup. They meet periodically to share information on emerging issues and cases they are working. They also plan for the ADAPT to work on issues where abusive schemes have impact across multiple field group areas or involve extensive interactions with enforcement functions/agencies inside or outside the IRS. In addition, they plan to begin cross matching Currency and Banking Retrieval System (CBRS)<sup>21</sup> data to other data to identify aberrations in the filing patterns of Indian tribes, which may indicate abusive transactions.

The EO and EP functional offices have plans to establish processes to identify ATATs outside of their normal work processing.

- The EO functional office plans to establish the EO Data Analysis Unit by September 2004 to identify trends and/or potential compliance issues, including the ATATs, through the use of the Internet, RICS, and other databases. They also plan to establish the EO Fraud and Financial Transaction Unit by April 2005 to address the complex fraud and ATAT referrals and also provide specialized expertise to law enforcement agents.

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<sup>21</sup> The CBRS is an on-line database that contains Bank Secrecy Act information. It is standard procedure for IRS field agents to use the system during tax fraud investigations and compliance probes.

## The Tax Exempt and Government Entities Division Strategy for Abusive Tax Avoidance Transactions Needs Further Development

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- The EP function plans to establish a Compliance Unit in FY 2005 to perform analysis to identify abusive scheme “footprints” and trends. This will assist in defining parameters for future projects.

The FSLG office has not established a process to proactively identify ATATs from outside normal processing.

### **Most functional offices have processes to communicate information about known ATATs**

Most of the TE/GE Division functional offices have communicated abusive transaction information to their employees, other IRS operating divisions, and to the public (i.e., promoters and taxpayers). Communicating information to employees about the TE/GE Division’s overall strategy and the functional offices’ detailed guidelines is essential to ensure consistency in addressing the ATATs. Communicating with other divisions helps the IRS overall in its efforts to address the ATATs IRS-wide. In addition, informing the public helps prevent the use of the ATATs by unsuspecting taxpayers and puts promoters and taxpayers on notice that certain transactions have been identified by the IRS as being abusive and will be subject to scrutiny.

- The EP and EO functional offices and the TEB office use a variety of media to communicate with their employees, other IRS operating divisions, and the public. For example, all three functional offices depend on their Intranet sites to communicate ATAT information to their employees and all three use presentations, publications, and the IRS Internet to communicate with the public. Additionally, all three functional offices provide information to the other IRS divisions through meetings or reports.
- The ITG office communicates the ATAT awareness to Indian tribes through a regional newsletter and includes information on the ATATs as part of its outreach efforts in Title 31 and employment tax presentations. In addition, the ITG office has plans to increase its communication capabilities in the future. They recently developed a web site that will be able to provide ATAT

## The Tax Exempt and Government Entities Division Strategy for Abusive Tax Avoidance Transactions Needs Further Development

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information to their employees and customer base in the future. Also, the ADAPT is currently developing formal internal and external communication strategies as one of its initial tasks.

The FSLG office has not taken any significant actions to communicate the ATAT information to either its customer base or other IRS divisions. However, the FSLG office management advised that they included a session at their FY 2004 employee training on LILO/SILO transactions and how to report such transactions if identified. In addition, one news article on LILO/SILOs was included in a newsletter to the FSLG office customers in June 2004.

### **The functional offices do not have a process to systemically track the ATAT efforts**

The functional offices within the TE/GE Division do not track the information necessary to systemically determine the extent of its efforts to address the ATATs, or the success of its ATAT Program, in stopping or reducing abusive transactions in its customer base. Current management information systems do not provide complete ATAT information such as the number of abusive transactions identified, potential ATATs referred to the functional office ATAT Coordinators, ATAT examinations completed, penalties applied, tax-exempt status revoked, time applied for the ATAT Program, the results of cases worked (the number of cases that turned out to be ATATs and the number that did not), and the future impact on stopping the ATATs. To identify this information currently is labor intensive, requiring ad-hoc analysis and manual data calls.

In prior attempts to determine the amount of resources expended to address the ATATs, the TE/GE Division could only provide speculative estimates. We determined that three functional offices use the following processes to track their ATAT related efforts:

- The EP and EO functional offices currently use manual processes (i.e. individual folders, spreadsheets, etc.) to track known or potentially abusive transactions. They both use the Audit Information Management System



## The Tax Exempt and Government Entities Division Strategy for Abusive Tax Avoidance Transactions Needs Further Development

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(AIMS)<sup>22</sup> to track the status of examination cases and the TE/GE Division Technical Time System<sup>23</sup> (ETS) to track the time applied to a case through the use of project codes and activity codes. However, the codes currently being used do not further define which case in a project was ATAT related and how much time applied to an activity was ATAT related.

- The TEB office tracks examination time and results on the AIMS. However, all I.R.C. § 6700 cases are tracked on a spreadsheet within the OPR office. In addition, TEB office employees track their time charged to examine I.R.C. § 6700 cases by a designated activity code on the TE/GE Division ETS.

Neither the ITG nor FSLG offices have processes for tracking the ATAT related casework.

The TE/GE Division is taking action to improve its ability to track resources expended on addressing abusive tax avoidance transactions. The Director, Planning, TE/GE Division, advised that the Division will institute new time report codes and procedures beginning in October 2004 that will allow the Division to track resources expended on the ATAT work. These new procedures will capture employee time applied to ATAT Examination cases, as well as the ATAT related work outside the Division's Examination Program. For example, employees in the Division's Rulings and Agreement programs and Customer Education and Outreach offices will use common codes to report their time working the ATAT issues. These same codes will also be used to track planning and monitoring activities as well as case-related management and review activities associated with the ATATs. While the new time reporting system will track the resources spent throughout the TE/GE Division on the ATAT Program, it will not capture all of the information needed to evaluate the success of the Program in reducing the ATATs.

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<sup>22</sup> The AIMS provides an automated inventory and activity control for active examination cases.

<sup>23</sup> The ETS is a software application that was developed in the early 1980's to automate the task of technical time reporting for the TE/GE Division specialists.

## The Tax Exempt and Government Entities Division Strategy for Abusive Tax Avoidance Transactions Needs Further Development

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Because division-wide policies have not been established for the five areas presented in this report and individual functional offices independently developed their own processes for addressing the ATATs, TE/GE Division management does not have assurance the ATATs are being adequately addressed or that the individual function's or office's processes conform to IRS policy. Providing division-wide direction will assure the proper priority is given to developing processes to identify the ATATs, the TE/GE Division's overall strategy is communicated to all employees to ensure consistency in addressing the ATATs, and resources and accomplishments are tracked.

### Recommendations

To ensure a unified approach to addressing the ATATs, the Commissioner, TE/GE Division, should provide the functional offices with guidance in developing the following common processes:

1. Identifying the ATATs during the normal work processing.

Management's Response: The TE/GE Division ATAT ESC will review the ATAT processes in place in each of the TE/GE Division functions and identify those processes which, if uniformly applied across the TE/GE Division's entire customer base, will help identify and reduce ATATs within the TE/GE Division's jurisdiction. Based on this review, the ESC will make recommendations on guidance to address the recommended process.

2. Identifying similar ATATs after known cases are identified.

Management's Response: The TE/GE Division ATAT ESC will review the ATAT processes in place in each of the TE/GE Division functions and identify those processes which, if uniformly applied across the TE/GE Division's entire customer base, will help identify and reduce ATATs within the TE/GE Division's jurisdiction. Based on this review, the ESC will make recommendations on guidance to address the recommended process.

## The Tax Exempt and Government Entities Division Strategy for Abusive Tax Avoidance Transactions Needs Further Development

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3. Pro-actively identifying the ATATs outside of the normal operating processes.

Management's Response: The TE/GE Division ATAT ESC will review the ATAT processes in place in each of the TE/GE Division functions and identify those processes which, if uniformly applied across the TE/GE Division's entire customer base, will help identify and reduce ATATs within the TE/GE Division's jurisdiction. Based on this review, the ESC will make recommendations on guidance to address the recommended process.

4. Communicating information about known or potential ATATs to employees, their respective client base, and other IRS divisions, as appropriate.

Management's Response: The TE/GE Division ATAT ESC will review, with the TE/GE Director of Communications and Liaison, the existing TE/GE ATAT communication programs and develop guidelines to ensure consistency and best practices in communicating with employees, the other IRS divisions, and the TE/GE Division client base.

5. Tracking adequate management information, such as the number of ATATs identified, examinations completed, penalties applied, tax-exempt status revoked, listed transactions, etc., so TE/GE Division management can evaluate the success of the program.

Management's Response: The TE/GE Division management will adopt the use of the ATAT tracking database developed by the Deputy Commissioner for Services and Enforcement. The database will track information such as the number of ATATs identified and ATAT results from examinations and determinations.

## The Tax Exempt and Government Entities Division Strategy for Abusive Tax Avoidance Transactions Needs Further Development

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### Appendix I

#### Detailed Objective, Scope, and Methodology

The objective of the audit was to assess the adequacy of the Tax Exempt and Government Entities (TE/GE) Division management's efforts to stop Abusive Tax Avoidance Transactions (ATAT) within the TE/GE Division's customer base. To accomplish this objective, we:

- I. Interviewed TE/GE Division management and reviewed appropriate documentation to determine the division-wide initiatives or processes for ensuring the ATATs are identified within TE/GE Division's customer base and appropriately addressed.
  - A. Determined if the Senior Technical Advisor was coordinating with each of the TE/GE functional offices (Employee Plans [EP] and Exempt Organizations [EO] functions, and the Indian Tribal Governments [ITG], Tax Exempt Bonds [TEB], and Federal, State, and Local Governments [FSLG] offices) to detect, deter, and monitor known ATATs.
  - B. Determined the extent of TE/GE Division management's efforts to coordinate with the other Internal Revenue Service (IRS) operating divisions (i.e., Large and Mid-Sized Business [LMSB] Division, Small Business/Self-Employed [SB/SE] Division, Criminal Investigation [CI] function, and Chief Counsel), IRS-wide Steering Committees/Tasks Forces, etc. to detect and deter the ATATs.
  - C. Determined if TE/GE Division management developed an overall strategy and/or guidance to detect and deter the ATATs.
- II. Interviewed management in each of the TE/GE functional offices (EP and EO functions, and the TEB, ITG, and FSLG offices) and reviewed appropriate documentation to determine their process or techniques to detect and deter the ATATs and the progress made to date.
  - A. Determined management's actions taken to identify potential or actual ATATs.
  - B. Determined if management developed a technique to identify similar ATATs within their customer base after discovery of the initial abusive transaction.
  - C. Determined if management developed a technique to proactively identify new or potential ATATs.
  - D. Determined if management had a process to ensure that all known ATATs are timely communicated to revenue agents.
  - E. Determined if the Customer Education and Outreach offices (or similar offices) provided specific warnings about known ATATs to the public, potential promoters, and affected taxpayers through issuance of official notices and other media.

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- F. Determined if management had a process to communicate and coordinate within the TE/GE Division and, if applicable, with other IRS operating divisions (i.e., the LMSB and SB/SE Divisions, CI function, and Chief Counsel) and outside sources (e.g., state tax organizations, Department of the Treasury).
- G. Determined if management developed a technique to track the handling of known ATATs within their customer base after discovery of the initial abusive transaction.
- H. Determined if management developed a technique to track enforcement actions taken against known ATATs.

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**Appendix II**

**Major Contributors to This Report**

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**Appendix III**

**Report Distribution List**

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Deputy Commissioner for Services and Enforcement SE  
Deputy Commissioner, Tax Exempt and Government Entities Division SE:T  
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Appendix IV

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

RECEIVED  
SEP 22 2004

September 21, 2004

MEMORANDUM FOR ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Steven T. Miller *STM / Sarah Hillman*  
Commissioner, Tax Exempt and Government Entities

SUBJECT: The Tax Exempt and Government Entities Division  
Strategy for Abusive Tax Avoidance Transactions  
Needs Further Development (Audit #200410014)

I am responding to your draft report on the Tax Exempt and Government Entities Division's strategy for Abusive Tax Avoidance Transactions. I am pleased your report takes note of steps TE/GE has already taken to develop a division-wide program to address abusive tax avoidance transactions (ATATs), and I agree with your overall recommendation that we should go further to ensure a unified approach to addressing ATATs across our diverse customer base.

The TE/GE Division is a full partner in the IRS war on abusive tax shelters and schemes. We have an active, aggressive ATAT program in place, and over the past two years we have developed organizational structures and procedures consistent with the high priority the Division accords to ATAT issues. As your report notes, we formed the TE/GE ATAT Executive Steering Committee (ESC) in February 2004. This high-level committee oversees the Division's ATAT programs and provides a mechanism the TE/GE functions employ to develop strategies and share best practices with respect to our ATAT programs. TE/GE also works closely with the other IRS operating divisions on ATAT initiatives. We serve on the Service-wide ATAT executive steering committee, and numerous TE/GE enforcement employees participate as members of cross-divisional ATAT issue management teams. I believe these efforts will help us meet the objective spelled out in the Service's FY 2005 – FY 2009 Strategic Plan: *"Deter abuse within tax-exempt and government entities and misuse of such entities by third parties for tax avoidance or other unintended purposes."*

I agree with your recommendation that our overall effort could be made even stronger by providing additional guidance to the TE/GE functional offices. This would enable us to take better advantage of common processes, thereby ensuring a unified TE/GE approach toward ATATs.



## The Tax Exempt and Government Entities Division Strategy for Abusive Tax Avoidance Transactions Needs Further Development

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### **Recommendations 1, 2, and 3:**

The Commissioner, TE/GE, should provide the TE/GE functional offices with guidance in developing the following processes:

1. Identifying ATATs during normal work processing.
2. Identifying similar ATATs after known cases are identified.
3. Pro-actively identifying ATATs outside of normal operating processes.

As you have reported, TE/GE formed the TE/GE ATAT ESC to share information and provide a joint working environment for the TE/GE functions. In the relatively short time that the ESC has been operational, we have made significant strides towards implementing division-level oversight over ATATs. As you have also reported:

- four of the five functions have processes in place for identifying ATATs during normal work processing
- four of the five functions have processes in place for identifying similar ATATs after known cases are identified
- two of the five functions have processes in place for identifying ATATs outside of normal work processes, while two more will have these processes in place soon.<sup>1</sup>

### **Corrective Action 1,2 and 3:**

The TE/GE ATAT ESC will review the ATAT processes in place in each of the functions and identify those processes which, if uniformly applied across TE/GE's entire customer base, will help identify and reduce ATATs within our jurisdiction. Based on this review, the ESC will make recommendations to the Commissioner, TE/GE, on guidance to address each of the three recommended processes that will ensure a unified approach across TE/GE.

### **Proposed Corrective Action Completion Date:**

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<sup>1</sup> The four TE/GE functions that now have ATAT processes in place – or, in the case of identifying ATATs outside of normal work processes, will have processes in place soon – are: Employee Plans, Exempt Organizations, Tax Exempt Bonds, and Indian Tribal Governments. The fifth function (Federal, State and Local Governments) has a customer base that generally has no tax return filing requirements other than for employment taxes and information returns. Accordingly, FSLG's participation in the TE/GE ATAT programs necessarily involves different procedures with a different emphasis. The report discusses FSLG's unique situation at page 11 and following.

## The Tax Exempt and Government Entities Division Strategy for Abusive Tax Avoidance Transactions Needs Further Development

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July 15, 2005

**Responsible Official :**

Commissioner, TE/GE.

**Corrective Action Monitoring Plan :**

We will monitor this corrective action through the Business Performance Review (BPR) process of the Commissioner of Internal Revenue , and the Joint Audit Management Enterprise System (JAMES).

**Recommendation 4:**

The Commissioner, TE/GE, should provide guidance to the functional offices with respect to communicating information about known or potential ATATs to employees, their respective client base, and other IRS Divisions, as appropriate.

**Corrective Action 4:**

The TE/GE ATAT ESC will review with the TE/GE Director of Communications and Liaison (C&L) the existing TE/GE ATAT communication programs, including the programs referred to on pages 19 and 20 of your report, and develop guidelines to ensure consistency and best practices in communicating with employees, the other IRS Divisions and the TE/GE client base. The TE/GE ATAT program will be included on the agenda of all meetings of TE/GE managers.

**Proposed Corrective Action Completion Date:**

July 15, 2005

**Responsible Official:**

Commissioner, TE/GE.

**Corrective Action Monitoring Plan :**

We will monitor this corrective action through the BPR and the JAMES.

**Recommendation 5:**

The Commissioner , TE/GE, should develop processes to track management information, such as the number of ATATs identified, examinations completed,

## The Tax Exempt and Government Entities Division Strategy for Abusive Tax Avoidance Transactions Needs Further Development

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penalties applied, tax-exempt status revoked, listed transactions, etc., so TE/GE Division management can evaluate the success of the program.

### **Corrective Action 5:**

TE/GE will adopt the use of the ATAT tracking database developed by the Deputy Commissioner, Services and Enforcement. This database will be accessible to TE/GE executives as well as those TE/GE employees working on ATATs. Information in this database includes: number of ATATs identified, number of open and closed examinations inventory including revocations, number of open and closed determinations inventory including approvals and denials, contact information for responsible parties and other reference information.

### **Proposed Corrective Action Completion Date:**

January 15, 2005

### **Responsible Official:**

Commissioner, TE/GE.

### **Corrective Action Monitoring Plan:**

We will monitor this corrective action through the BPR and the JAMES.