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IRS Chief Counsel Blasted for Favorable Ruling on Total Return Swaps.

WASHINGTON — Former Internal Revenue Service official Mark Scott is urging the IRS to revoke a private-letter ruling that was favorable for a total return swap, or TRS, arguing that they are "arbitrage schemes" that have "resulted in hundreds of millions of dollars of illegal tax benefits being stolen."

Scott, who spent 18 years at the IRS, was director of the tax-exempt bond office, or TEB, for several years before he left for private practice. He was also an ex-special assistant U.S. attorney for the Justice Department, who made the request in a blisteringly critical letter sent to William J. Wilkins, chief counsel in the IRS Office of Chief Counsel on Sept. 8. In an interview, Scott would not comment on whether he has launched a whistleblower case on TRS', but said this is irrelevant to his concerns about these transactions.

The website for his law practice says that he has been "specializing in representing whistleblowers on issues relating to tax-exempt bonds and taxes owed by state and local government," as well as arbitrage rebate payments.

Scott's letter to Wilkins refers to the favorable but limited PLR 201502008 that was dated May 21, 2014, but not publicly released by the IRS until Jan. 9 of this year. The ruling did not identify the parties involved but concluded that an extension of a TRS entered into between a borrower and a bank at the same time the underlying tax-exempt bonds were sold "will not be an abusive arbitrage device."

These transactions, possibly hundreds of which have been done, involve long-term bonds and a short-term TRS. In such deals, a hospital or other borrower through an issuer privately places long-term bonds with a bank, which then enters into a much shorter term TRS with the borrower. The bank becomes the holder of the bonds as well as the swap counterparty.

The borrower typically swaps fixed for variable rates to lower its cost of borrowing. It also takes risk and provides price protection for the bank/bondholder/swap counterparty. When the TRS terminates, or is terminated, the bonds are valued.

If the bonds' value is below par, the hospital pays the bank. If the value is above par, the bank pays the hospital. However, many TRS' are rolled over or replaced with new negotiated terms for the life of the bonds. The borrower could be forced to pay if interest rates rise.

The bank/bondholder/swap counter party can make money from the higher tax-exempt bond rate and also from a deduction of its loss from the swap payments. In the case underlying the PLR, the bond proceeds had all been used to current refund some previous bonds, as well as to pay issuance costs. As a result there were no bond proceeds remaining and there was no debt-service reserve fund, from which arbitrage might have generated. If there had been bond proceeds or a reserve fund outstanding, the IRS could have questioned whether calculations should have been based on the bond yield or on the integrated bond and swap. But the facts of this case rendered this issue moot.

The borrower/bondholder/swap counterparty wanted to extend the TRS for another five years. The PLR essentially had to examine the bond and TRS transaction done several years ago to respond to the issuer about whether the extension would violate tax requirements.

In his letter, Scott took issue with the fact that, in this transaction and in any typical TRS, “one party wears two hats as both the swap counterparty and the holder of the tax-exempt debt.” As a result, he said, “the swap counterparty/bondholder, through pricing terms applicable to the ‘total return’ portion of the TRS, can lower its taxable income in exchange for greater tax-exempt income.”

“The ruling, therefore, describes an arbitrage scheme that is quite easy to abuse,” Scott said. “The scheme has been abused using billions of dollars of bonds, and has resulted in millions of dollars of illegal tax benefits being stolen,” he said. In an interview, he said: “The net effect is the bank is reducing its taxable income and increasing its tax-exempt income in a way that looks to be a tax shelter. It’s a way to convert taxable income to tax-exempt income through the use of a tax-exempt bond issue and a TRS. It raises tax issues for the outstanding bonds and the bank.”

TEB GETS UNDERCUT

Scott criticized the chief counsel’s office for issuing the private-letter ruling, while the enforcement side of IRS’ tax-exempt bond office is auditing these deals and finding the bonds taxable. He suggested the chief counsel’s office be completely undercut, or steamrolled over, TEB. It “is well aware of this abuse” and “has investigated a number of high-coupon, tax-exempt bond issues where the bondholder/swap counterparty deployed TRS structures with phony terms to illegally generate greater tax-exempt income for a longer period of time in exchange for lower taxable income,” Scott told Wilkins.

“These audits have been ongoing for some time and the office of tax-exempt bonds has, rightfully, issued adverse findings. Your office knew about these audits and the TRS scheme,” Scott said.

Very few IRS audits of TRS’ have been disclosed on the Municipal Securities Rulemaking Board’s EMMA system: the Electronic Municipal Market Access website. In one that was, the IRS in 2013 found that revenue bonds issued by the New Jersey Health Care Facilities Authority for the Deborah Heart and Lung Center were taxable because the borrower entered into a total return swap. The $37.4 million of revenue bonds had been issued in 1993 and about $17.6 million remained outstanding. Neither the IRS nor the parties involved publicly disclosed the amount paid in settling the tax dispute.

Scott called this latest PLR “a mistake” and said that, “although innocent looking factual representations were presented, the favorable ruling, even with this ostensibly limited application, has emboldened the use of the TRS scheme.” Some lawyers said that while PLRs are only supposed to apply to those taxpayers that requested them, this one has been taken as an encouragement that TRS’ can be done without violating tax requirements.

Scott also claimed that the PLR was wrong by being limited and failing to address several tax issues. For example, the PLR declined to take a position on whether the TRS caused a reissuance, which would cause the bonds to be reissued and subject to the latest tax requirements. Lawyers had said a reissuance would not have been a problem because there have been no recent tax law changes that would have applied. The chief counsel’s office also did not express any opinion on whether the interest paid on the bonds may be excluded from gross income.

Scott said: “The ruling was wrongly reasoned and overlooked the proper application of several long-standing regulations. The ruling should have pointed out that the payment to the issuer for ‘price protection' results in additional gross proceeds, the TRS is investment property, and significant modifications made to outstanding tax-exempt debt by a person other than the governmental issuer results in the reissuance of taxable debt."

"By agreeing to entertain this ruling request and to restrict the scope of its legal analysis, your office was used to promote an abusive arbitrage scheme," he told Wilkins. Scott also claimed the chief counsel's office violated IRS procedures, which state that PLRs will not be issued for outstanding transactions. He accused the office of "erasing the distinction between private-letter rules and technical advice memorandums" and helping transaction participants "game the audit process."

"By expressing legal conclusions on outstanding bonds the ruling violates the clear standards set forth in [Revenue Procedure] 96-16, Section 5.04(1)" on rulings and determination letters, according to Scott. That section of the revenue procedure states: "The Service will not issue a nonreviewable ruling on whether an issued and outstanding obligation that is part of an issue of obligations meets one or more conditions for the exclusion of interest on the obligation from gross income under § 103 unless the request is received by the Service before interest on any obligation in that issue is required to be reported by a holder."

"It would be inexcusable to leave this mixed ruling (part technical advice memorandum/part private-letter ruling) on the books to serve as an example of how to game the audit process," Scott told Wilkins.

THE OTHER SIDE

Some lawyers disagreed with Scott.

"I think the ruling was sound and it was consistent with tax policy," said Hobby Presley, Jr. a partner at Balch & Bingham in Birmingham, Ala. "I can't tell from Mark's letter what his concern is. If people are using a total return swap structure in the existing environment, it's highly unlikely they are motivated by arbitrage. Because of the prevailing [low] investment rates, there's no arbitrage to be earned."

Other lawyers agreed, saying that in the TRS in the PLR, there was no real opportunity for arbitrage earnings because no bond proceeds remained outstanding and there was no debt service reserve fund. Milton Wakschlag, a partner at Katten Muchin Rosenman in Chicago, said that while Scott wants the ruling rescinded, "the IRS feels strongly about the quality of the guidance it issues in the first place and the process it goes through."

"In my anecdotal experience, they are not keen on interventions," he said. Wakschlag said the late, former House Ways and Means Committee chair Dan Rostenkowski, D-Ill., once tried to get one of his PLRs overturned, but did not succeed. "I suspect nothing will happen with this," Wakschlag said. The PLR "seems to have taken longer to be released than the norm," likely meaning it was reviewed by many IRS officials, he said. Some lawyers have said that there are questions in TRS' about whether a bank, which often serves as both the swap counterparty and issuer, should be allowed to take tax deductions for loss carry forwards. However, this is an issue for a different IRS division or bank regulators, not TEB, they said.

THE BOND BUYER

BY LYNN HUME

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