March 14, 2006

MEMORANDUM

TO: All Municipalities and Independent Certified Public Accountants

FROM: Dennis F. Dycus, CPA, CFE, Director
Division of Municipal Audit

SUBJECT: In Lieu of Tax

It has been brought to my attention that many municipalities with utility funds that make in lieu of tax payments to the general fund are not properly reporting the transactions in accordance with generally accepted accounting principles (GAAP).

Payments in lieu of taxes that are not payments for and are not reasonably equivalent in value to services provided should be reported as transfers. Please refer to the Codification of Governmental Accounting and Financial Reporting Standards, Section 1800.102, and the Governmental Accounting Standards Board (GASB) Comprehensive Implementation Guide - 2004, Question and Answer 7.321, for reporting guidance.

Additionally, a general description of the principal purpose of the transfer should be disclosed in the notes to the financial statements in accordance with the Codification of Governmental Accounting and Financial Reporting Standards, Section 2300.121.

Proper reporting of the above referenced payments of in lieu of taxes to the general fund is necessary to demonstrate compliance with GAAP and to allow a proper review of the propriety of such payments.

In reviewing recent audits we have noticed an apparent abuse in regard to the collection of in lieu of taxes by some municipalities. In some cases, the in lieu of tax amounts have been in excess of twice the allowable limit.

Please note that Section 7-34-115(a)(9) authorizes a municipality to request in lieu of tax payments from their municipal utilities. Sections 7-34-115(a) (9) and 7-39-404 Tennessee Code Annotated (TCA), provide formulas or methods for determining the tax equivalency payments for water/sewer and gas systems respectively. Using the guidelines set forth in
the TCA, the Municipal Technical Advisory Service (MTAS), developed schedules to assist local governments in calculating in lieu of tax payments.

The statutes address how the maximum amount of the payment must be calculated. Section (f) of the statute states that:

"If a municipality violates the provisions of this section, it must repay any funds illegally transferred. If the municipality does not have sufficient funds to repay any funds illegally transferred, the municipality is required to submit a plan covering a period not to exceed five (5) years in which to repay the funds. The plan shall be submitted to and approved by the director of local finance in the office of the comptroller of the treasury. Upon discovery of such violation through an audit, any city official in violation of this section is subject to ouster under title 8, chapter 47."

Beginning with the June 30, 2006 fiscal year end financial reports, we will be recalculating the in lieu of tax payments of each applicable municipality. If a material difference is noted in our calculation and what is presented in the financial report, the municipality will be requested to reconcile the difference.

We will notify the local District Attorney General of any material violations of the above referenced statute so that he/she may take whatever action deemed appropriate, if any.