



*Future Tax Revenues Are at Risk
Because Certain Tax-Exempt Bonds
May Exceed Annual Dollar Limits
Without Detection*

September 14, 2009

Reference Number: 2009-10-097

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.

Redaction Legend:

1 = Tax Return/Return Information



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 14, 2009

MEMORANDUM FOR COMMISSIONER, TAX EXEMPT AND GOVERNMENT ENTITIES
DIVISION

Michael R. Phillips

FROM:

Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – Future Tax Revenues Are at Risk Because Certain
Tax-Exempt Bonds May Exceed Annual Dollar Limits Without
Detection (Audit # 200910014)

This report presents the results of our review of the Tax Exempt and Government Entities (TE/GE) Division's administration of the State volume cap limitations applicable to certain tax-exempt private activity bonds under Section 146 of the Internal Revenue Code.¹ Our overall objective was to determine whether the Internal Revenue Service (IRS) has an effective program to identify and address noncompliance with State volume cap limits specified by Internal Revenue Code Section 146 for tax-exempt private activity bonds. This review was conducted as part of the Treasury Inspector General for Tax Administration Office of Audit Fiscal Year 2009 Annual Audit Plan related to the major management challenge of Tax Compliance Initiatives.

Impact on the Taxpayer

The Internal Revenue Code places a limit (volume cap) on the amount of tax-exempt private activity bonds that can be issued annually within each State. Any bonds issued above the maximum yearly dollar limit would be taxable. The Federal Government is at risk of losing future tax revenue because the Tax Exempt Bonds (TEB) office has not developed or implemented the processes necessary to identify and address noncompliance with State volume cap limits for tax-exempt private activity bonds. Without these processes, tax-exempt private activity bonds could be issued in excess of Federally mandated yearly State dollar limits without the IRS detecting and addressing the noncompliance.

¹ 26 U.S.C. Section 146 (2007).



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Synopsis

The TEB office has not developed needed processes because its compliance program is based on determining if individual bond issues are compliant with applicable regulations and not on determining whether aggregate bond issues exceeded yearly dollar limits. However, even though the TEB office does not have processes in place to identify States that have exceeded annual volume cap limits, we determined that no tax revenue was lost in Calendar Years 2006 and 2007 because the 50 States and the District of Columbia did not issue excess tax-exempt private activity bonds above their respective volume cap limits.

To ensure tax revenues are not lost in the future, the TEB office should expand its compliance program to address volume cap compliance. However, the IRS is not regularly receiving all the information it will need to verify volume cap compliance. For example, 18 percent of the bond returns we reviewed did not include required State certifications, which are the official approval from the State that indicate the bond issue has been allocated volume cap dollars and complies with Internal Revenue Code Section 146. Further, 28 percent of the bond returns we reviewed that were required to include carryforward documentation did not include this documentation which provides evidence that a State had previously carried forward unused volume cap dollars.

In addition, bond data are not always accurately entered into IRS computer systems. For example, we identified more than \$11 billion in transcription errors between amounts submitted on bond returns and bond carryforward returns and amounts entered into IRS computer systems. Without complete and accurate data, any processes the TEB office develops may not result in the accurate identification of bonds that are over the volume cap and therefore should be taxable. This could cause TEB office examiners to unnecessarily review bonds that are not actually over the volume cap and negatively impact the limited resources available to the TEB office compliance program.

Finally, the American Recovery and Reinvestment Act of 2009² has many provisions for volume caps and carryforwards in the bond-related sections. The TEB office has the opportunity to learn lessons from addressing issues with tax-exempt private activity bonds and using the knowledge gained to ensure that bonds in the Act do not exceed legislatively established dollar limits.

Recommendations

We recommended that the Director, Tax Exempt Bonds, Tax Exempt and Government Entities Division, develop and implement processes to identify and address tax-exempt private activity bonds that exceed the volume cap limitations in Internal Revenue Code Section 146. To ensure that processes accurately detect when volume caps have been exceeded, we also recommended

² Pub. L. No. 111-5, 123 Stat. 115.



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that the Director, Tax Exempt Bonds, work with the Wage and Investment Division to 1) ensure that required State certifications and carryforward elections are received with filed bond returns and 2) identify and implement a methodology to ensure that transcription errors for bond documentation are detected.

Response

TE/GE management agreed with all of our recommendations and provided planned actions to address them. These actions include identifying approaches available to identify and address Section 146 compliance, improving guidance for processing bond information returns, and identifying errors for previously processed bond information returns. Management's complete response to the draft report is included as Appendix V.

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 Nancy A. Nakamura, Assistant Inspector General for Audit (Management Services and Exempt Organizations), at (202) 622-8500.



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Abbreviations

IRS	Internal Revenue Service
TE/GE	Tax Exempt and Government Entities
TEB	Tax Exempt Bonds



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Background

Internal Revenue Code Sections 142 through 145 and Section 1394¹ allow financing of certain private activities with tax-exempt bonds. Tax-exempt private activity bonds are subject to limitations outlined in the Internal Revenue Code, by State, to a maximum dollar amount (volume cap) of bonds that can be issued tax exempt² during a calendar year. The Internal Revenue Code also allows for a cost of living adjustment, which results in the volume cap varying from 1 year to the next. For example, in Calendar Year 2006, a State's volume cap was the greater of \$246,610,000 or the State's population multiplied by \$80. In Calendar Year 2007, a State's volume cap was the greater of \$256,235,000 or the State's population multiplied by \$85. Since any tax-exempt bonds issued over the volume cap will result in the loss of tax revenue to the Federal Government, it is crucial that the Internal Revenue Service (IRS) determine if volume caps are exceeded.

For private activity bonds to be tax exempt, 95 percent or more of the net bond proceeds must be used for 1 of the following qualified purposes:

- Exempt facility bonds.
- Qualified mortgage revenue bonds.
- Qualified small issue bonds.
- Qualified student loan bonds.
- Qualified redevelopment bonds.

If private activities do not fall into the previous categories, the bonds do not meet the qualifications for tax-exempt status and are considered taxable.

Bond issuers, such as housing authorities and community development authorities, submit information returns to the IRS to provide information about private activity bond issues and unused volume cap dollars. The forms filed are the:

- Information Return for Tax-Exempt Private Activity Bond Issues (Form 8038, hereafter referred to as bond returns) filed 1.5 months to 5.5 months after the bonds are issued. Forms 8038 identify the amount of the State volume cap allocated to the bond issuer by the State and the amount of bonds issued. The actual volume cap for the State is not reported on the return, only the amount allocated to each bond issue.

¹ 26 U.S.C. Sections 142 through 145 and 26 U.S.C. Section 1394 (2007).

² For the purpose of this document, bonds meeting the qualification limitations outlined in Internal Revenue Code Section 146 for tax-exempt status will be called tax-exempt private activity bonds.



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- Carryforward Election of Unused Private Activity Bond Volume Cap (Form 8328, hereafter referred to as bond carryforward returns) is required to be filed no later than February 15 of the year following the calendar year in which the unused amount arises to carryforward unused portions of the allocated volume cap. Bond issuers may elect to carryforward any unused amount of the allocated volume cap of a calendar year for up to 3 years. The Form 8328 must also designate the purpose of the unused volume cap dollars being carried forward at the time of filing.

In recent years, the dollar volume of tax-exempt private activity bonds has seen a noticeable increase (approximately 24 percent) from approximately \$86.1 billion annually from Calendar Years 1991 through 2001 to approximately \$106.7 billion annually from Calendar Years 2002 through 2005.

In February 2009, the American Recovery and Reinvestment Act of 2009³ was passed into law including several sections relating to bond issues. Though most of the bond provisions do not relate to tax-exempt private activity bonds, many of the bonds identified in the law include volume caps and carryforwards.

This audit was conducted while the IRS was implementing changes to its processes based on the enactment of the American Recovery and Reinvestment Act of 2009. As a result, this report might not reflect the most current status of the IRS' activities to identify and address States that have exceeded yearly dollar limitations for issuing tax-exempt private activity bonds.

This review was performed at the Tax Exempt and Government Entities (TE/GE) Division Tax Exempt Bonds (TEB) Headquarters Office in Washington, D.C., and the TE/GE Division Business Systems Planning Submission Processing Programs office located at the Ogden Campus⁴ from September 2008 through April 2009. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

³ Pub. L. No. 111-5, 123 Stat. 115.

⁴ The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.



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Results of Review

The TEB office has not developed or implemented an effective process to identify and address noncompliance with State volume cap limits for tax-exempt private activity bonds. Without these processes, the Federal Government risks losing future tax revenue because tax-exempt private activity bonds could be issued in excess of Federally mandated yearly State dollar limits without the IRS detecting and addressing the noncompliance.

The TEB office has not developed or implemented the processes necessary to identify and address noncompliance with State volume cap limits for tax-exempt private activity bonds.

The TEB office has not developed needed processes because its compliance program is based on determining if individual bond issues are compliant with applicable regulations and not on determining whether aggregate tax-exempt private activity bond issues exceeded yearly dollar limits. However, even though the TEB office does not have processes in place to identify States that have exceeded annual volume cap limits, we determined that no tax revenue was lost in Calendar Years 2006 and 2007 because the 50 States and the District of Columbia did not issue excess tax-exempt private activity bonds above their respective volume cap limits.

To ensure tax revenues are not lost in the future, the TEB office should expand its compliance program to address volume cap compliance. However, the IRS is not regularly receiving all the information it will need to verify volume cap compliance. In addition, bond data are not always accurately entered into IRS computer systems.⁵ Without complete and accurate data, any processes the TEB office develops may not result in the accurate identification of bonds that are over the volume cap and therefore should be taxable. This could cause TEB office examiners to unnecessarily review bonds that are not actually over the volume cap and negatively impact the limited resources available to the TEB office compliance program.

Finally, the American Recovery and Reinvestment Act of 2009 has many provisions for volume caps and carryforwards in the bond-related sections. The TEB office has the opportunity to learn lessons from addressing issues with tax-exempt private activity bonds and using the knowledge gained to ensure that bonds in the Act do not exceed legislatively established dollar limits.

⁵ The data are entered into the Business Returns Transaction File, which is the IRS file that contains information from tax returns filed for the current year and previous 2 years.



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***Future Tax Revenues Are at Risk Because the Tax Exempt Bonds
Office Can Not Determine if State Volume Caps Are Being Exceeded***

The Internal Revenue Code places a limit on the amount of tax-exempt private activity bonds that can be issued annually by each State, and the IRS is responsible for enforcing the Internal Revenue Code. However the TEB office does not have processes in place to detect when volume caps have been exceeded. For example,

- Discussions with IRS campus and TE/GE Division management revealed there currently are no systemic controls to identify when States exceed the volume cap. A systemic process would allow IRS computer systems to identify States that potentially exceeded their volume cap, thereby limiting the number of bonds needing review and allowing the TEB office to use their limited staffing resources more efficiently.
- The Internal Revenue Manual does not designate responsibility for identifying or addressing noncompliance with State volume cap limitations as part of the TEB office examination program. As a result, the volume cap is not reviewed as part of the TEB office compliance program.

Processes are not in place because the TEB office compliance program focuses on individual bond issues rather than on all of a State's tax-exempt private activity bonds that have been issued in a year. As a result, the TEB office is relying on each State to ensure compliance with volume cap limitation.

To determine if this missing part of the TEB office compliance program has resulted in any lost revenue to the Federal Government, we independently calculated the volume caps for each of the 50 States and the District of Columbia for Calendar Years 2006 and 2007 and, based on our review of tax-exempt private activity bond information, determined that no tax revenue was lost. However, due to the challenging economic times the country is facing today, it is even more important that the IRS ensure that volume cap limitations are not exceeded as the Federal Government works to stimulate the economy. While none of the States exceeded their respective annual dollar limitations in the years we reviewed, the TEB office would not have known if they had. Until the TEB office implements an effective program for identifying and addressing States that have exceeded their volume caps, the Federal Government risks losing future tax revenue if States exceed their volume cap limits without detection.

***The 50 States and the District
of Columbia did not issue
excess tax-exempt private
activity bonds in Calendar
Years 2006 and 2007.***



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Recommendation

Recommendation 1: The Director, Tax Exempt Bonds, Tax Exempt and Government Entities Division, should develop and implement processes to identify and address tax-exempt private activity bonds that exceed the volume cap limitations in Internal Revenue Code Section 146.⁶

Management's Response: TE/GE Division management agreed with this recommendation. During Fiscal Year 2010, the TEB office will conduct a compliance research project to gather information about the various processes used by the States in allocating volume cap and identify potential compliance and educational approaches available to the IRS to identify and address Section 146 compliance on a State-wide basis.

Tax-Exempt Private Activity Bond Information Needs to Be Complete and Accurate

Even if the TEB office establishes a systemic process to identify bond issues that exceed State volume caps, the results may not be accurate due to missing required documents and data transcription errors. Without complete documentation, the IRS can not verify that the bond issuer has State approval to issue tax-exempt private activity bonds that are subject to yearly volume caps or that unused volume cap (carryforward) dollars are available from previous years. Errors in the data could misstate the amount of volume cap allocated, the amount of bonds issued, and the amount of carryforward dollars available for future years.

Tax-exempt private activity bond documents are received, processed, and entered into IRS computer systems at the IRS Ogden Campus. These documents are later digitally scanned into a computer system for the TEB office to use during bond examinations, and the original forms are sent to storage facilities.

Based on our review of the data and the associated scanned return images, we determined that required documentation was not always submitted with the filed returns, and the data transcribed from the bond returns were not always accurate. We projected that 665 bond returns and 60 bond carryforward returns were either submitted and processed with missing documentation or were inaccurately entered into IRS computer systems.⁷

⁶ 26 U.S.C. Section 146 (2007).

⁷ See Appendix IV for additional details.



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Required documentation is not always provided to the IRS

The instructions for tax-exempt private activity bond returns require State certifications be attached to filed bond returns. The State certification is an official approval from the State that indicates the bond issue has been allocated volume cap dollars and complies with Internal Revenue Code Section 146. In addition, when unused volume cap allocations from previous calendar years are used, a copy of the bond carryforward return is required to be attached to the new bond return to provide evidence that the State had previously carried forward unused volume cap dollars.

State certifications and carryforward documentation are not always received by the IRS. We determined the following:

- In 71 (18 percent) of 391 imaged bond returns,⁸ the required State certifications were not attached.⁹
- In 10 (28 percent) of 36 imaged bond returns claiming a carryforward of unused volume cap dollars from previous years, the required bond carryforward return was not attached.

Without access to the State certifications and carryforward forms, the IRS can not verify that the issuer has State approval to issue tax-exempt private activity bonds under the State volume cap limitations or have assurance that carryforward dollars are available from previous years. Incomplete documentation may prevent the TEB office from identifying and addressing noncompliance with the volume cap limitations.

Based on our review of the returns that were missing the State certifications and the bond carryforward returns, we determined that, generally, the issuers did not include the missing documentation when the returns were filed. In addition, Internal Revenue Manual procedures do not require processing employees to determine whether all required documentation is attached to bond returns, and employees are not familiar with the documentation that should be attached. Therefore, the IRS did not identify that required documentation was missing when tax-exempt bond returns were received and processed.

***Required State certifications and
carryforward documentation are
not always received by the IRS.***

⁸ The 391 bond returns are a statistical sample from a population of 2,736.

⁹ The original bond returns (Forms 8038) were requested, but the IRS could locate only 26 of the 71 requested forms.



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Data from bond forms are not always accurately entered into IRS computer systems

Accurate data are central to an organization's decision-making process and, therefore, should be complete and error free. The quality of data entered into IRS computer systems will be vital to the IRS in terms of systemically determining whether a State exceeded its volume cap. However, there is no quality review or verification of the data transcribed from bond returns and bond carryforward returns. While it is unlikely that any computer system contains perfect data, transcription errors on a few forms can have a significant dollar variance impact.¹⁰ For example,

We identified more than \$11 billion in transcription errors between amounts on bond documentation and amounts entered into IRS computer systems.

- Transcription errors were found in 14 of 391 bond returns.
 - More than \$2.3 billion in errors were identified on 6 of 391 returns for the amount of State volume cap allocated to the bond issuer.
 - More than \$3.7 million in errors were identified on 1 of 391 returns for the amount of bonds issued.
 - There were 6 of 391 returns that had the zip code incorrectly entered. This could potentially inhibit the IRS from identifying the State that issued the tax-exempt private activity bonds.
- Transcription errors were found in 21¹¹ of 304 bond carryforward returns.¹²
 - More than \$3.6 billion in errors were identified on 5 of 304 returns for the amount of total volume cap.
 - More than \$5.8 billion in errors were identified on 21 of 304 returns for the total carryforward amount.

Generally, data transcribed into computer systems can be systemically validated through comparison of numeric totals or by matching numeric figures from one part of a document to the same figure from another part of the document. TE/GE Division management advised that these validation methodologies can not be used because there are no fields to compare the keyed information against. Another validation technique could involve an independent party re-inputting the data to improve the chances that the data have been input accurately.

¹⁰ See Appendix IV for additional details.

¹¹ Five of the bond carryforward returns had multiple transcription errors in the lines for total volume cap amount and the total carryforward amount, thus the detailed breakdown of errors equals more than the total of 21.

¹² The 304 bond carryforward returns are a statistical sample from a population of 867. See Appendix I for additional details.



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While State volume cap compliance has not been part of the TEB office compliance program in the past, the TEB office will need to correct this omission. This is important not only for tax-exempt private activity bonds, but also for American Recovery and Reinvestment Act of 2009 bond provisions that include volume caps and carryforwards. The IRS should ensure that the data are accurate because inaccurate data from bond documentation transcribed into IRS computers during initial processing may prevent the TEB office from systemically identifying and addressing noncompliance with the Internal Revenue Code.

Recommendation

Recommendation 2: To ensure that processes accurately detect when volume caps have been exceeded, the Director, Tax Exempt Bonds, Tax Exempt and Government Entities Division, should work with the Wage and Investment Division to 1) ensure that required State certifications and carryforward elections are received with filed bond returns (Forms 8038) and 2) identify and implement a methodology to ensure that transcription errors for bond documentation are detected.

Management's Response: TE/GE Division management agreed with this recommendation. The Director, TEB, and the Director, TE/GE Business Systems Planning, will coordinate a review of Internal Revenue Manual procedures to improve guidance available to Wage and Investment Division Submission Processing function employees for the processing of the Form 8038 information return, including confirming receipt of State volume cap certifications and carryforward elections. The Director, TEB, will also coordinate with the Government Entities Compliance Unit to develop and implement a data verification project to identify transcription and documentation errors for previously processed Form 8038 series information returns.



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Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether the IRS has an effective program to identify and address noncompliance with State volume cap limits specified by Internal Revenue Code Section 146¹ for tax-exempt private activity bonds. To accomplish our objective, we:

- I. Determined the tax-exempt private activity bond volume cap allowed by Internal Revenue Code Section 146, by State, for Calendar Years 2006 through 2007.
- II. Determined the amount of tax-exempt private activity bonds issued by each State for Calendar Years 2006 and 2007 and if there were any related carryforward elections.
 - A. Obtained all Information Return for Tax-Exempt Private Activity Bond Issues (Form 8038) data from the Business Returns Transaction File² for Calendar Years 2006 through 2007.
 - B. Obtained all Carryforward Election of Unused Private Activity Bond Volume Cap (Form 8328) data from the IRS Master File³ for Calendar Years 2003 through 2008.
 - C. Compiled Form 8038 and Form 8328 datasets into a database for analysis.
 - D. Compared record counts obtained from the Business Returns Transaction File and the IRS Master File to the number of returns processed through the Ogden Campus⁴ as provided by the TE/GE Division Business Systems Planning Submission Processing Programs office to validate the correct number of records were received.
 - E. Selected statistical samples of 391 Forms 8038 (from a population of 2,736 Forms 8038) and 304 Forms 8328 (from a population of 867 Forms 8328) based on a confidence level of 95 percent, a precision rate of ± 2 percent, and an expected error rate of 5 percent. The samples were compared to scanned images from the Distributive Processing System Image Net⁵ to validate the accuracy and

¹ 26 U.S.C. Section 146 (2007).

² The IRS file that contains information from tax returns filed for the current year and previous 2 years.

³ The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

⁴ The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

⁵ The Distributed Processing System Image Net is part of a system owned by the IRS Statistics of Income Division. It includes databases, applications, and scanned returns to support the IRS' requirement to report to Congress annually on the numbers and types of returns filed, the characteristics of those returns, and the money amounts reported on those returns.



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- completeness of the data received. We selected a statistical sample because we wanted to project the results to the entire universe.
- F. Summarized the Forms 8038 total bond issuance amounts by State and year.
 - G. Compared volume cap amounts of tax-exempt private activity bonds (identified from the Business Returns Transaction File and IRS Master File) to State volume cap limits specified by Internal Revenue Code Section 146 to identify instances where issued tax-exempt private activity bonds exceeded the allowable volume cap limits.
 - H. Analyzed carryforwards (Forms 8328) that may explain States exceeding volume cap limits.
 - I. Traced tax-exempt private activity bond data for those States exceeding allowable volume cap limits to the Distributive Processing System Image Net to validate accuracy of the data.
- III. Determined how the TEB office identifies and addresses noncompliance with State volume caps specified in Internal Revenue Code Section 146.
- A. Researched the TEB office Internet web site and reviewed guidelines for identifying and addressing noncompliance with State volume cap limits.
 - B. Researched the TEB office Internal Revenue Manual to identify guidelines for identifying and addressing noncompliance with State volume cap limits.
 - C. Discussed procedures with TEB office personnel and assessed whether the IRS has an effective program to identify and address noncompliance with Internal Revenue Code Section 146.

Internal Controls Methodology

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: TEB office policies, procedures, and practices for identifying and addressing States that exceeded volume caps for tax-exempt private activity bonds, and policies and procedures for processing Forms 8038 and 8238. We evaluated these controls by interviewing management, reviewing applicable information, and reviewing Forms 8038 and 8328.



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Appendix II

Major Contributors to This Report

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Yolanda D. Brown, Auditor
David F. Allen, Program Analyst
Michele S. Cove, Information Technology Specialist



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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Commissioner, Wage and Investment Division SE:W
Deputy Commissioner, Tax Exempt and Government Entities Division SE:T
Director, Business Systems Planning, Tax Exempt and Government Entities Division SE:T:BSP
Director, Government Entities, Tax Exempt and Government Entities Division SE:T:GE
Director, Tax Exempt Bonds, Tax Exempt and Government Entities Division SE:T:GE:TEB
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaisons:
 Director, Communications and Liaison, Tax Exempt and Government Entities
 Division SE:T:CL
 Senior Operations Advisor, Wage and Investment Division SE:W:S



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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

- Reliability of Information – Potential; 665 bond returns affected (see page 5).

Methodology Used to Measure the Reported Benefit:

We identified a population of 2,736 bond returns (Information Return for Tax-Exempt Private Activity Bond Issues (Form 8038)) that were filed after Calendar Year 2005 that had a value in the field for the amount of volume cap allocated to the issuer (Line 42). From this population, we reviewed a random statistical sample of 391 tax returns using a confidence level of 95 percent, a precision rate of ± 2 percent, and an expected error rate of 5 percent.

We reviewed the 391 imaged bond returns to determine whether 1) all required documentation was included with the filed returns and 2) the transcribed data matched the electronically scanned return image in the Distributed Processing System Image Net.¹ We determined that:

- 71 (18 percent) of 391 imaged bond returns did not include the required State certifications.²
- 14 (4 percent) of 391 imaged bond returns contained transcription errors.

Based on these 85 cases, we projected that 595 bond returns in our population might either be missing required documentation or have transcription errors. This is based on the ratio of 85 (21.739 percent) to 391 applied to the total population of 2,736 bond returns, which resulted in 595 returns that could be affected.

¹ The Distributed Processing System Image Net is part of a system owned by the IRS Statistics of Income Division. It includes databases, applications, and scanned returns to support the IRS' requirement to report to Congress annually on the numbers and types of returns filed, the characteristics of those returns, and the money amounts reported on those returns.

² The original bond returns (Forms 8038) were requested, but the IRS could locate only 26 of the 71 requested returns.



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We also determined that 36 bond returns indicated that a carryforward of unused volume cap dollars from previous years was being used. In these circumstances, a carryforward bond return (Carryforward Election of Unused Private Activity Bond Volume Cap (Form 8328)) is required to be attached to the bond returns. However, we determined that 10 of 36 bond returns that were claiming carryforwards of unused volume cap dollars from previous years did not include the required bond carryforward returns.

We projected the percentage of bond returns in the population that should have attached carryforward documentation by using the ratio of 36 (9.207 percent) to 391 bond returns applied to the total population of 2,736 bond returns, which resulted in 252 returns in the population that should have had bond carryforward returns attached. We projected the percentage of bond returns missing the carryforward documentation in our sample by using the ratio of 10 (27.778 percent) to 36 and multiplying the ratio to the potential returns in the population (252), resulting in 70 bond returns that could have been missing carryforward documentation. Adding together the 2 results (595 + 70) resulted in 665 bond returns that might either be missing required documentation or have transcription errors.

Type and Value of Outcome Measure:

- Reliability of Information – Potential; 60 bond carryforward returns affected (see page 5).

Methodology Used to Measure the Reported Benefit:

We identified a population of 867 bond carryforward returns (Forms 8328) that were filed after Calendar Year 2003 that had a value in the field for the amount of State volume cap allocated to the issuer and that had a value in the field for carryforward amount. From this population, we reviewed a statistical sample of 304 bond carryforward returns, using a confidence level of 95 percent, a precision rate of ± 2 percent, and an expected error rate of 5 percent.

We reviewed the 304 bond carryforward returns to determine whether the transcribed data matched the electronically scanned return image in the Distributed Processing System Image Net. There were 21 returns that had transcription errors.

Based on these 21 returns, we estimated that 60 returns in our population could have transcription errors. This is based on the ratio of 21 (6.908 percent) to 304 bond carryforward returns applied to the total population of 867 bond carryforward returns, which resulted in 60 returns that could be affected.



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Type and Value of Outcome Measure:

- Reliability of Information – Actual; \$11.7 billion in transcription errors (see page 5).

Methodology Used to Measure the Reported Benefit:

We identified a population of 2,736 bond returns that were filed after Calendar Year 2005 that had a value in the field for the amount of volume cap allocated to the issuer (Line 42), and a population of 867 bond carryforward returns that were filed after Calendar Year 2003 that had a value in the field for the amount of State volume cap allocated to the issuer and that had a value in the field for carryforward amount.

We reviewed a random statistical sample of 391 bond returns and 304 bond carryforward returns using a confidence level of 95 percent, a precision rate of ± 2 percent, and an expected error rate of 5 percent. We identified 8 bond returns and 21 bond carryforward returns from the sample populations that had more than \$11.7 billion in transcription errors in the dollar fields. Due to the dollar amounts not being part of the sampling criteria and the varying amount of tax-exempt bond issuances, we did not try to project the dollar value of the transcription errors to the entire population.

The \$11.7 billion in transcription errors consists of the following:

- More than \$2.3 billion in errors were identified on 6 of 391 bond returns for the amount of State volume cap allocated to the bond issuer.
- More than \$3.7 million in errors were identified on 1 of 391 bond returns for the amount of bonds issued.
- More than \$3.6 billion in errors were identified on 5 of 304 bond carryforward returns for the amount of total volume cap.
- More than \$5.8 billion in errors were identified on 21 of 304 bond carryforward returns for the total carryforward amount.



*Future Tax Revenues Are at Risk Because Certain
Tax-Exempt Bonds May Exceed Annual Dollar Limits
Without Detection*

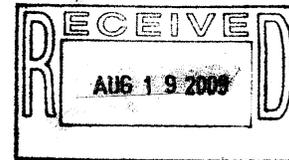
Appendix V

Management's Response to the Draft Report



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

AUG 14 2009



MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Sarah Hall Ingram *Sarah Hall Ingram*
Commissioner, Tax Exempt and Government Entities

SUBJECT: Future Tax Revenues Are at Risk Because Certain Tax-Exempt
Bonds May Exceed Annual Dollar Limits without Detection
(Audit #200910014)

I am pleased to respond to your report concerning the effectiveness of the Tax Exempt and Government Entities Division in administering the state volume cap limitations applicable to certain tax-exempt private activity bonds under section 146 of the Internal Revenue Code. The purpose of this audit was to determine whether the Internal Revenue Service has effective processes in place to identify states that issue tax-exempt private activity bonds in excess of their annual volume cap limit.

We appreciate your finding that no tax revenue was lost in calendar years 2006 and 2007 because the 50 states and the District of Columbia did not issue tax-exempt private activity bonds in excess of their calendar year volume cap limits. As you noted, our Tax Exempt Bonds (TEB) office includes a comprehensive review of applicable volume cap limitations in the audit scope of tax-exempt private activity bond transactional examinations. We believe that these efforts directly contributed to the tax-exempt bond market's overall compliance with the requirements of section 146 of the Code.

Although your review did not identify any actual noncompliance with section 146, we agree that it is important to develop effective compliance and educational programs to promote continued compliance by the states in administering their volume cap allocation processes. Accordingly, we accept your recommendation to develop and implement processes to more effectively identify states which potentially exceed their calendar year volume cap limits on an aggregate basis.

We also appreciate your identification of instances in which IRS employees either inaccurately transcribed data from filed Form 8038 returns or failed to confirm receipt of the required state volume cap certifications or carry forward elections. As you noted, inaccurate data or missing documentation limits the effectiveness of compliance monitoring processes.



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We are committed to ensuring the accurate collection of information and other documents received from governmental issuers through the filing of Form 8038 series information returns. We therefore accept your recommendation to work with the Wage and Investment Division to resolve these processing issues.

We attach a response outlining our corrective actions.

We concur with your statement of measurable benefits on tax administration.

If you have any questions, please contact Clifford Gannett at (202) 283-9820 or Moises Medina at (202) 283-9738.



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Attachment

Recommendation 1

The Director, Tax Exempt Bonds, Tax Exempt and Government Entities Division, should develop and implement processes to identify and address tax-exempt private activity bonds that exceed the volume cap limitations in Internal Revenue Code section 146.

Corrective Action

During FY 2010, TEB will conduct a compliance research project to gather information about the various processes used by the states in allocating volume cap and identify potential compliance and educational approaches available to the IRS to identify and address section 146 compliance on a statewide basis.

Implementation Date

January 31, 2011

Responsible Official

Director, Tax Exempt Bonds

Recommendation 2

To ensure that processes accurately detect when volume caps have been exceeded, the Director, Tax Exempt Bonds, Tax Exempt and Government Entities Division, should work with the Wage and Investment Division to 1) ensure that required State certifications and carryforward elections are received with filed bond returns (Forms 8038) and 2) identify and implement a methodology to ensure that transcription errors for bond documentation are detected.

Corrective Action

The Director, Tax Exempt Bonds and the Director, TE/GE Business Systems Planning will coordinate a review of Internal Revenue Manual procedures to improve guidance available to W&I Submission Processing employees for the processing of the Form 8038 information return, including confirming receipt of state



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volume cap certifications and carryforward elections. The Director, Tax Exempt Bonds will also coordinate with the Government Entities Compliance Unit to develop and implement a data verification project to identify transcription and documentation errors for previously processed Form 8038 series information returns.

Implementation Date

January 31, 2011

Responsible Officials

Director, Tax-Exempt Bonds
Director, TE/GE Business Systems Planning