



*Legislative Requirements Were Met
When Awarding Credits and Grants
for the Qualifying Therapeutic
Discovery Project Program*

September 14, 2011

Reference Number: 2011-40-100

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

2(f) = Risk Circumvention of Agency Regulation or Statute



HIGHLIGHTS

LEGISLATIVE REQUIREMENTS WERE MET WHEN AWARDING CREDITS AND GRANTS FOR THE QUALIFYING THERAPEUTIC DISCOVERY PROJECT PROGRAM

Highlights

Final Report issued on September 14, 2011

Highlights of Reference Number: 2011-40-100 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division.

IMPACT ON TAXPAYERS

The Qualifying Therapeutic Discovery Project (QTDP) Program is a tax benefit (a credit or a grant) targeted to therapeutic discovery projects that show a reasonable potential to: 1) result in new therapies to treat areas of unmet medical need; 2) reduce the long-term growth of health care costs; and 3) advance the goal of curing cancer within 30 years. The QTDP Program's tax benefit is available only to taxpayers with no more than 250 employees and covers up to 50 percent of a taxpayer's qualified investment. The Internal Revenue Service (IRS) distributed \$1 billion in credits and grants to 4,606 recipients.

WHY TIGTA DID THE AUDIT

This audit was initiated to determine whether the QTDP Program met legislative requirements when considering and awarding credits and grants to qualifying therapeutic discovery project applicants, and whether the IRS implemented adequate controls to monitor the credits and grants.

WHAT TIGTA FOUND

The IRS met legislative requirements when awarding credits and grants to QTDP Program recipients. Despite the unprecedented short time period allotted by the law for creating the QTDP Program, the IRS achieved its goal.

The IRS team administering the QTDP Program, in consultation with the Department of Health and Human Services, processed 5,663

Applications for Certification of Qualified Investments Eligible for Credits and Grants Under the Qualifying Therapeutic Discovery Project Program (Form 8942). Of the 5,663 Forms 8942 received, 4,606 (81.3 percent) were approved for a credit or grant.

All QTDP Program certified applicants were listed by State on IRS.gov, as required by law. The IRS has internally revised and corrected the number of entities receiving credits or grants, but it has not updated IRS.gov since November 1, 2010.

The IRS prepared numerous documents that record the process for implementing the QTDP Program. These documents will be helpful for implementing future unique and similar projects.

A compliance plan was developed and is being implemented. The plan includes reviewing the tax returns of taxpayers who accepted QTDP Program credits and grants. The IRS mailed 326 letters to grant recipients that had not yet filed an amended Tax Year 2009 tax return.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the Commissioner, Small Business/Self-Employed Division, ensure: 1) the information regarding the applicant names and amounts allocated are updated on IRS.gov to accurately show which taxpayers and projects were originally awarded QTDP Program credits and grants; and 2) the QTDP Program line item is removed from Investment Credit (Form 3468) after a determination is made that all QTDP Program taxpayers have filed their Tax Year 2010 returns.

The IRS agreed with the recommendations. The IRS plans to: 1) update the information on IRS.gov regarding the applicant names and amounts allocated through July 31, 2011; and 2) by July 15, 2012, make a final update to IRS.gov to reflect any activity from August 1, 2011, to the end of the QTDP Program. Concerning the second recommendation, the IRS has notified the Forms and Publications function of the need to remove the QTDP Program line from Form 3468 once it has determined that all QTDP Program taxpayers have filed their Tax Year 2010 returns.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 14, 2011

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

Margaret E. Bezz

FROM: (for) Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Legislative Requirements Were Met
When Awarding Credits and Grants for the Qualifying Therapeutic
Discovery Project Program (Audit # 201140040)

This report presents the results of our review to determine whether the Qualifying Therapeutic Discovery Project Program met legislative requirements when considering and awarding credits and grants to qualifying therapeutic discovery project applicants. We also determined whether the Internal Revenue Service implemented adequate controls to monitor the credits and grants. This audit was added to our Fiscal Year 2011 Annual Audit Plan and addresses the major management challenge of Implementing Health Care and Other Tax Law Changes.

Management's complete response to the draft report is included as Appendix VI.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services), at (202) 622-5916.



Legislative Requirements Were Met When Awarding Credits and Grants for the Qualifying Therapeutic Discovery Project Program

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Legislative Requirements Were Met When Awarding Credits and Grants for the Qualifying Therapeutic Discovery Project Program

Abbreviations

| | |
|------|--|
| HHS | Department of Health and Human Services |
| IRS | Internal Revenue Service |
| QTDP | Qualifying Therapeutic Discovery Project |



Legislative Requirements Were Met When Awarding Credits and Grants for the Qualifying Therapeutic Discovery Project Program

Background

The Qualifying Therapeutic Discovery Project (QTDP) Program is a tax benefit (a tax credit or grant) to small firms that show significant potential to produce new and cost-saving therapies, support United States jobs, and increase United States competitiveness. A Qualifying Therapeutic Discovery Project is a project that is designed to:

1. Treat or prevent diseases or conditions by conducting pre-clinical activities, clinical trials, and clinical studies, or carrying out research protocols, for the purpose of securing approval of a product under section 505(b) of the Federal Food, Drug, and Cosmetic Act¹ or section 351(a) of the Public Health Services Act.²
2. Diagnose diseases or conditions or to determine molecular factors related to diseases or conditions by developing molecular diagnostics to guide therapeutic decisions.
3. Develop a product, process, or technology to further the delivery or administration of therapeutics.

The QTDP Program is targeted to projects that show a reasonable potential to:

On June 18, 2010, the Internal Revenue Service announced it was accepting applications for the new QTDP Program.

“This new tax credit was designed to promote medical research that could improve health and save lives,” Internal Revenue Service Commissioner Doug Shulman said. “I encourage taxpayers that are involved in this groundbreaking type of work to apply.”

- Result in new therapies to treat areas of unmet medical need or prevent, detect, or treat chronic or acute diseases and conditions.
- Reduce the long-term growth of health care costs in the United States.
- Significantly advance the goal of curing cancer within 30 years.

Allocation of the credit or grant included consideration of which projects showed the greatest potential to create and sustain high-quality, high-paying United States jobs and to advance United States competitiveness in life, biological, and medical sciences.

The QTDP Program is part of the new health care law, the Patient Protection and Affordable Care Act of 2010,³ and is included in Internal Revenue Code Section 48D. The Internal Revenue Service (IRS), in consultation with the United States Department of Health and Human Services

¹ Pub. L. No. 75-717, 52 Stat. 1040 (1938).

² Pub. L. No. 78-410, 58 Stat. 682 (1944).

³ Pub. L. No. 111-148, 124 Stat. 119 (2010).



Legislative Requirements Were Met When Awarding Credits and Grants for the Qualifying Therapeutic Discovery Project Program

(HHS), implemented the QTDP Program. The IRS entered into an agreement with the HHS to pay more than \$1.5 million to the HHS for its review of packages that taxpayers submitted requesting a credit or a grant during the period June 25 to September 30, 2010.

The QTDP Program's tax benefit is available only to taxpayers with no more than 250 employees. It covers up to 50 percent of a taxpayer's qualified investment. To provide an immediate boost to United States biomedical research, the credit or grant was available for qualified investments made, or to be made, in Tax Years⁴ 2009 and 2010.

To claim the credit or grant, a taxpayer must have applied for certification of its qualified investments. The amount of the credit or grant was limited to a maximum of \$5 million per taxpayer, and the total amount available to all taxpayers was limited to \$1 billion.

Application Process

IRS Notice 2010-45, released on May 21, 2010, established the Program as required by law, and described the application process taxpayers were to use to have a therapeutic discovery project certified as eligible for a credit or grant. Applicants were instructed to submit an Application for Certification of Qualified Investments Eligible for Credits and Grants Under the Qualifying Therapeutic Discovery Project Program (Form 8942).⁵ Form 8942 had to be postmarked no later than July 21, 2010, and had to include a Project Information Memorandum. The Memorandum should provide an overview of the project, including a description of the product, process, or technology under development. The law required that the IRS issue certifications by October 29, 2010.

The IRS could certify an applicant's qualified investment as eligible under the QTDP Program, only if:

- The HHS determined the applicant's project qualified as a therapeutic discovery project.
- The HHS determined the applicant's project showed reasonable potential to: a) result in new therapies (i) treat areas of unmet medical need or (ii) prevent, detect, or treat chronic or acute diseases and conditions; b) reduce long-term health care costs in the United States; or c) significantly advance the goal of curing cancer within the 30-year period beginning on May 21, 2010.
- The IRS determined that the applicant's project was among those projects that have the greatest potential to: a) create and sustain (directly or indirectly) high-quality, high-paying jobs in the United States; and b) advance United States competitiveness in the fields of life, biological, and medical sciences.

⁴ A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

⁵ See Appendix IV for a copy of Form 8942.



Legislative Requirements Were Met When Awarding Credits and Grants for the Qualifying Therapeutic Discovery Project Program

This review was performed at the Small Business/Self-Employed Division Headquarters in Lanham, Maryland; the Accounts Management and Campus Compliance Operations, Cincinnati functions in Covington, Kentucky; and the Small Business/Self-Employed Division Campus Compliance Operations function in Ogden, Utah, during the period November 2010 through May 2011. 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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Detailed information on our audit objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



Legislative Requirements Were Met When Awarding Credits and Grants for the Qualifying Therapeutic Discovery Project Program

Results of Review

Legislative Requirements Were Met When Awarding Credits and Grants to Qualifying Therapeutic Discovery Project Program Recipients

The IRS achieved its Program goals and met legislative requirements when awarding credits and grants to QTDP Program recipients. Within 3 months of the enactment of the law, the IRS established the QTDP Program and began soliciting applications. Within 8 months, it had awarded the credits and grants.

The law required that no later than 60 days after the date of the enactment of the law, March 23, 2010, the IRS, in consultation with the HHS, was to establish a QTDP Program. Immediately after the law was enacted, the IRS quickly established the process and procedures for implementing the law. The IRS:

Within 3 months of the enactment of the law, the IRS established the QTDP Program and began soliciting applications.

- Set up the necessary infrastructure to solicit and process applications. A QTDP Program Implementation Team was formed and included more than 60 employees during the planning and processing phases.
- Developed interagency procedures and agreements.
- Developed a flowchart, guidelines, and procedures to process applications and award the credits and grants.
- Developed Form 8942 and instructions, ensuring it accurately captured the elements of the law.
- Established an executive steering committee comprised of representatives from the IRS and the HHS to coordinate the technical review of Project Information Memorandums.
- Established a dedicated email address staffed by subject matter experts trained specifically on the QTDP Program and law. This facilitated the exchange of information with potential applicants and responses to questions from those either receiving or denied credits or grants.
- Established controls and a database to manage and track the applications.
- Created and implemented a communication initiative, including press releases, frequently asked questions, and fact sheets.

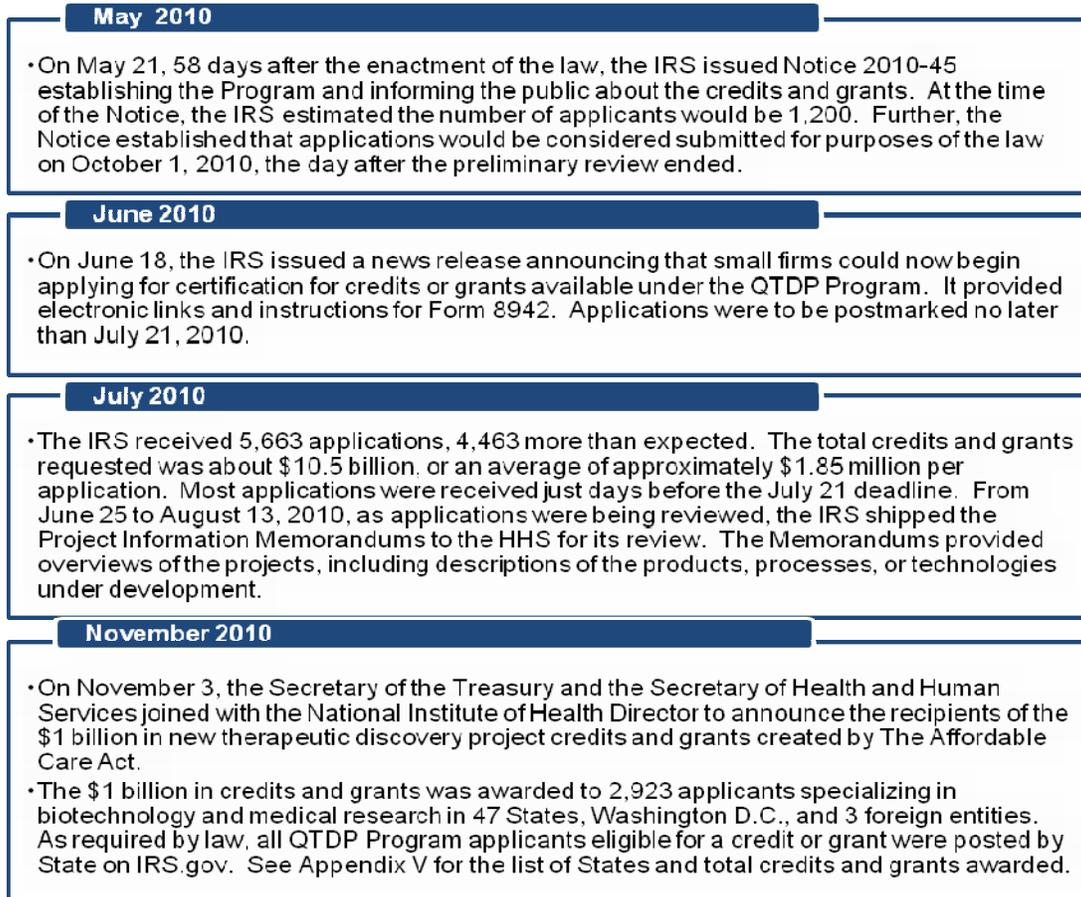


Legislative Requirements Were Met When Awarding Credits and Grants for the Qualifying Therapeutic Discovery Project Program

- Established the QTDP Program on the HHS Payment Management System to facilitate grant payments. This system provides online disbursement, grant monitoring and reporting, and cash management services to both awarding agencies and grant recipients.
- Created and mailed letters to all credit or grant recipients advising them of their respective awards and of their filing requirements. The letters were tailored to the recipients with attachments including highlighted key information.

Figure 1 shows the milestones for the QTDP Program from establishment of the Program to November 3, 2010, when the Program recipients were announced.

Figure 1: QTDP Program Milestones



Source: IRS news releases and the QTDP Program Implementation Team.

The QTDP Program Implementation Team conducted 156 stakeholder presentations and produced 11 external and 4 internal articles.



Legislative Requirements Were Met When Awarding Credits and Grants for the Qualifying Therapeutic Discovery Project Program

The cost of implementing the QTDP Program and processing Forms 8942 was approximately \$5.4 million in Fiscal Year 2010 and approximately \$0.8 million for Fiscal Year 2011, as of January 31, 2011. In addition, more than \$1.5 million was paid to the HHS for determining whether the taxpayer projects met the health care requirements. The cost to the IRS was about \$1,360 for each Form 8942 processed.

Of the 5,663 Forms 8942 received, 4,606 (81.3 percent) projects were certified and awarded either a credit or a grant. Figure 2 shows the number of applications initially processed and the amounts and types of the awards initially granted.

Figure 2: Initial Number of QTDP Program Credit and Grant Applications (as of November 1, 2010)

| | | |
|---|------------------------|---------------|
| Number of Applications Received | 5,663 | 100.0% |
| Not Certified by the HHS | 1,025 | 18.1% |
| Not Certified by the IRS | 32 | 0.6% |
| Number Approved for Credits/Grants | 4,606 | 81.3% |
| Grants Awarded | 4,516 | 98.0% |
| Credits Awarded | 90 | 2.0% |
| Total Amount Awarded | \$1,000,000,000 | |

Source: IRS analysis of credits and grants as of November 1, 2010.

After announcing the recipients of the awards, the QTDP Program Implementation Team identified processing errors and some applicants questioned why they had not received awards. Subsequently, the IRS and the HHS reviewed the applications again and determined four projects qualified for awards.

In addition, after the credits and grants were posted to IRS.gov, 20 award recipients requested that their awards be changed from credits to grants and/or from grants to credits.⁶

- 16 taxpayers with 21 projects that received credits for Tax Year 2009 amended their applications to request grants for Tax Year 2010.
- *****1*****

⁶ As of April 29, 2011.



Legislative Requirements Were Met When Awarding Credits and Grants for the Qualifying Therapeutic Discovery Project Program

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Sixty taxpayers (76 projects) amended their applications to reduce qualified expenses and, therefore, reduce the award amounts. In addition, 11 award recipients (13 projects) have amended their applications to withdraw completely from the QTDP Program. This happened because the projects were not undertaken as planned. Form 8942 instructions advise applicants to:

File an amended Form 8942 to correct the amount of qualified investment previously reported if the applicant requested a grant. If the applicant requested a grant and amount of actual costs paid or incurred for qualified investment is less than the amount included on line 35, for which certification was requested, file an amended Form 8942 within 15 days after the close of the applicant's tax year to show the actual costs paid or incurred for qualified investment.

Figure 3 reflects the disposition of awards as of April 30, 2011.

Figure 3: QTDP Program Credit and Grant Dispositions

| | |
|--|--------------------------|
| Number of Applications Approved for Credit or Grant | 4,597⁷ |
| Grants Awarded | 4,527 |
| Credits Awarded | 91 |
| Adjusted Amount Awarded | \$991,610,727 |

Source: Our reconciliation of IRS records from November 1, 2010, to April 29, 2011.

Applications were appropriately processed and most funds were correctly distributed

The IRS had internal controls in place to track, monitor, and control all applications. For example:

- Controls and procedures were documented and all documents pertaining to the Program were organized and centrally controlled.
- Integrated Data Retrieval System⁸ checks were performed on each applicant. Several applicants had no prior tax return filing history.
- The applicants, as required by the law, had no more than 250 employees.

⁷ The number of credits and grants awarded exceeds the number of total grants because 21 projects receiving credits in Tax Year 2009 switched to grants for Tax Year 2010.

⁸ The IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.



Legislative Requirements Were Met When Awarding Credits and Grants for the Qualifying Therapeutic Discovery Project Program

projects under a certain amount receiving grants for the full 50 percent of their qualified investment as allowed by law. The remaining funds were then apportioned to the remaining applicants. This was repeated until the funds were completely allocated.

The certification and award amounts were accurate based on the formula. No award exceeded the \$5 million in credits or grants allowed by the law for any single taxpayer. *****1*****
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Funds were generally entered correctly into the HHS Payment Management System for distribution to the grantees

Generally, funds were correctly accounted for and information was correctly entered into the HHS Payment Management System, which maintains and distributes the grant funds. The IRS enters the grantees and their award amounts and grantees draw funds directly from the System via electronic transfers.

Changes to grant amounts occurred that required the IRS to update the award amounts and available funds on the System. *****1*****
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After the initial announcement, the IRS received inquiries from applicants questioning why they had not received awards

The law does not provide appeal rights. Notice 2010-45 includes the following:

Notice 2010-45, Section 7.05 *No Right to a Conference or Appeal.* A taxpayer does not have a right to a conference relating to any matters under this notice. Further, a taxpayer does not have a right to appeal the decisions made under this notice (including the amount of credit allocated to the project and whether or not to certify the project) to any official of the HHS or the Service or the Department of the Treasury.

However, if an inquiry was received from an applicant that was denied a credit or grant, the IRS reviewed the application again and, if applicable, referred it to the HHS. The HHS reviewed the actions taken on the case again to determine if an administrative error had occurred. ***1*** cases received a second review. *****1*****
s*****1*****. The IRS stated that it had not checked all denied applications for scoring errors. In four other cases, the HHS did not change its original assessment of the projects. The IRS notified all ****1***** applicants of the final decisions.



Legislative Requirements Were Met When Awarding Credits and Grants for the Qualifying Therapeutic Discovery Project Program

The complexity of the law created confusion and difficulties in administering the QTDP Program

The law is complex and, like many laws, has special rules, includes only certain costs, excludes certain costs and entities, requires recapturing certain credits and reducing the basis of property by the amount of the QTDP Program credit, and sets very short time periods for implementation. For example:

- Some types of entities (i.e., any Federal, State, or local government; charitable organization; and certain others) were excluded from receiving grants.
- The qualified investment could not include certain costs, including: certain employee remuneration; interest expenses; facility maintenance expenses (e.g., mortgage, rent, insurance, and maintenance); certain investments in which bonus depreciation is allowed; and any cost identified as a service cost under current regulations.
- The qualified investment includes only investments made in Tax Years 2009 or 2010. Thus, the qualified investment may include both amounts already paid or incurred and amounts that have not yet been paid or incurred at the time the application was filed. These qualified investments are reported on Form 8942, Part III.
- If the allocation of credits awarded in Tax Years 2009 or 2010 exceeds the actual amount of the qualified investment incurred for the qualified therapeutic discovery project, then the credits must be recaptured. If the amount of the grant awarded exceeds the amount allowable after the actual amount of qualified investment is subsequently determined, then recapture of some or the entire grant may be required. However, this amount would be recaptured as an increase in tax.
- The law required that the QTDP Program be implemented within a very short time period. Applicants had only 1 month from the date the application was posted on IRS.gov to submit a completed Form 8942. The IRS and the HHS had only 30 calendar days after the submission deadline of the applications to certify the applicants.

The complexity of the law made it difficult to develop a process that would ensure applicants met all requirements. From June 2010 to March 2011, the QTDP Program Implementation Team received and responded to 6,554 telephone calls and 3,206 emails with questions about the Program. During May and June 2010, calls pertained to application preparation. Beginning in October 2010, calls ranged from how to file amended Forms 8942 to questions about projects that were not approved (rejected) and income tax return issues.



Legislative Requirements Were Met When Awarding Credits and Grants for the Qualifying Therapeutic Discovery Project Program

Certain taxpayers were required to amend their previously filed income tax returns

All taxpayers that applied for and received a QTDP Program tax credit or grant for Tax Year 2009 and had already filed their Tax Year 2009 returns would, depending on whether they received a credit or a grant, have to file an amended tax return to either:

- 1) Reduce the amount of otherwise deductible expenses included on their Tax Year 2009 return by the amount of such expenses included in computing the credit and claim the QTDP Program credit.
- 2) Reduce the expenses included on their Tax Year 2009 return by the amount of the Tax Year 2009 certified qualified investment used to receive a grant.

Certain taxpayers were required to amend their previously filed income tax returns, including all related flow-through entities.

When amending the tax return, if additional tax is owed, the taxpayer would also be subject to interest. *****1*****
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The short time period to implement the law and award the credits and grants limited the verification of information submitted

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*****2(f)*****. The law required that consideration be given to those projects that showed the greatest potential to:

- 1) Create and sustain (directly or indirectly) high-quality, high-paying jobs in the United States.
- 2) Advance United States competitiveness in the fields of life, biological, and medical sciences.

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Legislative Requirements Were Met When Awarding Credits and Grants for the Qualifying Therapeutic Discovery Project Program

Figure 3: Excerpt From Form 8942

Part II Certification and Grant Election Information (continued)
20 Will this project create and sustain (directly or indirectly) high-quality, high-paying jobs in the United States?
21 Enter the number of full-time and part-time employees in the United States whose work is directly billed to the project and the average salaries of the employees in each category.
22a Enter the number of contractors in the United States paid for work on the project
22b Enter the average monthly hours of the contractors entered on line 22a
22c Enter the average monthly compensation of the contractors entered on line 22a.
23 Will this project advance United States competitiveness in the fields of life, biological, and medical sciences?
24 As of the date this application is submitted, is the project active, terminated, or suspended?
25 If the project is terminated or suspended for any of the failures below, check all boxes that apply.
26 Will the project produce a new or significantly improved technology, or a new application of or significant improvement to existing technology, as compared to commercial technologies currently in service?
27 Is the project expected to lead to the construction or use of a contract production facility in the United States in the next 5 years?

Source: Form 8942 and IRS.gov.

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addition, Form 8942 also contains a Penalties of Perjury Statement that required the signer to declare he or she has examined the application, including the accompanying documents, and, to the best of his or her knowledge and belief, all of the facts contained therein are true, correct, and complete.

The short time period may also have affected the outcome of the QTDP Program

The rejection rate of HHS Small Business Innovative Research health care projects is about 70 percent compared to approximately 20 percent for the QTDP Program. The Small Business Innovative Research Program was created to ensure that small businesses received a greater



Legislative Requirements Were Met When Awarding Credits and Grants for the Qualifying Therapeutic Discovery Project Program

share of Federal research and development awards. The greater than 80 percent acceptance rate of the QTDP Program was attributed to the streamlined procedures and an expedited process of review.

The rejection rate of HHS Small Business Innovative Research health care projects is about 70 percent compared to approximately 20 percent for the QTDP Program.

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Recommendation

Recommendation 1: The Commissioner, Small Business/Self-Employed Division, should ensure the information regarding the applicant names and amounts allocated are updated on IRS.gov to accurately show the recipients and projects awarded QTDP Program credits and grants.

Management’s Response: IRS management agreed with the recommendation. The IRS will update the information on IRS.gov regarding the applicant names and amounts allocated through July 31, 2011. The IRS will also make a final update to IRS.gov to reflect any activity from August 1, 2011, to the end of the QTDP Program.

Some Award Recipients Owe Federal Taxes

Eighteen QTDP Program grant recipients owe approximately \$800,000 in delinquent taxes,¹¹ extending as far back as Tax Year 2005. These 18 recipients received more than \$5 million in QTDP Program grants. *****1*****
*****1*****. See Figure 4 for the range of grants and the amount of taxes owed.

¹¹ As of May 25, 2011.



Legislative Requirements Were Met When Awarding Credits and Grants for the Qualifying Therapeutic Discovery Project Program

Figure 4: Range of Grants and Taxes Owed

| Range of Grants | Taxes and Penalties Owed |
|-------------------------------|--------------------------|
| <\$250,000 | \$528,619 |
| \$250,000 - \$349,999 | \$102,826 |
| \$350,000 - \$499,999 | \$115,120 |
| \$500,000 - \$749,999 | \$10,210 |
| \$750,000 - \$1,000,000 | \$36,874 |
| Total Delinquent Taxes | \$793,649 |

Source: Our analysis of QTDP Program records.

The majority of the \$793,649 delinquent taxes is for employment taxes (Federal income tax withholding, Social Security and Medicare taxes, and Federal unemployment tax). However, it also includes *****1*****.

These taxes are owed by the organizations that received the QTDP Program grants. The Affordable Care Act did not require that applicants or award recipients be compliant with their Federal tax obligations or not have any outstanding unpaid taxes. The IRS verified the Taxpayer Identification Numbers for all applicants and validated certain other information submitted that was available on IRS computer systems but not whether the applicants had paid all their Federal taxes.

A Compliance Plan to Monitor Credit and Grant Recipient Tax Returns Is Being Implemented

The QTDP Program Implementation Team drafted a Compliance Plan that includes a review of the tax returns filed by taxpayers that accepted QTDP Program credits and grants. The Compliance Plan includes procedures to determine whether taxpayers that did not apply for a credit or grant attempt to claim an investment credit.

The IRS developed a compliance plan to review tax returns of taxpayers that accepted credits and grants.

Certain transaction and action codes¹² were to be posted to the Tax Years 2009 and 2010 accounts of the respective QTDP Program applicants. In addition, the applicants' tax accounts were to be updated to reflect the amount of the approved credit or grant or denial of

¹² Transaction Codes are used to identify a transaction being processed and to maintain a history of actions posted to a taxpayer's account on the Master File. Action Codes provide additional definitions for certain Transaction Codes.



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the credit or grant. For flow-through entities, partners and shareholders will be identified so their accounts can be updated.

The IRS currently plans to review tax account transcripts¹³ to classify and select tax returns for a limited scope examination. The tax returns will be sent to the IRS Small Business/Self-Employed Division's Abusive Transaction and Technical Issues function for screening. If warranted, the tax return will be sent for a field examination.

Applicants that have already filed their Tax Year 2009 returns and received a credit for Tax Year 2009 were advised to file amended returns and to include the credit on the General Business Credit (Form 3800). Taxpayers are advised to annotate Form 3468 (Investment Credit), which is then reviewed by the IRS for accuracy. For applicants filing Tax Year 2010 tax returns, a line was added to the Form 3468 and the QTDP credit amount is to be carried over to Form 3800. Tax Year 2010 taxpayers are required to project qualified expenditures.

As of April 18, 2011, the IRS has mailed 326 letters to grant recipients that have not filed an amended Tax Year 2009 return. Although there were about 2,000 applicants that have yet to file amended returns, the IRS stated most do not appear to have an additional tax liability due to large, unused losses or a lack of taxable receipts. The IRS will also be reviewing all QTDP Program credit recipients' tax returns to ensure they have included a corresponding reduction in qualifying expenses on amended returns for those recipients claiming Tax Year 2009 credits.

Specific Compliance Initiative Projects, which will focus on grant recipients, are also planned to identify potential noncompliance. The amount of the qualified expenditures reported on Form 8942 will be verified.

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In addition, once the IRS determines all eligible taxpayers have filed their Tax Year 2010 tax returns, the IRS should remove the QTDP Program line item from Form 3468. This would

¹³ Transcripts provide most of the information contained in a tax return.

¹⁴ A tax module is part of a taxpayer's account that reflects tax data for one tax type and one tax period.



Legislative Requirements Were Met When Awarding Credits and Grants for the Qualifying Therapeutic Discovery Project Program

prevent unscrupulous taxpayers from using the form to claim QTDP Program investment credits for which they are not entitled.

Recommendation

Recommendation 2: The Commissioner, Small Business/Self-Employed Division, should ensure the QTDP Program line item is removed from Form 3468 after it is determined that all QTDP Program taxpayers have filed their Tax Year 2010 returns.

Management's Response: IRS management agreed with the recommendation. The IRS has notified the Forms and Publications function of the need to remove the QTDP Program line from Form 3468. The IRS will request such action once it has determined that all QTDP Program taxpayers have filed their Tax Year 2010 returns.



Legislative Requirements Were Met When Awarding Credits and Grants for the Qualifying Therapeutic Discovery Project Program

Appendix I

Detailed Objectives, Scope, and Methodology

Our overall objective was to determine whether the QTDP Program met legislative requirements when considering and awarding credits and grants to QTDP Program applicants. We also determined whether the IRS implemented adequate controls to monitor the credits and grants. To accomplish our objectives, we:

- I. Obtained a clear understanding of the law and its requirements by reviewing the laws and related Committee reports; IRS notices, forms, and publications; and all IRS communications to taxpayers and news releases relating to the Program. We also discussed the concerns and challenges with administration of the Program with the IRS and HHS officials responsible for the Program.
- II. Determined whether the IRS complied with the laws establishing the Program and certifying applicants.
 - A. Determined whether the IRS communication and application process complied with the law and was sufficient to ensure all taxpayers wanting to apply were able to apply.
 - B. Determined whether the verification of applicant information performed prior to the awards was adequate to ensure compliance with all laws.
- III. Selected a statistically valid sample of 96 applicants from a population of 5,663 QTDP Program applicants. We oversampled by 13 applicants to ensure the sample selected included a representative number of denied and approved applications. The result of the oversample brought the total applicants selected to 109. We used a ± 5 percent precision level, a 90 percent confidence interval, and a 10 percent error rate to select the statistical sample. The sample was used to determine:
 - A. Whether applicants met the criteria for receiving the QTDP Program credit or grant.
 - B. Whether Applications for Certification of Qualified Investments Eligible for Credits and Grants Under the Qualifying Therapeutic Discovery Project Program (Form 8942)¹ were accurate and complete.
 - C. Whether the applicants were recorded accurately on the QTDP Program database. We assessed the reliability of the QTDP Program database by matching 10 taxpayer applications to all fields to determine any inaccuracies or missing data.

¹ See Appendix IV for a copy of Form 8942.



Legislative Requirements Were Met When Awarding Credits and Grants for the Qualifying Therapeutic Discovery Project Program

- D. Whether any of the sample applicants were on the Excluded Parties List System.²
 - E. Whether approved applicants were posted to IRS.gov.
 - F. Whether the proper posting of transaction and action codes³ and denial and approval results were accurately posted to the taxpayers' accounts.
 - G. Whether taxpayers correctly filed amended and/or original tax returns as required, to offset credits taken for expenditures.
 - H. Whether the applicant awards were correctly posted to the HHS Payment Management System. We assessed the reliability of the HHS Payment Management System by assessing data validation performed by the database administrator and by verifying the contents and relationship of the data fields.
 - I. Whether there were any tax liabilities for the QTDP Program applicants. We assessed the reliability of IRS Integrated Collection System⁴ used to determine if there were Federal tax liabilities. We matched applicant data to the IRS Integrated Collection System and to the IRS Integrated Data Retrieval System⁵ to determine if the information was accurate and consistent.
- IV. Determined whether internal controls were and are in place to accurately distribute and track funds allocated to the recipients.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their 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 objectives: the IRS's policies, procedures, and practices relative to implementing the QTDP Program and processing the applications. We evaluated related controls by assessing the internal control environment, interviewing IRS and HHS officials, and reviewing QTDP Program management reports. We also assessed the QTDP Program database developed for recording and tracking QTDP Program applications.

² A worldwide web site, provided as a public service by the General Services Administration, for the purpose of disseminating information on parties excluded from receiving Federal contracts, certain subcontracts, and certain Federal financial and nonfinancial assistance and benefits.

³ Transaction Codes are used to identify a transaction being processed and to maintain a history of actions posted to a taxpayer's account on the Master File. Action Codes provide additional definitions for certain transaction codes.

⁴ An automated system used to control and monitor delinquent tax cases assigned to IRS employees.

⁵ IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.



Legislative Requirements Were Met When Awarding Credits and Grants for the Qualifying Therapeutic Discovery Project Program

Appendix II

Major Contributors to This Report

Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services)

Augusta R. Cook, Director

Lena Dietles, Audit Manager

Tracy Harper, Lead Auditor

Tanya Adams, Senior Auditor

Jerry Douglas, Senior Auditor

Kathy Coote, Auditor

Johnathan Elder, Auditor

Nelva Usher, Auditor



Legislative Requirements Were Met When Awarding Credits and Grants for the Qualifying Therapeutic Discovery Project Program

Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Operations Support OS
Deputy Commissioner for Services and Enforcement SE
Chief Technology Officer OS:CTO
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Director, Strategy and Finance, Wage and Investment Division SE:W:S
Director, Campus Compliance Operations, Cincinnati, Small Business/Self-Employed Division
SE:S:CCS:CCO:CIN
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:
 Chief Technology Officer OS:CTO
 Commissioner, Small Business/Self-Employed Division SE:S
 Chief, Program Evaluation and Improvement, Wage and Investment Division SE:W:S:PEI



Legislative Requirements Were Met When Awarding Credits and Grants for the Qualifying Therapeutic Discovery Project Program

Appendix IV

Application for Certification of Qualified Investments Eligible for Credits and Grants Under the Qualifying Therapeutic Discovery Project Program

Form **8942** Application for Certification of Qualified Investments Eligible for Credits and Grants Under the Qualifying Therapeutic Discovery Project Program
 (June 2010) OMB No. 1545-2175
 Department of the Treasury Internal Revenue Service ▶ See separate instructions for required attachments.

Part I Applicant Information Check if this is an amended application

1 Name of applicant **2** Taxpayer identification number (TIN)

3 Number and street Room/suite

4 City, town, or post office, state, and ZIP code

5 Telephone number

6 URL address for applicant's website

7 Is the applicant a member of an affiliated group filing consolidated returns? Yes No
 If "Yes," complete lines 8 through 12.

8 This corporation has been a member of this group:
a For the entire year
b From / / 20 until / / 20

9 Name of the common parent of the affiliated group **10** Employer identification number (EIN)

11 Number and street Room/suite

12 City, town, or post office, state, and ZIP code

13 Contact person. Attach a properly completed Form 2848, Power of Attorney and Declaration of Representative, if necessary. See instructions.
a Name of contact person
b Number and street Room/suite
c City, town, or post office, state, and ZIP code
d Telephone number **e** Fax number

14a Name of the project
b Description of the project (see instructions)

Part II Certification and Grant Election Information (see instructions)

15 Enter the number of employees in all businesses of the applicant on the date this application is submitted. See instructions. ▶
 If more than 250, do not continue with this application.

16 Are the applicant and any other entities considered to be a single employer under section 52(a) or (b) or section 414(m) or (o)? See instructions. ▶ Yes No
 If "Yes":
 • Attach a statement listing the name, address, and employer identification number (EIN) for each of the other entities; and
 • Applicant certifies it has 250 or fewer employees, taking into account the employees of these other entities, on the date this application is submitted.

17 Is the applicant electing for this application for certification to be an application for a grant for a tax year beginning in:
a 2009? Yes No If "Yes" for either **a** or **b**, complete lines 18 and 19.
b 2010? Yes No If "No" to both **a** and **b**, skip to line 20.

18 Enter the applicant's Data Universal Numbering System (D-U-N-S) number. See instructions. ▶

19 Check the applicable box that describes the applicant. If any of the following describes the applicant, the applicant is not eligible for a grant.
 Federal, state, or local government or any political subdivision, agency, or instrumentality thereof.
 Organization described in section 501(c) and exempt from tax under section 501(a).
 Entity referred to in section 54(j)(4).
 Partnership or other pass-through entity with a government or any political subdivision, agency, or instrumentality thereof, section 501(c) organization, or section 54(j)(4) entity as a direct or indirect partner (or other direct or indirect holder of an equity or profits interest). **Note:** Do not check this box if such entity owns only an indirect interest in the applicant through a C corporation.

For Privacy Act and Paperwork Reduction Act Notice, see instructions. Cat. No. 37758D Form 8942 (6-2010)



Legislative Requirements Were Met When Awarding Credits and Grants for the Qualifying Therapeutic Discovery Project Program

Form 8942 (6-2010)

Page 2

Part II Certification and Grant Election Information (continued)

20 Will this project create and sustain (directly or indirectly) high-quality, high-paying jobs in the United States? Yes No

21 Enter the number of full-time and part-time employees in the United States whose work is directly billed to the project and the average salaries of the employees in each category. See instructions.

| Employees | Number of employees | Average salaries of the employees |
|-------------|---------------------|-----------------------------------|
| a Full-time | | |
| b Part-time | | |

22a Enter the number of contractors in the United States paid for work on the project

b Enter the average monthly hours of the contractors entered on line 22a

c Enter the average monthly compensation of the contractors entered on line 22a.

23 Will this project advance United States competitiveness in the fields of life, biological, and medical sciences? Yes No

24 As of the date this application is submitted, is the project active, terminated, or suspended? Check one.
 Active Terminated Suspended

25 If the project is terminated or suspended for any of the failures below, check all boxes that apply.
 The project failed a clinical trial.
 The project failed a pre-clinical research milestone.
 The project failed to secure FDA licensure.
 If the applicant checked any of the boxes above, do not continue with this application.

26 Will the project produce a new or significantly improved technology, or a new application of or significant improvement to existing technology, as compared to commercial technologies currently in service? . . . Yes No

27 Is the project expected to lead to the construction or use of a contract production facility in the United States in the next 5 years? Yes No

Part III Qualified Investment (see instructions)

Complete columns (a), (b), and (c), as applicable. See instructions.
 Complete column (a) only for 2009 grant applications if the applicant's 2009 tax year ends after the application date.

| | (a) As of September 30, 2010 (tax year 2009 only) (see instructions) | (b) Tax year 2009 | (c) Tax year 2010 |
|--|---|----------------------|----------------------|
| 28 Qualified investment derived from employee wages. | | | |
| 29 Qualified investment derived from supplies and lab costs. | | | |
| 30 Qualified investment derived from depreciable property. | | | |
| 31 Qualified investment derived from third-party contractors. | | | |
| 32 Qualified investment derived from other costs. | | | |
| 33 Amount in line 30 attributable to qualified progress expenditures. | | | |
| 34 Total. Add lines 28 through 32 in each column. | | | |
| 35 Qualified investment for which certification is requested. Add line 34 columns (b) and (c). | | | |

36 This application is for certification of qualified investment, related to a qualifying therapeutic discovery project, for (check only one):
 Tax year beginning in 2009 only. Enter the ending date of the tax year / /
 Tax year beginning in 2010 only. Enter the ending date of the tax year / /
 Tax years beginning in 2009 and 2010. Enter the ending date of the tax year for 2009 / /
 and for 2010 / /

Sign Here Under penalties of perjury, I declare that I have examined this submission, including the accompanying documents, and, to the best of my knowledge and belief, all of the facts contained herein are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Keep a copy of this form for your records.

Signature of Applicant _____ Date _____ Title _____

Paid Preparer's Use Only Preparer's signature _____ Date _____ Check if self-employed Preparer's SSN or PTIN _____
 Firm's name (or yours if self-employed), address, and ZIP code _____ EIN _____
 Phone no. _____

Form 8942 (6-2010)

Source: IRS.gov and Form 8942.



Legislative Requirements Were Met When Awarding Credits and Grants for the Qualifying Therapeutic Discovery Project Program

Appendix V

Credits and Grants Distributed by State¹

| | | | | |
|----------------------|-------------|-------------|---------------|--------------|
| Alabama | \$294,009 | \$376 | \$3,132,530 | \$575,775 |
| Arizona | \$749,192 | \$352,576 | \$4,342,604 | \$3,645,232 |
| Arkansas | | | \$535,229 | \$195,065 |
| California | \$2,218,169 | \$1,084,667 | \$214,448,844 | \$63,640,722 |
| Colorado | \$362,108 | \$126,851 | \$15,790,023 | \$6,986,495 |
| Connecticut | \$520,019 | \$509,003 | \$11,500,143 | \$2,562,681 |
| Delaware | | | \$1,047,339 | \$1,177,462 |
| District of Columbia | \$451,115 | \$244,479 | \$377,597 | \$342,494 |
| Florida | \$102,657 | \$239,306 | \$16,709,462 | \$9,507,260 |
| Foreign ² | | | \$733,438 | |
| Georgia | \$244,479 | | \$10,554,302 | \$4,856,124 |
| Hawaii | | | \$3,916,381 | \$871,969 |
| Illinois | \$84,816 | \$95,347 | \$8,985,727 | \$5,178,174 |
| Indiana | | | \$7,198,044 | \$3,111,122 |
| Iowa | | | \$1,427,740 | \$343,488 |
| Kansas | | | \$2,476,966 | \$1,554,290 |
| Kentucky | \$578,894 | \$154,544 | \$2,395,705 | \$1,896,883 |
| Louisiana | \$127,834 | \$116,645 | \$1,633,927 | \$504,540 |
| Maine | \$217,486 | \$117,118 | \$149,768 | \$82,019 |
| Maryland | \$244,479 | | \$35,437,612 | \$13,330,875 |
| Massachusetts | \$2,391,671 | \$253,279 | \$96,270,166 | \$29,695,570 |
| Michigan | | | \$11,287,706 | \$7,086,991 |
| Minnesota | \$226,991 | \$461,968 | \$14,311,920 | \$8,907,998 |
| Mississippi | | | \$463,796 | \$461,023 |
| Missouri | \$244,479 | | \$4,828,826 | \$2,892,649 |
| Montana | \$239,204 | \$249,754 | \$885,792 | \$411,179 |

¹ These data do not reflect the updates of the applicants that changed tax credits to grants and grants to tax credits.

² Three grants were issued to foreign entities.



Legislative Requirements Were Met When Awarding Credits and Grants for the Qualifying Therapeutic Discovery Project Program

| | | | | |
|---------------------------|---------------------|--------------------|----------------------|----------------------|
| Nebraska | \$39,145 | \$205,334 | \$1,101,229 | \$1,072,500 |
| Nevada | | | \$1,214,502 | \$1,888,782 |
| New Hampshire | | | \$836,591 | \$1,807,359 |
| New Jersey | \$365,479 | \$123,479 | \$41,091,787 | \$10,864,362 |
| New Mexico | | | \$3,043,477 | \$1,682,399 |
| New York | \$308,689 | \$147,249 | \$32,774,141 | \$15,240,814 |
| North Carolina | | | \$27,547,804 | \$8,487,967 |
| North Dakota | | | \$296,494 | \$436,943 |
| Ohio | \$696,067 | \$87,495 | \$9,104,250 | \$6,022,597 |
| Oklahoma | | | \$1,833,173 | \$1,152,365 |
| Oregon | | | \$3,714,454 | \$1,732,863 |
| Pennsylvania | \$576,527 | \$645,869 | \$32,723,388 | \$15,381,713 |
| Rhode Island | \$120,704 | \$123,309 | \$3,104,983 | \$1,453,645 |
| South Carolina | | | \$1,172,404 | \$1,415,873 |
| South Dakota | | | \$11,738 | \$232,742 |
| Tennessee | | \$244,479 | \$5,042,706 | \$1,688,745 |
| Texas | \$1,000,995 | \$188,668 | \$22,160,281 | \$11,974,635 |
| Utah | \$17,834 | \$35,892 | \$8,302,851 | \$4,381,667 |
| Vermont | | | \$120,659 | \$123,820 |
| Virginia | \$352,198 | \$13,820 | \$6,706,613 | \$4,019,720 |
| Washington | | | \$24,695,119 | \$9,407,220 |
| West Virginia | | | \$392,379 | \$96,580 |
| Wisconsin | \$12,975 | \$120,156 | \$8,490,228 | \$4,563,893 |
| Totals³ | \$12,788,214 | \$5,941,662 | \$706,322,840 | \$274,947,284 |

Source: Data posted to IRS.gov, dated November 2010.

³ Due to rounding, the totals may not equal the sum of the column amounts.



Legislative Requirements Were Met When Awarding Credits and Grants for the Qualifying Therapeutic Discovery Project Program

Appendix VI

Management's Response to the Draft Report

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

**COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION**

AUG 18 2011

**MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT**

**FROM: Faris R. Fink /s/ Faris R. Fink
Commissioner, Small Business/Self-Employed Division**

**SUBJECT: Draft Audit Report - Legislative Requirements Were Met When Awarding
Grants and Tax Credits for the Qualifying Therapeutic Discovery Project
Program (201140040)**

Thank you for the opportunity to review TIGTA's draft report titled: "Legislative Requirements Were Met When Awarding Grants and Tax Credits for the Qualifying Therapeutic Discovery Project Program."

We appreciate your acknowledgement of our efforts to implement this legislation within an extraordinarily short timeframe. As highlighted in your report, we established the Qualifying Therapeutic Discovery Project (QTDP) Program and began soliciting applications within 3 months of enactment of the law, and awarded credits and grants to certified applicants within 8 months of enactment. To satisfy the objectives of this program, we established the necessary infrastructure to receive, process, and review applications within a short period of time. We also developed interagency procedures and agreements, created Form 8942 and instructions, created internal training materials, and provided a variety of external communications. As a result of our efforts, we received and were able to timely process over 5,663 applications and approve 4,606 credits and grants in lieu of credits to certified applicants.

All credits and grants in lieu of credits were awarded and timely published on IRS.gov by state in accordance with the statutory timeframe. As your report notes, however, updates are needed to reflect the actual results of the program based on events subsequent to the initial web posting. For example, following the initial posting, the IRS discovered that *****1***** and three additional taxpayers' projects were subsequently certified and notified accordingly. In concurrence with your recommendation, we will update the published list to reflect these subsequent events.



Legislative Requirements Were Met When Awarding Credits and Grants for the Qualifying Therapeutic Discovery Project Program

We concur with all of your recommendations. Attached is a detailed response outlining our corrective actions. If you have any questions, please contact me or a member of your staff may contact Shenita Hicks, Director, Examination, Small Business/Self-Employed Division (SB/SE), at (859) 669-5526.

Attachment



Legislative Requirements Were Met When Awarding Credits and Grants for the Qualifying Therapeutic Discovery Project Program

Attachment

RECOMMENDATION 1:

The Commissioner, Small Business/Self-Employed Division should ensure the information regarding the applicant names and amounts allocated are updated on IRS.gov to accurately show the taxpayers and projects originally awarded QTDP Program grants and credits.

CORRECTIVE ACTION:

We concur with this recommendation. 1) We will update the information on IRS.gov regarding the applicant names and amounts allocated through July 31, 2011. 2) We will make a final update to IRS.gov to reflect any activity from August 1, 2011, to the end of the QTDP program.

IMPLEMENTATION DATE:

- 1) October 15, 2011
- 2) July 15, 2012

RESPONSIBLE OFFICIAL(S):

Director, Abusive Transactions and Technical Issues, Small Business/Self-Employed Division (SB/SE)

CORRECTIVE ACTION MONITORING PLAN:

We will monitor this action as part of our internal management control process.

RECOMMENDATION 2:

The Commissioner, Small Business/Self-Employed Division, should ensure the QTDP Program line item is removed from Form 3468 after it is determined that all QTDP Program taxpayers have filed their Tax Year 2010 returns.

CORRECTIVE ACTION:

We concur with this recommendation. We have notified Forms and Publications of the need to remove the QTDP Program line from Form 3468, *Investment Credit*. We will request such action once we have determined that all QTDP Program taxpayers have filed their Tax Year 2010 returns.

IMPLEMENTATION DATE:

July 15, 2012

RESPONSIBLE OFFICIAL(S):

Director, Abusive Transactions and Technical Issues, Small Business/Self-Employed Division (SB/SE)

CORRECTIVE ACTION MONITORING PLAN:

We will monitor this action as part of our internal management control process.