The Voluntary Closing Agreement Program for Tax-Exempt Bonds Has Been Implemented, but Its Impact on Voluntary Compliance Has Not Been Determined

September 2004

Reference Number: 2004-10-175

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 22, 2004

MEMORANDUM FOR COMMISSIONER, TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION

Gordon C. Milbourn III

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

SUBJECT: Final Audit Report – The Voluntary Closing Agreement Program for Tax-Exempt Bonds Has Been Implemented, but Its Impact on Voluntary Compliance Has Not Been Determined (Audit # 200410005)

This report presents the results of our review of the Office of Tax Exempt Bonds' (TEB) Voluntary Closing Agreement Program (VCAP). The overall objectives of this review were to determine whether the TEB office and Tax Exempt and Government Entities (TE/GE) Division have taken appropriate actions to increase bond issuer participation in the VCAP and whether the process established for VCAP cases ensures settlement requests are processed timely, consistently, and effectively to meet the goal of increasing voluntary compliance. The VCAP was established to supplement the Examination Program and provide a means for bond issuers to self-identify Internal Revenue Code violations and report them to the Internal Revenue Service (IRS). The VCAP also allows a reduced settlement (sanction) amount of less than the amount the bond issuer would be assessed if the violation was identified during an examination.

The revenue impact of tax-exempt bonds to the Federal Government is substantial. TEB office management advised that the Department of the Treasury projects approximately $30 billion in tax revenue would be gained in Fiscal Year 2004 if the tax-exempt bonds were taxable.

In summary, TEB office management has taken steps to develop and implement the VCAP in accordance with "Voluntary Closing Agreement Program for Tax-Exempt Bonds" (Internal Revenue Service Notice 2001-60, issued October 1, 2001), and participation in the VCAP has increased over the first 2 years. In addition, the TEB office is continuing to develop the Program to make the settlement process more effective, efficient, and consistent. However, TEB office management does not know the overall levels of voluntary compliance for tax-exempt bonds and cannot determine the effect VCAP closures will have on voluntary compliance. As a result, it is difficult for

TEB office management to determine the extent of value this Program has had on the tax-exempt bond industry compliance levels.

We also determined that TEB office management attempts to increase the impact of the VCAP by performing education and outreach on noncompliance issues and is working with the IRS Office of Chief Counsel and the Department of the Treasury to make changes to the VCAP that should improve the timeliness and consistency of case processing.

We recommended the Director, TEB, TE/GE Division, identify the data needed to adequately baseline tax-exempt bond noncompliance issues, coordinate with Modernization and Information Technology Services organization management to determine how these data could be tracked on current TEB office management information systems, and establish a process to collect and maintain these data.

Management's Response: The Commissioner, TE/GE Division, agreed with our recommendations and determined that all line items on TEB returns should be transcribed to the Business Master File.[1] TEB management, in coordination with Information Technology Services, determined that the data tracking process for risk assessments and noncompliance issues identified through examinations and the VCAP will be integrated into the TE/GE Reporting and Electronic Examination System (TREES). Also, the TEB office's process of collecting and maintaining the data will be integrated into the TREES. Management's complete response to the draft report is included as Appendix IV.

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

[1] The IRS database that consists of Federal tax-related transactions and accounts for businesses. These include employment taxes, income taxes on businesses, and excise taxes.

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The Voluntary Closing Agreement Program for Tax-Exempt Bonds Has Been Implemented, but Its Impact on Voluntary Compliance Has Not Been Determined

Background

Tax-exempt bonds include governmental and qualified private activity certificates of debt issued by state and local governments or by organizations acting on their behalf, such as universities and nonprofit organizations. These bonds are considered tax-exempt because the bond issuers are tax-exempt entities and the bonds will be used for tax-exempt purposes, such as courthouses, hospitals, airport expansions, and highways. The bond issuers typically reinvest the bond proceeds, until they are needed to finance the tax-exempt project. If the tax-exempt bond issuers meet certain requirements under the Internal Revenue Code (I.R.C.), the interest income from the bond issuances can be excluded from gross income for tax purposes for both the bond issuer and the bond investors (i.e., bondholders). However, the bond issuers and investors can be held liable for paying sanctions[1] if the I.R.C. requirements are not met.

The number of outstanding tax-exempt bonds and their total worth is not known. However, Internal Revenue Service (IRS) records show that more than 450,000 Information Returns for Tax-Exempt Private Activity Bond Issues (Form 8038)[2] were filed with the IRS from 1985 through 2002. During the same period, the value of outstanding bonds grew from $650 billion to nearly $1.8 trillion.

The revenue impact of tax-exempt bonds to the Federal Government is substantial. The Office of Tax Exempt Bonds (TEB), Tax Exempt and Government Entities (TE/GE) Division, advised that the Department of the Treasury projects approximately $30 billion in tax revenue would be gained in Fiscal Year (FY) 2004 if the tax-exempt bonds were taxable.

The TEB office's primary methods for ensuring compliance with the I.R.C. are its examination and outreach and

[1] Sanctions are additional taxes, interest, and penalties assessed against taxpayers who are found to be in violation of the I.R.C.
[2] Forms 8038 are filed only when bonds are issued. Usually, the bond issuer is not required to file any additional forms in relation to the bond issuance unless there is an obligation to pay arbitrage rebate. The 450,000 Forms 8038 also include the number of Information Return for Tax-Exempt Governmental Obligations (Form 8038-G) that were filed.

education programs. In an examination, TEB office examiners review the books and records of the bond issuers to determine whether they are complying with the I.R.C. In FY 2003, 53 field operations employees closed 349 bond examinations. This represents approximately 0.8 percent of the estimated universe of bonds issued from 1985 through 2002. Sanctions in regard to these examinations were negotiated in the amount of $18.3 million.

"Voluntary Closing Agreement Program for Tax-Exempt Bonds" (IRS Notice 2001-60) was issued on October 1, 2001, to establish the Voluntary Closing Agreement Program (VCAP) in the Outreach, Planning, and Review (OPR) function within the TEB office. The VCAP was intended to supplement the Examination Program and make better use of the TEB office's scarce resources by having bond issuers self-identify violations with their bond issuances and report them to the IRS. To encourage bond issuers to voluntarily report I.R.C. violations, the VCAP allows for a reduced settlement (sanction) amount of less than the amount the bond issuer would be assessed if the violation was identified during an examination.

VCAP requests are worked by the OPR function, which is separate from the Examination function. The OPR function reviews the settlement request, verifies the circumstances of the violation, and, based on the severity of the violation, negotiates a sanction amount with the bond issuer and issues a closing agreement. The sanction is applied to the bond issuer due to the IRS policy of not taxing investors for bond issuance violations of the I.R.C.

The VCAP had been in existence officially for 2 years at the time of our audit.[3] The OPR function has increased the level of participation in the VCAP from 43 closures in FY 2002 to 50 closures in FY 2003. As a result of noncompliance issues resolved through the VCAP, bond

[3] Although the VCAP was officially implemented on October 1, 2001 (FY 2002), TEB office management informed us the VCAP had been operating informally for several years prior to this. In FY 2001, TEB office management decided to emphasize the VCAP and increased participation from an average of 2 to 4 closures per year to 15 closures.

issuers paid sanctions of $4.6 million in FY 2002 and $9.3 million in FY 2003.

This review was performed in the Office of the TEB, TE/GE Division, in Washington, D.C., during the period October 2003 through June 2004, in accordance with *Government Auditing Standards*. Detailed information on our audit objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

The Voluntary Closing Agreement Program's Impact on Voluntary Compliance Is Currently Limited

The VCAP has been in existence officially for only 2 years, and the TEB office is continuing to develop the Program to make the settlement process more effective, efficient, and consistent. Although participation in the VCAP increased during the first 2 years of the Program, the 93 total VCAP closures represent only a small portion of total tax-exempt bonds outstanding. In addition, TEB office management does not have a process to determine what impact the VCAP has had on voluntary compliance. As a result, it is difficult for TEB office management to determine the extent of the value of this Program to the tax-exempt bond industry.

The TEB office does not adequately track data on the tax-exempt bond population and the results of VCAP closures and has not developed performance indicators to measure what impact the VCAP may have on voluntary compliance. For example, the TEB office does not know the overall levels of voluntary compliance (i.e., baselines) for tax-exempt bonds and cannot determine the effect VCAP closures will have on voluntary compliance.

The Government Performance and Results Act of 1993 (GPRA)[4] requires major functions of operations to specify in annual plans their general goals and objectives, including outcome-related goals; to determine the skills, technology, and human capital necessary to achieve these goals; and to determine the management information necessary to monitor whether they are achieving their goals.

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[4] Pub. L. No. 103-62, 107 Stat. 285 (codified as amended in scattered section of 5 U.S.C., 31 U.S.C., and 39 U.S.C.).

Without adequate information to measure the population of outstanding bonds and indicators to measure the change in compliance levels, the TEB office faces the following challenges in measuring the VCAP's impact on program goals:

- Complete data on tax-exempt bonds are not available on the TEB office's computer systems. For example, the tax-exempt bond universe is not known because data from Forms 8038 were not captured on the Returns Information Computer System (RICS)[5] until 1987 or processed on the IRS Business Master File (BMF)[6] until FY 2001. Bonds issued prior to FY 2001 were entered on the BMF only if they were examined. In addition, the TEB office started capturing the results of tax-exempt bond examination case information on the Audit Information Management System (AIMS)[7] in FY 2003. Prior to then, tax-exempt bond examination information was maintained on the AIMS Non-Master File[8] with some special reports on Microsoft Excel® spreadsheets. Furthermore, VCAP cases are not tracked on a computer system but maintained on a Microsoft Access® database. Because VCAP cases and the prior examinations were not added to the IRS computer system, comparisons of prior and current case information to measure the change in voluntary compliance cannot be achieved.

- The TEB office does not have meaningful outcome data from which to establish baselines of compliance levels and taxpayer burden reduction. OPR function management has established a method to measure the increase in customer participation in the VCAP by

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[5] RICS is an IRS system that provides user access to return and filer information related to the filing and processing of Employee Plan, Exempt Organization, and Government Entity forms.
[6] The IRS database that consists of Federal tax-related transactions and accounts for businesses. These include employment taxes, income taxes on businesses, and excise taxes.
[7] The AIMS provides an automated inventory and activity control for active examination cases.
[8] The Non-Master File consists of transactions on tax accounts not included on the Master File.

setting numeric goals for FYs 2003 and 2004. VCAP closures are tracked on internal reports and reviewed each month by the Director, TEB. While these are valid measures to help management determine whether resources are used properly, to gauge the activity or productivity (output) of the VCAP, and to aid in setting short-term goals for the program, they do not measure the impact on voluntary compliance.

TEB office management advised us they would like to measure the impact of VCAP closures on compliance but are having difficulty because they do not track the types of data necessary to measure this. Another difficulty in measuring the impact of VCAP closures is that requests for closure under the VCAP are dependent on and directly related to the examination, and outreach and education programs. For example, an increase in examinations in a certain tax-exempt bond market segment will result in an increase in requests for closure under the VCAP.

Because the effect of the VCAP on noncompliance cannot be adequately measured, TEB office management looks for general indicators of overall compliance levels through the Examination Program, research projects, and trend analyses of noncompliance in tax-exempt bond market segments. For example, one research project involves working with the Bureau of Public Debt to determine whether bond issuers involved in advance refunding[9] are more likely in 2003, than they were in 1993, to participate in the acceptable practice of investing proceeds allocable to an advance refunding escrow in Department of the Treasury or State and Local Government Series (SLGS) securities, as opposed to open market securities. TEB office management believes this will be an indicator of a change in voluntary compliance.

Because the information about tax-exempt bond issuer compliance is limited to the relatively few examinations and VCAP cases worked and is not adequately tracked, a

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[9] Advance refunding occurs when the bond issuer makes an early refund to the bond investors more than 90 days before the final payment of principal or interest (redemption) on the bond issue.

systematic analysis of noncompliance information is needed for TEB office management to make informed decisions about the use of their Examination function and VCAP resources. Until TEB office management can determine the impact the VCAP has on reducing taxpayer burden and increasing voluntary compliance, beyond the actual case closures each year, the real value of the VCAP cannot be determined.

Recommendations

The Director, TEB, TE/GE Division, should:

1. Identify the data needed to adequately baseline tax-exempt bond noncompliance issues.

Management's Response: The Director, TEB, TE/GE Division identified that, for the purpose of improving its process related to baselining tax-exempt bond noncompliance issues, all line items on TEB returns should be transcribed to the BMF. To meet this need, TEB coordinated with the TE/GE Division's Customer Account Services staff to submit a request to Information Technology Services that all line items on the TEB returns be transcribed. This request was submitted in July 2004.

2. Coordinate with Modernization and Information Technology Services organization management to determine how these data could be tracked on current TEB office management information systems.

Management's Response: The Director, TEB, TE/GE Division determined, in coordination with Information Technology Services, that the data tracking process for risk assessments and noncompliance issues identified through examinations and the VCAP will be integrated into the TE/GE Reporting and Electronic Examination System (TREES).

3. Establish a process to collect and maintain these data.

Management's Response: The TEB office's process of collecting and maintaining the data will be integrated into the TREES.

Participation Goals Were Met, and Management Is Working to Improve Timeliness and Increase Consistency of Case Processing

TEB office management has taken steps to develop and implement the VCAP in accordance with IRS Notice 2001-60. As implemented, the Program encourages bond issuers to comply with the I.R.C. and provides a vehicle for issuers to correct violations. Because of their publicity efforts, OPR management exceeded their VCAP participation goal (45 closures) for FY 2003. They have increased their goal to 50 VCAP closures for FY 2004. In addition, TEB office management has recommended changes to the Department of the Treasury regulations that should improve the efficiency of processing VCAP cases.

We also determined that TEB office management attempts to increase the impact of the VCAP by performing education and outreach on noncompliance issues to encourage other bond issuers to come in under the VCAP for these same noncompliance issues. Education and outreach efforts are important because bond issuers have demonstrated their willingness to come forward to report violations.

To publicize the VCAP and encourage participation, the TEB office has included information in IRS publications and on its Internet web site and made presentations at conferences, seminars, and other meetings attended by their customers. To determine whether the TEB Outreach and Education Program has been successful in making TEB office customers aware of the VCAP and determining their level of satisfaction with the process, we submitted questions to the Government Finance Officers Association (GFOA) and the National Association of Bond Lawyers (NABL). We requested information from their members about their knowledge and experiences related to the VCAP. They responded as follows:[10]

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[10] Responses were forwarded to the Treasury Inspector General for Tax Administration from the GFOA and the NABL and not from individual members. In some instances, the organizations summarized responses; in other instances, the organizations provided individual comments.

- TEB office officials make presentations at GFOA and NABL meetings, and members have access to VCAP information through their respective Internet web sites, the TEB office web site, and newsletters.
- Both GFOA and NABL members generally agreed the VCAP case closure process was fair.
- There is a negative impression among some GFOA members that the VCAP is not as welcoming as it could be and that the process is slow and cumbersome. In addition, there is some concern that the IRS is using the VCAP to gather names of issuers who have inadvertently violated the I.R.C. and may refer them to the Examination function for enforcement.

Overall, responses to the survey indicated TEB office efforts to publicize the VCAP were successful. When we discussed the survey responses with TEB office management, they agreed that, at times, the VCAP process is time-consuming. TEB office management also advised that the Program is not intended to be a “cure” for all noncompliance issues. In the past, bond issuers have submitted some inappropriate issues for closure under the VCAP, and TEB office management has had to forward them to another program area for consideration. For example, some bonds involving fraudulent activities were submitted for closure under the VCAP and were referred to the Criminal Investigation function for further investigation.

We reviewed the 35 FY 2003 VCAP cases closed with closing agreements[11] to determine whether they were timely, consistently, and effectively processed. TEB office management has not established time standards for processing VCAP closures, so we could not determine whether there was a timeliness problem. However, we did

[11] The TEB office closed 50 cases via the VCAP in FY 2003; however, only 35 of these cases were closed through the use of closing agreements. The remaining 15 cases were closed as part of the VCAP but not through the use of VCAP closing agreements. For example, fraud issues cannot be closed through VCAP closing agreements, and some issues can be self-corrected without using the VCAP closing agreement.

note the amount of time to close VCAP cases varied tremendously. TEB office examiners required 21 to 801 days to close the 35 VCAP cases; 24 of the 35 cases required more than 90 days. On average, the 35 cases were closed within 163 days. TEB office examiners attempt to close simple cases that require no additional information within 90 days and all cases within 1 year. An example of a simple case is a request in which the bond issuer made an inadvertent error, the request package is complete, and no additional information is needed. Other requests can be extremely difficult and require technical opinions from the IRS Office of Chief Counsel. These cases can take up to a year or more to close. We did not determine which of the 35 cases should have been closed in 90 days and which required technical opinions.

IRS management recognized early on that the VCAP needed more detailed procedures.[12] TEB office management has tried to increase the consistency and efficiency of closing VCAP cases through the development of standardized closing agreements. The use of standardized closing agreements and specified sanction amounts for similar violations could improve the efficiency and effectiveness of case closing by providing guidelines for working common types of I.R.C. violations and for negotiating sanctions. This should provide for greater consistency in working cases and determining sanctions and should reduce the time to close cases.

The Director, TEB, made an attempt to gain approval for standardized closing agreements. A request was submitted on May 29, 2003, to the IRS Chief Counsel to issue a revenue procedure that would implement a comprehensive voluntary resolution system. However, this request was not acted on. According to TEB office management, the IRS Chief Counsel has recently begun to consider implementation of such a system for the TEB office.

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[12] IRS Notice 2001-60 anticipated that more detailed procedures about the VCAP would be provided, as the Program was refined. One example included in the Notice was the need to develop standardized closing agreements and specified sanction amounts for particular violations.

Of the 35 VCAP closures with settlement agreements in FY 2003, 33 cases (94 percent) contained the following 5 common issues:

- **Change In Use –** Eleven (31 percent) of 35 cases involved an unapproved change in the use of proceeds of state or local bonds after the date of issue. The sanction amounts ranged from $0 to almost $1.5 million for the 11 cases.
- **Arbitrage/Excess Yield –** Eight (23 percent) of 35 cases involved investments that earned a yield materially higher than the yield on the bonds of the issue. The sanction amounts ranged from approximately $7,000 to $2.2 million for the 8 cases.
- **Guaranty –** Five (14 percent) of 35 cases involved bonds that were inappropriately guaranteed directly or indirectly by the Federal Government with respect to the payment of principle or interest. The sanction amounts ranged from approximately $2,000 to $21,000 for the 5 cases.
- **Announcement 2002-43 Hospital Refinancing Closing Agreement Program –** Five (14 percent) of 35 cases involved bonds in connection with hospital affiliation transactions in which 2 or more existing I.R.C. Section 501(c)(3)[13] organizations agreed to inappropriately merge their operations. The sanction amounts ranged from $0 to approximately $500,000 for the 5 cases.
- **SLGS Arbitrage –** Four (11 percent) of 35 cases involved the impermissible use of bond proceeds by issuers to acquire a higher yielding investment or to replace funds used to acquire higher yielding investments. The sanction amounts ranged from approximately $4,000 to $143,000 for the 4 cases.

The remaining 2 cases (6 percent) involved 2 different issues (Failure to Redeem Bonds and Failure to Pay). The

[13] 26 U.S.C. Section 501 (2003).

sanction amounts for all 35 cases ranged from $0 to approximately $2.2 million.

The use of standardized closing agreements and specified sanction amounts for the similar violations listed above may have improved the efficiency and effectiveness of case closings for the common issues.

TEB office management uses an informal process in both the Examination function and the VCAP to decide what issues need to be addressed through education and outreach efforts. These efforts are designed to inform bond issuers of violations and to provide additional guidance for complying with the I.R.C. To determine whether the TEB office addressed the seven types of noncompliance issues worked in the VCAP in FY 2003, we reviewed IRS Publications, Private Letter Rulings, Field Service Advice,[14] the TEB office Internet web site, and topics addressed during outreach speeches to bond issuer groups such as the GFOA and NABL. We determined the seven types of noncompliance issues were addressed through education and outreach activities. In a prior audit,[15] we determined TEB office management adequately used the results of examinations to focus their taxpayer education and outreach program in an effort to reduce the number of similar errors in the future.

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[14] Private Letter Rulings and Field Service Advice are taxpayer specific rulings furnished by the IRS Chief Counsel in response to requests made by taxpayers and/or IRS officials.

[15] *Tax-Exempt Bond Examination Results Are Used to Focus Customer Education Programs* (Reference Number 2003-10-172, dated August 2003).

Appendix I

Detailed Objectives, Scope, and Methodology

The overall objectives of this review were to determine whether the Office of Tax Exempt Bonds (TEB) and Tax Exempt and Government Entities Division have taken appropriate actions to increase bond issuer participation in the Voluntary Closing Agreement Program (VCAP) and whether the process established for VCAP cases ensures settlement requests are processed timely, consistently, and effectively to meet the goal of increasing voluntary compliance. To accomplish these objectives, we:

I. Determined whether TEB office management's education and outreach efforts provide complete guidance for bond issuers to submit a VCAP request.

  A. Interviewed TEB office management and reviewed available documentation to identify the education and outreach efforts undertaken to inform customers of the VCAP and whether the customers were provided a listing of issues that would be considered for resolution under the VCAP.

  B. Interviewed members of the National Association of Bond Lawyers and the Government Finance Officers Association to determine the organizations' understanding of and participation in the VCAP.

II. Determined whether the TEB office's education and outreach efforts were focused to help those bond markets/issuers that would benefit the most from the VCAP.

  A. Interviewed TEB office management to determine how they focused their education and outreach efforts based on the results of prior VCAP cases.

  B. Obtained a listing of noncompliance issues from prior VCAP cases (from subobjective IV. below) to determine how TEB office management focused their related education and outreach efforts to provide guidance to the bond community.

III. Determined whether TEB office management has developed a method to measure the increase in participation and any change in voluntary compliance related to their efforts to increase closures under the VCAP.

  A. Interviewed TEB office management and reviewed other documentation (Strategic Plan, TEB Work Plan, etc.) to identify goals established for the VCAP and whether the goals had been met: goals for increasing voluntary compliance overall and goals for increasing voluntary compliance attributable to the VCAP.

  B. Interviewed TEB office management and reviewed other documentation (Strategic Plan, TEB Work Plan, etc.) to determine whether methodologies have been developed to measure changes in voluntary compliance attributable to the VCAP.

IV. Determined whether requests for closure under the VCAP were processed timely, consistently, and effectively.

A. Interviewed TEB office management to identify procedures for closing cases timely, consistently, and effectively under the VCAP.

B. Reviewed TEB office management's documented guidance to determine whether procedures have been established to define time standards for case closure, guidance has been provided to ensure consistency of case closure, and standardized closing agreements have been developed.

C. Reviewed all closing agreements for VCAP cases closed in Fiscal Year 2003[1] and determined the length of time it took to close the cases and whether cases with similar issues were settled with similar sanction amounts.

D. Interviewed TEB office management to determine the cause of any discrepancies and resolved any questions identified.

[1] The TEB office closed 50 cases via the VCAP in FY 2003; however, only 35 of these cases were closed through the use of closing agreements. The remaining 15 cases were closed as part of the VCAP but not through the use of VCAP closing agreements. For example, fraud issues cannot be closed through VCAP closing agreements, and some issues can be self-corrected without using the VCAP closing agreement.

Appendix II

Major Contributors to This Report

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Appendix III

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Appendix IV

Management's Response to the Draft Report

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

COMMISSIONER
TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

SEP 10 2004

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDIT

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

SUBJECT: Draft Audit Report – The Voluntary Closing Agreement Program for Tax-Exempt Bonds Has Been Implemented but Its Impact on Voluntary Compliance Has Not Been Determined (Audit # 200410005)

Thank you for the opportunity to respond to your draft report dated July 14, 2004, regarding the Tax-Exempt Bond Voluntary Closing Agreement Program ("VCAP"). The IRS appreciates the efforts and recommendations of your staff.

Attached are our responses to the recommendations in the draft report.

Questions regarding this response should be directed to Preston R. Butcher, Director, Government Entities, SE:T:GE at (202) 283-9738.

Attachment

Attachment

Identity of Recommendation/Finding #1
The Director, TEB, TE/GE Division, should identify the data needed to adequately baseline tax-exempt bond noncompliance issues.

Corrective Action
TEB has identified that, for the purpose of improving its process related to baselining tax-exempt bond noncompliance issues, all line items on TEB returns should be transcribed to the Business Master File ("BMF"). Without complete data, TEB may fail to identify, through its Risk Assessment process, segments in which examination project initiatives would be appropriate, particularly with respect to short-term obligations. Evaluating the impact of VCAP closures on compliance requires that TEB be able to baseline noncompliance, and changes in noncompliance, in its market segments.

To meet this need, TEB coordinated with the TE/GE Customer Account Services ("CAS") staff a request to Information Technology Services that all line items on the TEB returns be transcribed. This request was submitted in July 2004.

Implementation Date
Completed

Responsible Official
Director, Tax Exempt Bonds

Corrective Action Monitoring Plan
TEB will monitor the actions taken by Information Technology Services in response to our request.

Identity of Recommendation/Finding #2
The Director, TEB, TE/GE Division, should coordinate with Modernization and Information Technology Services organization management to determine how the data could be tracked on current TEB office management information systems.

Corrective Action
TEB has determined, in coordination with Information Technology Services, that the data tracking process for risk assessments and noncompliance issues identified through examination and VCAP will be integrated into the TE/GE Reporting and Electronic Examination System ("TREES").

Implementation Date
Completed

Responsible Official
Director, Tax Exempt Bonds
Director, Information Technology Services

Corrective Action Monitoring Plan
TEB will monitor the implementation of these modernization efforts through direct contact with the TE/GE CAS staff, TREES Implementation Team, and Information Technology Services.

Identity of Recommendation/Finding #3
The Director, TEB, TE/GE Division, should establish a process to collect and maintain these data.

Corrective Action
The process of collecting and maintaining the data will be integrated into TREES. This TEB process involves performing annual Risk Assessments using data from TEB returns to identify segments in which examination project initiatives would be appropriate. Examination components of an initiative are determined through the use of statistical sampling techniques. A checksheet is used to gather data on each examination to measure the level of noncompliance and to identify issues that cause the noncompliance. Reports summarizing the results of the initiatives are generated after analyzing the checksheets. This information is used to expand the issues eligible for VCAP, within the limitations of Notice 2001-60, and to develop priority and emphasis areas for examination.

Implementation Date
Completed FY September 30, 2006.

Responsible Official
Director, Tax Exempt Bonds
Director, TE/GE Business System Planning

Corrective Action Monitoring Plan
TEB will monitor the implementation of these modernization efforts through direct contact with the TE/GE CAS staff, TREES Implementation Team, and Information Technology Services.