TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

RECOVERY ACT

The Direct Pay Build America Bond Compliance Check Program Has Yet to Result in Wide-Scale Examinations

June 3, 2011

Reference Number: 2011-11-053

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HIGHLIGHTS

THE DIRECT PAY BUILD AMERICA BOND COMPLIANCE CHECK PROGRAM HAS YET TO RESULT IN WIDE-SCALE EXAMINATIONS

Highlights

Final Report issued on June 3, 2011

Highlights of Reference Number: 2011-11-053 to the Internal Revenue Service Acting Commissioner for the Tax Exempt and Government Entities Division.

IMPACT ON TAXPAYERS

In February 2010, the Tax Exempt Bonds (TEB) office mailed 375 compliance check questionnaires to issuers of Build America Bonds, which resulted in concerns from the bond industry that responses could result in wide-scale examinations and potential loss of a Federal subsidy. TIGTA determined the initiation and scope of compliance checks were appropriate and, as of the end of our fieldwork, very few Build America Bond examinations had been initiated, contrary to bond industry fears. However, written procedures for developing and conducting compliance checks had not been established. Procedures would provide added assurance that the TEB office does not exceed its authority when executing future compliance check programs and could ease concerns within the bond community by improving the transparency of future compliance checks.

WHY TIGTA DID THE AUDIT

The overall objectives of this review were to evaluate the TEB office's use of compliance checks to identify indications of a high risk of noncompliance for Build America Bonds and to evaluate the TEB office's plans to address the high-risk indicators.

WHAT TIGTA FOUND

The compliance check questionnaires issued by the TEB office were appropriate for identifying indications of a high risk of potential noncompliance for Build America Bonds and did not request information specific enough to start examinations. In fact, as of the end of our fieldwork, very few Build America Bond examinations had been initiated, contrary to bond industry fears. According to TEB office management, these examinations were started based on research and reviews of requests for subsidy payments, rather than responses to compliance check questionnaires.

While the TEB office questionnaires were appropriate for gathering information for use in developing a longer term compliance strategy, the TEB office does not have formal written procedures for developing and conducting compliance checks. Procedures would be beneficial to help TEB office employees develop future compliance check programs, provide added assurance the IRS does not exceed its authority when executing such programs, and ease concerns by improving transparency so the bond community will have a better understanding of the compliance check process.

In addition, TIGTA could not evaluate the TEB office's plans to address high-risk indicators because the TEB office has yet to complete an in-depth review of the compliance check questionnaire responses and develop a longer term compliance plan.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the Director, TEB, Tax Exempt and Government Entities Division, document formal guidelines for planning and conducting compliance check programs.

In their response to the report, IRS management agreed with the recommendation. The TEB office plans to publish new procedures on 1) the roles and responsibilities of TEB office managers and employees assigned to the program, 2) the planning process for developing questionnaire projects, 3) documenting the approval for questionnaire projects, 4) the process for evaluating collected data, and, 5) the decision points for proceeding with follow-up compliance efforts, including examinations when appropriate.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

June 3, 2011

MEMORANDUM FOR ACTING COMMISSIONER, TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION

Nancy A. Nakamura

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

SUBJECT: Final Audit Report – The Direct Pay Build America Bond Compliance Check Program Has Yet to Result in Wide-Scale Examinations (Audit # 201010111)

This report presents the results of our review of the Internal Revenue Service's use of the Build America Bond Compliance Check Program under the American Recovery and Reinvestment Act of 2009 (Recovery Act).[1] The overall objectives of this review were to evaluate the Tax Exempt Bonds office's use of compliance checks to identify indications of a high risk of noncompliance for Build America Bonds and to evaluate the Tax Exempt Bonds office's plans to address the high-risk indicators. This review was conducted as part of our Fiscal Year 2011 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

The Recovery Act provides separate funding to the Treasury Inspector General for Tax Administration through September 30, 2013, to be used in oversight activities of Internal Revenue Service programs. This audit was conducted using Recovery Act funds.

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

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendation. Please contact me at (202) 622-6510 if you have questions or Nancy A. Nakamura, Assistant Inspector General for Audit (Management Services and Exempt Organizations), at (202) 622-8500.

[1] Pub. L. No. 111-5, 123 Stat. 115 (2009).

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Abbreviations

BAB	Build America Bond
EMMA	Electronic Municipal Market Access
IRS	Internal Revenue Service
TEB	Tax Exempt Bonds

Background

The American Recovery and Reinvestment Act of 2009 (Recovery Act)[1] was enacted on February 17, 2009, and created one specific type of bond known as a Build America Bond (BAB). Between April 2009 and December 2010, more than $181 billion of BABs were issued by 49 States, the District of Columbia, and 2 United States territories.

BABs were created in response to the unprecedented challenge that State and local governments encountered accessing the credit markets during Calendar Year 2008. During that time, banks and other financial institutions suffered significant investment losses and reduced their involvement in tax-exempt municipal bonds. As a result, State and local governments could not easily obtain funding for capital projects such as construction of highways, bridges, or schools. The BAB program expired on December 31, 2010; however, legislation has been proposed to reintroduce BABs with slightly different program requirements.

Bond investors (bondholders) earn interest income on their BAB investment, which is paid by the State or local government that issued the bonds. Unlike tax-exempt bonds, BAB bondholders must claim this interest income on their tax returns for the bond interest payments. BABs can be issued with a direct pay or a tax credit option.

- **Direct Payment Option –** Under the direct payment option, the Department of the Treasury pays either the bond issuer or a designated third party 35 or 45 percent of the interest payable to bond investors. This partially offsets the State and local governments' cost of paying bond interest.
- **Tax Credit Option –** Under the tax credit option, bondholders receive a tax credit to be applied against their Federal income tax liability equal to generally 35 or 45 percent of the bond coupon interest.

BABs have unique rules when compared to traditional tax-exempt bonds, including that the issue price of bonds can be only a minor or insignificant amount over the stated principal amount of the bonds. For Direct Pay BABs, these rules include 1) a requirement that bond revenue be used for capital improvements (e.g., construction of airports, hospitals, recreational and cultural facilities, schools, and water infrastructure) and not for operating capital (e.g., funds used for day-to-day operation of the entity such as paying salaries), and 2) the issuer is required to make an irrevocable election and timely file a correctly completed Return for Credit Payments to Issuers of Qualified Bonds (Form 8038-CP) in order to receive the credit payment from the

[1] Pub. L. No 111-5, 123 Stat. 115 (2009).

Federal Government over the life of the bond instead of having bondholders claim a tax credit on their individual tax returns.

Upon passage of the Recovery Act, the Department of the Treasury directed the Internal Revenue Service (IRS) to assess the risk associated with Recovery Act bonds, including BABs, and to develop a plan to address risks that were identified. Tax Exempt Bonds (TEB) office management, within the Tax Exempt and Government Entities Division, identified information reporting requirements, refundable credit payments, and payments claimed from nonqualified bonds as the potential risks associated with Recovery Act bonds. The TEB office determined that because of the unique requirements of BABs, issuers may not understand or ensure that compliance requirements are met. Based on this risk, the TEB office developed a compliance check program to gather information on bond issuer understanding of the requirements so TEB office management could better understand and identify remedies for customer issues and reduce the need for future enforcement actions, such as examinations.

The TEB office developed a Direct Pay Bonds Compliance Check Program, and in February 2010, it mailed 375 compliance check questionnaires[2] to all issuers of Direct Pay BABs issued from February through September 2009. Compliance checks serve a different purpose and are not the same, legally, as examinations.

- **Compliance checks** are voluntary for IRS customers and provide the TEB office a method of gathering information to better understand customer needs and to identify appropriate remedies for compliance issues. Although bond issuers are not required to participate in compliance checks, they are an important part of the TEB office's strategy to reduce the need for enforcement by keeping abreast of trends emerging in the tax-exempt and tax credit bond sector. Specifically, compliance checks evaluate post-issuance and record retention policies, procedures, and practices of the bond issuers, but do not include a review of books and records to determine an entity's liability for taxes.
- **Examinations** are legal proceedings, require participation by IRS customers, and include a review of books and records to determine compliance with the Internal Revenue Code. Examinations usually do not occur until approximately 5 years after the bond transaction to allow time for completion of the final allocation of the proceeds.

[2] See Appendix IV for a copy of the Direct Pay Bonds Compliance Check Questionnaire.

The audit was initiated because of bond issuer concerns that appeared in the news media in the spring of Fiscal Year 2010 about whether responding to the compliance checks would result in wide-scale future examinations. Issuers were concerned that responding inappropriately to compliance check questions about issue price could lead to examinations and eventual loss of the Federal subsidy. In the past, very limited information was available to the IRS on the sales price of municipal bonds; however, beginning in June 2009, trading information, including pricing, was required to be publicly available on the Electronic Municipal Market Access (EMMA).[3] Due to the Recovery Act requirement of transparency on certain bond transactions, a spotlight was put on the issue of how bond prices are set.

In Fiscal Year 2010, news articles appeared that expressed bond issuer concerns about the Direct Pay Bonds Compliance Check Program.

This is our fourth audit of Recovery Act bond provisions. See Appendix V for a synopsis of the prior three audits.

This review was performed at the Tax Exempt and Government Entities Division TEB Headquarters Office in Washington, D.C., and the TEB Compliance and Program Management office located in St. Louis, Missouri, during the period August 2010 through January 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.

[3] The EMMA web site allows investors to view municipal bond trading trends to better understand market activity. The EMMA provides snapshots of daily trade data based on municipal bond characteristics such as trade type, size, sector, maturity, source of repayment, and type of coupon.

Results of Review

The compliance check questionnaires issued by the TEB office were appropriate for identifying indications of a high risk of potential noncompliance for BABs. However, we could not evaluate the TEB office's plans to address high-risk indicators because the TEB office has yet to complete a detailed review of the compliance check questionnaire responses and develop a longer term compliance plan.

Based on our analysis of the compliance check questionnaire, we believe the questions were appropriate because they were designed to elicit responses that could indicate a high risk of potential noncompliance without requesting information specific enough to start examinations. In fact, as of the end of our fieldwork, very few BAB examinations had been initiated, contrary to bond industry fears. According to TEB office management, these examinations were started based on research and reviews of requests for subsidy payments, rather than responses to compliance check questionnaires.

While the TEB office questionnaires were appropriate for gathering information for use in developing a longer term compliance strategy, the TEB office does not have formal written procedures for developing and conducting compliance checks. Procedures would be beneficial to help TEB office employees develop future compliance check programs, provide added assurance the IRS does not exceed its authority when executing such programs, and ease concerns by improving transparency so the bond community will have a better understanding of the compliance check process.

The Initiation and Scope of the Build America Bonds Compliance Checks Were Appropriate; However, Plans to Identify and Address Potential High-Risk Indicators Have Not Been Developed

Our review determined that the manner in which the compliance check program was initiated and the scope of the questions mailed to bond issuers were appropriate. Specifically:

- The compliance check questionnaire focused on whether the bond issuer had written procedures and record retention policies and whether bond trading activity was recorded on the EMMA.
- The design of the compliance check questionnaire did not suggest an examination or investigation of the bond issuer's books and records.
- The compliance check questions did not solicit information that should be requested only during examination activity.

At the time of our audit, TEB office management had not performed a detailed review of the 220 issuer responses to the compliance check questionnaires because they were waiting to determine if additional responses would be received. Although TEB office management has not performed a detailed review, our review and analysis of the 220 compliance check responses from bond issuers identified indicators of a high risk of potential noncompliance based on answers to the issues covered on the questionnaire. See Appendix VI for our analysis.

TEB office management stated they plan to conduct additional detailed analysis of compliance check responses, along with a review of information such as data from the Master File,[4] Municipal Securities Rulemaking Board,[5] the EMMA, Statistics of Income Distributed Processing Image Net,[6] and Returns Inventory and Classification System,[7] to identify indications of a high risk of potential noncompliance. If indicators of potential noncompliance are identified, the TEB office can address the potential risk through programs that are already in place, such as the Education and Outreach Program, the Voluntary Closing Agreement Program, or the Examination Program.

At the time of our audit, the TEB office had opened several examinations of BABs. The potential risk indicators that eventually resulted in the opening of examinations were identified from research and reviews of requests for subsidy payments, rather than responses to compliance check questionnaires. TEB office management stressed that compliance check responses alone would never provide an indication of potential noncompliance strong enough to result in examinations. However, until this understanding is strengthened through implementation of formal guidelines for planning and conducting compliance check programs, TEB office management will not have assurance that their compliance check programs will comply with the Internal Revenue Code or that useful information will be gathered to ensure indicators of potential noncompliance are identified, evaluated, and appropriately addressed.

The Tax Exempt Bonds Office Does Not Have Documented Guidelines for Developing and Initiating Compliance Check Programs

The *Standards for Internal Control in the Federal Government* requires that internal controls need to be clearly documented in management directives, administrative policies, or operating

[4] The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.
[5] A regulating body that creates rules and policies for investment firms and banks in the issuance and sale of municipal bonds, notes, and other municipal securities by States, cities, and counties.
[6] A Statistics of Income Division computer system that includes databases, applications, and scanned returns to support the IRS's requirement to report to Congress annually on the numbers and types of returns filed, the characteristics of those returns, and the money amounts reported on those returns.
[7] The Tax Exempt and Government Entities Division's computer system that provides access to filing, processing, and posting of returns.

manuals. However, TEB office internal guidelines do not include formal written procedures for developing and conducting compliance checks. Therefore, the TEB office did not document a formal plan for development and execution of the Direct Pay Compliance Check program. Instead, the program was based on the "Risk Assessment and Impact Analysis" process required by the Department of the Treasury to document risks, plans of action, and expected completion dates of tasks for addressing risks for the Recovery Act bonds. In addition, the questionnaire was patterned after a prior TEB office compliance check program that did not include a formal plan and a compliance check program from another IRS office that did include a formal plan.

The TEB office had not developed guidance because of time pressures to begin assessing the risks associated with BABs. Without documented guidance for future projects, TEB office employees may not develop and initiate compliance check programs that are within their statutory authority, or gather information that is useful for assessing risk. In addition, increased burden could be created for bond issuers by requesting information that is unnecessary, and information gathered may not be useful if results are not properly anticipated and plans developed to evaluate indicators for measuring potential noncompliance. Without adequately designed and useful compliance programs, the TEB office may not have an understanding of the potential sources of risk in order to be able to address potential noncompliance, if needed. Also, documenting compliance check procedures could reduce concerns, such as those expressed in the news media, by increasing awareness so the bond community will have a better understanding of the compliance check process.

Recommendation

Recommendation 1: The Director, TEB, Tax Exempt and Government Entities Division, should document formal guidelines for planning and conducting compliance check programs. These guidelines should include, but not be limited to:

- Documenting the purpose, goals, anticipation of results; how the results will be collected and evaluated; and decision points for proceeding to examinations. These guidelines should ensure that the scope and execution of compliance checks are within the statutory authority of the TEB office.
- Requiring a review and approval process to include the basis for proceeding with the compliance check program.
- Including an explanation of the responsibilities of team members.

Management's Response: Tax Exempt and Government Entities Division management agreed with this recommendation and will publish guidelines for the TEB office compliance check program. This guidance will include: 1) the roles and responsibilities of TEB office managers and employees assigned to the program, 2) the planning process for developing questionnaire projects, 3) documenting the approval for questionnaire projects, 4) the process for evaluating collected data, and 5) the decision points for proceeding with follow-up compliance efforts, including examinations when appropriate.

Appendix I

Detailed Objectives, Scope, and Methodology

Our overall objectives were to evaluate the TEB office's use of compliance checks to identify indications of a high risk of noncompliance for BABs and to evaluate the TEB office's plans to address the high-risk indicators. To accomplish this, we:

I. Evaluated the controls over the development of compliance check questionnaires to assess the risk of BAB noncompliance.

   A. Determined whether the TEB office developed a written plan documenting its objective and methodology of how the risk assessment would be conducted.

   B. Compared the risk assessment plan to the Internal Revenue Manual and determined whether the questions exceeded IRS written procedures for assessing the risk of noncompliance prior to opening examinations.

   C. Evaluated the compliance check questions and determined whether all questions were in line with the goals and purpose of the risk assessment as documented in the risk assessment plan or other documentation.

II. Determined whether controls ensured the TEB office would make appropriate use of the compliance check results.

   A. Analyzed the compliance check questions and a judgmental sample of issuer responses to identify the types and purpose of information requested by the questionnaire. A judgmental sample of 30 issuer responses from a population of 220 responses was selected and reviewed. Judgmental sampling techniques were used to validate the accuracy and completeness of the data captured from the questionnaires and were not used to project the results across the population.

   B. Determined how responses to compliance check questions would be evaluated and identified the potential use of the information.

III. Based on the results of the analyses performed by the TEB office, determined what subsequent actions were planned to address indicators of potential noncompliance.

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 Internal Revenue Code, IRS publications and letters defining compliance checks, and the compliance check questionnaire. We evaluated these controls by interviewing management, reviewing the questionnaires, reviewing responses to the questionnaires, and reviewing other applicable documentation.

Appendix II

Major Contributors to This Report

Nancy A. Nakamura, Assistant Inspector General for Audit (Management Services and Exempt Organizations)
Troy D. Paterson, Director
Gerald T. Hawkins, Audit Manager
Andrew J. Burns, Lead Auditor
Yolanda D. Brown, Auditor
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Appendix III

Report Distribution List

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

Appendix IV

Direct Pay Bonds Compliance Check Questionnaire

Form **14127** (January 2010)	Department of the Treasury — Internal Revenue Service **Direct Pay Bonds Compliance Check Questionnaire**	OMB No. 1545-2071

We are asking for information regarding your Direct Pay Bonds, post-issuance bond compliance and record retention practices. Direct Pay Bonds referred to in this questionnaire are Build America Bonds described in section 54AA(g) of the Internal Revenue Code. Please complete the questionnaire and follow the instructions in the accompanying letter for returning it to us. Please note that section references in this questionnaire are to sections of the Internal Revenue Code unless otherwise indicated. For all accompanying documentation, please clearly label the question to which it relates.

Name of Governmental Entity: ______________________

Employer Identification Number: ______________________

1. Do you have written procedures to ensure that none of the maturities of your Direct Pay Bonds are issued with more than a de minimis amount of premium as required by section 54AA(d)(2)(C)? ☐ Yes ☐ No

   If Yes, date they were implemented? ______________ *(dd/mm/yyyy)*

   If Yes, describe in detail your procedures for ensuring compliance with such de minimis rule and how you implement such procedures, including dates of revisions, if any. In lieu of the above description, you may attach a copy of your written procedures. If you have no written procedures, explain what guidelines you have in place and from what source these guidelines are derived that ensure Direct Pay Bonds issued with premium fall within the de minimis rule. *(Attach sheet with description)*

2. Are records of secondary market trading activity for your Direct Pay Bonds available through the Municipal Securities Rulemaking Board's Electronic Municipal Market Access System *(see http://www.emma.msrb.org)*? ☐ Yes ☐ No ☐ Do not know

   If Yes, did you or a consultant to the issuer, other than the underwriter or initial purchaser of the Direct Pay Bonds, review the records of the secondary market trading activity for the Direct Pay Bonds after the sale date of the bonds but before the bonds were delivered on the date of issue? ☐ Yes ☐ No ☐ Do not know

   If Yes, that is, if such records were reviewed as described above, did any of your Direct Pay Bonds trade at a price greater than the issue price prior to the delivery of those Direct Pay Bonds on the date of issue? ☐ Yes ☐ No ☐ Do not know

Catalog Number 54588D | www.irs.gov | Form **14127** (Rev. 01-2010)

3. Do you have written procedures to ensure that your Direct Pay Bonds remain in compliance with the following Federal tax requirements after the bonds are issued:

   a. Timely expenditure of bond proceeds? ☐ Yes ☐ No
      If Yes, date they were implemented? ________________ *(dd/mm/yyyy)*

   b. Correct calculation of Available Project Proceeds *(See section 54A(e)(4))*? ☐ Yes ☐ No
      If Yes, date they were implemented? ________________ *(dd/mm/yyyy)*

   c. Use of 100% of Available Project Proceeds less amount in a reasonably required reserve fund only for capital expenditures *(See section 54AA(g)(2)(A))*? ☐ Yes ☐ No
      If Yes, date they were implemented? ________________ *(dd/mm/yyyy)*

   d. Arbitrage yield restriction and rebate? ☐ Yes ☐ No
      If Yes, date they were implemented? ________________ *(dd/mm/yyyy)*

   e. Costs of issuance financed by the issue do not exceed 2% of the proceeds of sale *(See section 54A(e)(4)(A)(ii))*? ☐ Yes ☐ No
      If Yes, date they were implemented? ________________ *(dd/mm/yyyy)*

   f. Proper determination of the amount of interest payable on each interest payment date? ☐ Yes ☐ No
      If Yes, date they were implemented? ________________ *(dd/mm/yyyy)*

   g. Proper amount of refundable credit reported on Form 8038-CP? ☐ Yes ☐ No
      If Yes, date they were implemented? ________________ *(dd/mm/yyyy)*

   h. Timely filing of Form 8038-CP? ☐ Yes ☐ No
      If Yes, date they were implemented? ________________ *(dd/mm/yyyy)*

   i. Payment of refundable credit will be made to the proper person? ☐ Yes ☐ No
      If Yes, date they were implemented? ________________ *(dd/mm/yyyy)*

   If Yes, describe in detail your procedures for each of the above items *(a-i)* and how you implement such procedures, including dates of revisions, if any. In lieu of the above descriptions, you may attach a copy of your written procedures. If you have no written procedures, explain what guidelines you have in place and from what source these guidelines are derived that ensure bond financings are in compliance with Federal tax requirements. *(Attach sheet with description)*

4. Do you have written procedures to ensure timely identification of violations of Federal tax requirements after your Direct Pay Bonds are issued and the timely correction of any identified violation(s) through remedial actions described in the Treasury Regulations or through the Tax Exempt Bonds Voluntary Closing Agreement Program described under Notice 2008-31? ☐ Yes ☐ No

   If Yes, date they were implemented? ______________________ *(dd/mm/yyyy)*

   If Yes, describe in detail your procedures for timely identification and correction of any such violations and how you implement such procedures, including dates of revisions, if any. In lieu of the above description, you may attach a copy of your written procedures. If you have no written procedures, explain what guidelines you have in place and from what source these guidelines are derived that ensure timely identification and correction of any violations of Federal tax requirements. *(Attach sheet with description)*

5. Do you maintain records necessary to support the status of the bonds as qualified to receive the tax advantaged treatment described in section 54AA(g)? ☐ Yes ☐ No

   If yes, for how long?

   ☐ Less than life of bonds

   ☐ Life of bonds

   ☐ Life of bonds plus 3 years

6. How do you maintain your bond records?

   ☐ On Paper

   ☐ Electronic media *(e.g.,CD, disks, tapes)*

   ☐ *Combination of paper and electronic*

Under penalties of perjury, I declare that I have examined this completed questionnaire, including accompanying documents and statements, and to the best of my knowledge and belief, the completed questionnaire contains all the relevant facts relating to the answers to the questionnaire, and such facts are true, correct, and complete.

Signature: ______________________________ Date: ____________________

Printed Name: ______________________________

Title: ______________________________

Privacy Act and Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. We need it to ensure that you are complying with these laws.

The IRS may not conduct or sponsor, and an organization is not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB number. Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103 and 6104.

Appendix V

Previous Audit Coverage of Bond Provisions in the American Recovery and Reinvestment Act of 2009[1]

Title	Results
Observations About Annual Dollar Limits for American Recovery and Reinvestment Act of 2009 Bonds (Reference Number 2010-11-016, dated January 8, 2010)	The American Recovery and Reinvestment Act of 2009 (Recovery Act) authorizes State and local governments to issue more than $45 billion in new bonds, some with volume caps on the dollar amounts that can be issued. The TEB office will need to be vigilant to ensure that Recovery Act bonds are not issued in excess of annual limits. If annual limits are exceeded, the Federal Government risks losing future tax revenue because excess Recovery Act bonds may not be eligible for tax credits or may be taxable. The TEB office believes it has taken steps to ensure it is adequately monitoring the volumes of Recovery Act bonds.
Initial Published Guidance for American Recovery and Reinvestment Act of 2009 Bonds Was Complete, Accurate, and Consistent (Reference Number 2010-11-035, dated March 16, 2010)	The Recovery Act authorizes new and expanded bond financing subsidies. The initial guidance published by the IRS in the form of notices was complete, accurate, and consistent with the tax-exempt and tax credit bond requirements of the Recovery Act. The notices were issued quickly to help bond issuers understand how to issue tax-exempt and tax credit bonds intended to stimulate the economy by preserving and creating jobs.
Initial Build America Bond Subsidy Payments Were Processed Accurately and Timely (Reference Number 2010-11-083, dated July 14, 2010)	The Recovery Act created a new type of bond, known as BABs, for which the Federal Government will partially offset the State and local governments' cost of paying bond interest. Generally, all complete requests for payment of the BAB Federal subsidies were processed accurately, timely, and without indications of fraudulent or erroneous disbursement.

[1] Pub. L. No 111-5, 123 Stat. 115 (2009).

Appendix VI

Analysis of 220 Bond Issuer Responses to the Direct Pay Bonds Compliance Check Questionnaires

Compliance Check Question	TIGTA Analysis of Issuer Responses
Do you have written procedures to ensure that none of the maturities of your Direct Pay Bonds are issued with more than a de minimis amount of premium as required by Internal Revenue Code Section 54AA (d)(2)(C)?	Sixty-seven percent of the issuers indicated they have written procedures to ensure compliance with Internal Revenue Code Section 54AA (d)(2)(C). Written procedures are not a requirement; however, they are important in assisting the bond issuers with monitoring the bond throughout its life to assure compliance. If bonds fall out of compliance, the potential exists that the BAB status of the bond could be revoked and issuers may not continue to receive the subsidy from the Federal Government. For example, if a school board issued BABs without formal written procedures, future employees of the board may not understand what is needed to ensure compliance with the Internal Revenue Code. Therefore, the bond could lose its status as a BAB and the Federal Government could discontinue the Federal subsidy that partially offsets the State and local governments' cost of paying bond interest. We believe the absence of written procedures is an indicator of potential noncompliance.
Are records of secondary market trading activity for your Direct Pay Bonds available through the Municipal Securities Rulemaking Board's Electronic Municipal Market Access System (EMMA)?	Seventy percent of issuers indicated records of secondary market trading activity are available on the EMMA. Access to secondary market trading activity provides bond investors key information needed when investing in municipal securities, allows the bond issuers to monitor the bonds' trading prices to verify information provided by the underwriters, and allows the bond counsel to ensure there is no change to their tax opinion. If secondary market trading activity is not available in a centralized location, municipal market participants will not have easy access to the most recent sales information. We believe not entering secondary market trading activity on the EMMA when required is an indicator of potential noncompliance.

Compliance Check Question	TIGTA Analysis of Issuer Responses
Do you have written procedures to ensure that your Direct Pay Bonds remain in compliance with Federal tax requirements after the bonds are issued?	Seventy-six percent of issuers indicated written procedures are maintained to ensure bonds remain in compliance with the Federal tax requirements. If the Federal requirements are not met, the bonds may no longer qualify as BABs and, therefore, could potentially lose the Federal subsidy payment of 35 or 45 percent of the interest payable to bond investors. We believe that not documenting procedures to ensure bonds remain in compliance with the Internal Revenue Code after bonds are issued is an indicator of potential noncompliance.
Do you have written procedures to ensure timely identification of violations of Federal tax requirements after your Direct Pay Bonds are issued and the timely correction of any identified violation(s) through remedial actions described in the Treasury Regulations or through the Tax Exempt Bonds Voluntary Closing Agreement Program described under Notice 2008-31?	Fifty-nine percent of issuers indicated written procedures are maintained to ensure timely identification of violations of Federal tax requirements after bond issuance. Written procedures are important to prevent bond issuers jeopardizing the bond status. If the Federal requirements are not met, or noncompliance is not identified and corrected, the bonds may no longer qualify as BABs and, therefore, could potentially lose the Federal subsidy payment of 35 or 45 percent of the interest payable to bond investors. We believe that not documenting procedures to ensure timely identification of violations of Federal tax requirements after bonds are issued is an indicator of potential noncompliance.
Do you maintain records necessary to support the status of the bonds as qualified to receive the tax advantaged treatment described in Internal Revenue Code Section 54AA (g)?	Ninety-nine percent of issuers indicated records are maintained to support the status of the bonds qualified to receive the tax advantaged treatment under Internal Revenue Code Section 54AA (g). It is important to maintain documentation for the sale of the bond to support the BAB status to ensure continued receipt of the Federal subsidy payment of 35 or 45 percent of the interest payable to bond investors. We believe not maintaining appropriate documentation to support the tax advantaged treatment described in Internal Revenue Code Section 54AA (g) would be an indicator of potential noncompliance.

Compliance Check Question	TIGTA Analysis of Issuer Responses
How do you maintain your bond records?	All issuers indicated bond records are maintained on paper or electronic media. It is important to maintain documentation for the sale of the bond to support the BAB status and ensure continued receipt of the Federal subsidy payment of 35 or 45 percent of the interest payable to bond investors. We believe not maintaining appropriate documentation in either paper or electronic media to support the tax advantaged treatment described in Internal Revenue Code Section 54AA (g) would be an indicator of potential noncompliance.

Appendix VII

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

RECEIVED
MAY 13 2011

MAY 13 2011

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Joseph H. Grant
Acting Commissioner, Tax Exempt & Government Entities

SUBJECT: The Direct Pay Build America Bond Compliance Check Program Has Yet To Result In Wide-Scale Examinations (Audit #201010111)

I am pleased to respond to your report evaluating the Tax Exempt and Government Entities Division's use of compliance check questionnaires as part of its compliance strategy for addressing risks related to build America bonds. This performance audit was initiated to determine whether the questions used in the build America bonds questionnaire project were appropriate for identifying indications of a high risk of potential noncompliance.

We appreciate your finding that the questions included in the questionnaire were appropriately designed to elicit responses that could indicate a high risk of potential noncompliance without requesting information specific enough to start an actual examination of a bond issue. In particular, we agree that general questions relating to an issuer's specific processes and procedures for monitoring post-issuance tax compliance and ensuring the retention of adequate records to substantiate such compliance are directly relevant in assessing the potential noncompliance of that issuer's bond issues. These questions have been and will continue to be an integral part of our compliance check questionnaires for bonds.

We also agree with your finding that general questions relating to how an issuer reviews the pricing and secondary market trading activity of its bonds in evaluating the accuracy of pricing information provided by the underwriter are appropriate in identifying high risk of potential noncompliance relating to the mispricing of bonds. Such noncompliance could relate to violations of the arbitrage requirements, volume cap limitations, and the de minimis premium limitation applicable to build America bonds. As you stated in your report, a review of secondary market trading activity allows bond counsel to ensure there is no change to their tax opinion with respect to the pricing of bonds.

Finally, we agree that written procedures for planning and implementing compliance check questionnaire projects would help ensure both the program's operational effectiveness and its transparency to taxpayers. As you noted in your report, we have implemented three bond-related questionnaire projects to date relating to qualified 501(c)(3) bonds, governmental bonds, and build America bonds. While each of these projects were developed and implemented following formal administrative guidelines prepared by TE/GE for projects relating to exempt organizations, we agree that TE/GE should publish new procedures for planning and implementing bond-related questionnaire projects. We accept your recommendation to publish such guidelines for the TEB compliance check program. We agree that they would further our goal of providing quality programs and service to TE/GE taxpayers.

Our response to your proposed corrective action is on the attachment. If you have any questions, please contact Clifford Gannett, Acting Director, Government Entities, at 202-283-9820 or Robert Henn, Acting Director, Tax-Exempt Bonds, at 718-488-2014.

Attachment

Attachment

Recommendation 1

The Director, TEB, should document formal guidelines for planning and conducting compliance check programs. These guidelines should include, but not be limited to:

- Documenting the purpose, goals, anticipation of results, how the results will be collected and evaluated, and decision points for proceeding to examinations. These guidelines should ensure that the scope and execution of compliance checks are within the statutory authority of the TEB office.
- Requiring a review and approval process to include the basis for proceeding with the compliance check program.
- Including an explanation of the responsibilities of team members.

Corrective Action

TEB will publish new procedures under section 4.81 of the Internal Revenue Manual providing administrative guidelines for the TEB compliance check program. These procedures will include guidance on: 1) the roles and responsibilities of TEB managers and employees assigned to the program; 2) the planning process for developing questionnaire projects; 3) documenting the approval for questionnaire projects; 4) the process for evaluating collected data; and 5) the decision points for proceeding with follow-up compliance efforts including examinations when appropriate.

Implementation Date

March 30, 2012

Responsible Official

Robert Henn, Acting Director, Tax Exempt Bonds