TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Statistical Portrayal of the Tax Exempt Bonds Office's Enforcement Activities From Fiscal Year 2002 Through Fiscal Year 2004

September 2005

Reference Number: 2005-10-186

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.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

September 30, 2005

MEMORANDUM FOR COMMISSIONER, TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Statistical Portrayal of the Tax Exempt Bonds Office's Enforcement Activities From Fiscal Year 2002 Through Fiscal Year 2004 (Audit # 200510006)

This report presents the results of our review of the Tax Exempt Bonds (TEB) office's enforcement data for a 3-year period. The overall objectives of this review were to review relevant statistical data of the TEB office's enforcement activities for Fiscal Years (FY) 2002 – 2004 and analyze the data for trends.

The TEB office's primary method of ensuring tax-exempt bonds are in compliance with the Internal Revenue Code (I.R.C.) is through its Examination Program. The Program is designed to determine if bond issuers are in compliance with the legal guidelines for tax-exempt bonds. In addition, the TEB office performs examinations to determine if promoters of tax-exempt bonds should be penalized under I.R.C. Section (§) 6700[1] for misconduct.

Synopsis

Although the TEB office's resources declined between FY 2002 and FY 2004, we determined the number of Full-Time Equivalents (FTE)[2] applied to examination activities in the TEB office

[1] I.R.C. § 6700 (2004) imposes a penalty for promoting an abusive tax shelter while making a false or fraudulent misrepresentation as to any material matter or for making a material gross valuation overstatement as to any material matter.

[2] A measure of labor hours in which 1 FTE is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year. For FYs 2002 and 2003, 1 FTE was equal to 2,088 staff hours; for FY 2004, 1 FTE was equal to 2,096 staff hours.

remained consistent. This higher percentage is consistent with the Internal Revenue Service's (IRS) commitment to divert more resources to the Enforcement Program areas. During the 3-year period we reviewed, the number of examinations increased; the number of examinations that improved compliance increased; the number of examinations on compliant bond issues decreased but were still more than 50 percent of the examinations conducted; the average time spent on compliant bond examinations remained the same; average examination assessment amounts decreased; and high-risk market segment examinations resulted in a slightly higher average assessment amount than other examinations, but they took more than twice the average staff days to complete.

Response

We made no recommendations in this report. The Commissioner, Tax Exempt and Government Entities (TE/GE) Division, generally agreed with our statistical portrayal and noted that the data usefully illuminate aspects of the TEB office's operations and will be considered as the TEB office continues to pursue a focused, ambitious compliance program. However, the Commissioner, TE/GE Division, believes some statements in the report–those that seem to equate success in compliance with dollars assessed–were misdirected and incomplete and some conclusions may have been reached too casually. The Commissioner's response provided examples of additional types of data showing the TEB office's impact on compliance, particularly rebates collected, bonds redeemed, and revenue protected in future years. Management's complete response to the draft report is included as Appendix V.

Office of Audit Comment

Our review was based on the data provided by the TEB office during our fieldwork, and we believe our results are representative of the data provided. While we agree the additional types of data the Commissioner, TE/GE Division, referred to in the response are important measures, the data were not included in the TEB office's databases or records provided to us. Also, it was never intended that our analysis include all TEB office program information. We concentrated on the TEB office enforcement data resulting directly from the TEB office Enforcement Program.

Copies of this report are also being sent to the IRS managers affected by the report findings. 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.

Table of Contents

Background

The Tax Exempt Bonds (TEB) office within the Tax Exempt and Government Entities (TE/GE) Division administers the Federal tax laws applicable to tax-exempt bonds.[1] 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. They are used to finance various tax-exempt projects that are of benefit to the public, such as courthouses, hospitals, airport expansions, and highways.

The economic benefit of tax-exempt status is a privilege the Federal Government provides to governmental issuers. However, this economic benefit comes with a cost. The Department of the Treasury estimated that $30 billion in Federal tax revenue would be lost for Fiscal Year (FY) 2004 alone from tax on interest earned if the bonds were taxable.

The Internal Revenue Service (IRS) has acknowledged the need to address noncompliance for tax-exempt bonds. For example, one of the objectives in the IRS' FY 2005 – 2009 Strategic Plan, issued June 2004, is to deter abuse within tax-exempt and governmental entities and misuse of such entities by third parties for tax avoidance or other unintended purposes. In addition, one part of the TEB office's Enforcement Program focuses on identifying third-party abuse and misconduct such as questionable financing transactions involving the use of bond financing to cover current operating expenses instead of for a tax-exempt purpose. Another part of its program involves tax promoter penalty investigations, which may result in referring lawyers, and other professionals involved in abuse to the IRS Office of Professional Responsibility.

Bond issuers generally rely on attorneys specializing in tax-exempt bonds to ensure proposed bonds comply with Federal laws and regulations. If the proceeds of the tax-exempt bonds are not used for their intended purpose, the bonds may no longer be tax exempt, and the issuing organization may be liable for the taxes as well as paying sanctions.[2] In rare instances, if the tax-exempt status of the bond issuance is rescinded, the bondholders may be required to pay tax on the interest earned. The TEB office's primary method of ensuring tax-exempt bonds are in compliance with the I.R.C. is through its Examination Program. In addition, the TEB office performs examinations to determine if promoters of tax-exempt bonds who engage in misconduct should be penalized under Internal Revenue Code (I.R.C.) Section (§) 6700.[3]

[1] Internal Revenue Code (I.RC.) Section (§) 103(a) (2002) is the primary statutory provision that excludes interest on municipal bonds from Federal income tax.
[2] Sanctions are payments intended to enforce compliance with the I.R.C.
[3] I.R.C. § 6700 (2004) imposes a penalty for promoting an abusive tax shelter while making a false or fraudulent misrepresentation as to any material matter or for making a material gross valuation overstatement as to any material matter.

We have several qualifying limitations about the statistical analyses presented in this report. We did not receive sufficient and reliable data to complete all of our audit tests timely. TEB office management informed us during the planning for this audit they did not have the resources to obtain and copy the data we requested. As a result, we received the last of the data 6 months after they were initially requested but did not receive explanations for questionable items in the data until we completed our review. After TEB office management provided additional information to explain some of the analyses, we revised the report accordingly. In addition, the TEB office instituted procedures that prevented us from obtaining most information, manual or electronic, directly from its source and required all information to be forwarded to the Director, TEB, for review prior to being sent to us. Because we could not examine information from its source, we could not independently confirm whether all information forwarded to us was accurate and complete. We believe our results are representative of the data provided, but we do not have assurance the data are an accurate reflection of all work accomplished by the TEB office.

This review was performed at the TEB Headquarters Office in Washington, D.C., during the period November 2004 through July 2005. With the exception of the scope limitations described above, the audit was conducted 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.

Results of Review

Challenges Remain for the Tax Exempt Bonds Office to Improve Enforcement of the Internal Revenue Code

The TEB office was established after the TE/GE Division became operational in FY 1999. At that time, approximately 30 Exempt Organizations function revenue agents were reassigned along with 2 managers to staff the new office. Because the revenue agents had only limited tax-exempt bond experience, TEB office management spent part of the first several years organizing the office and hiring and training new staff. TEB office management also developed programs to provide education and outreach to their customers to help them comply with the I.R.C., provided a program for their customers to voluntarily comply when they identify they are out of compliance with the I.R.C., and developed a program (Examination Program) to identify and examine customers who do not comply to bring them into compliance.

The remainder of this report reflects the efforts of the TEB office to enforce compliance with the I.R.C. for tax-exempt bond customers using the Examination Program. We identified the following trends from our analysis of TEB office data for FYs 2002 to 2004.

Resources applied to tax-exempt bond examination activities

According to the TE/GE Division Technical Time Reporting System[4] data, the number of Full-Time Equivalents (FTE)[5] applied to examination activities in the TEB office has remained consistent the past 3 years. In contrast, Chart 1 shows the number of FTEs available overall to the TEB office declined over the same period, which indicates a greater portion of the TEB office's FTEs were used for the Examination Program. This higher percentage is consistent with the IRS' commitment to divert more resources to the Enforcement Program areas.

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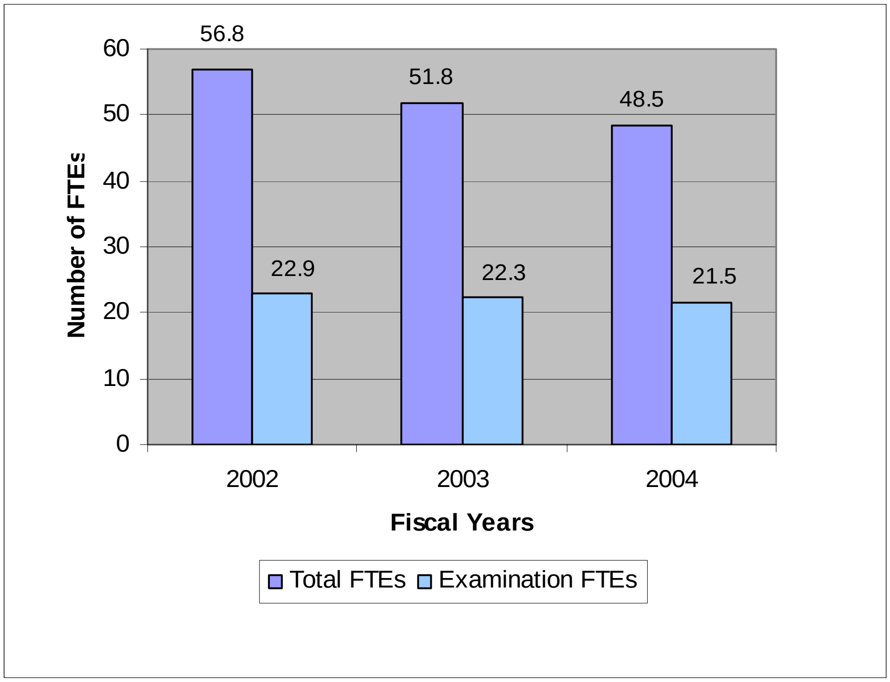
[4] This is a stand-alone DOS-based software application designed and developed to enable electronic tracking and reporting of technical time.

[5] A measure of labor hours in which 1 FTE is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year. For FYs 2002 and 2003, 1 FTE was equal to 2,088 staff hours; for FY 2004, 1 FTE was equal to 2,096 staff hours.

Chart 1: Total FTEs Expended in the TEB Office Versus FTEs Used for Examinations (FY 2002 – FY 2004)



Source: TE/GE Division Technical Time Reporting System.

Sustaining a full staff in the enforcement area may be a challenge. The Government Accountability Office (GAO) presented testimony[6] to Congress in March 2004, concluding that priorities other than enforcement, including unbudgeted expenses, have consumed IRS budget increases and savings over the last several years. TE/GE Division management has indicated staffing the TEB office is difficult because of the high level of technical expertise needed for tax-exempt bonds. Fewer employees available for the Enforcement Program could affect the ability of TEB office management to enforce I.R.C. provisions related to tax-exempt bonds.

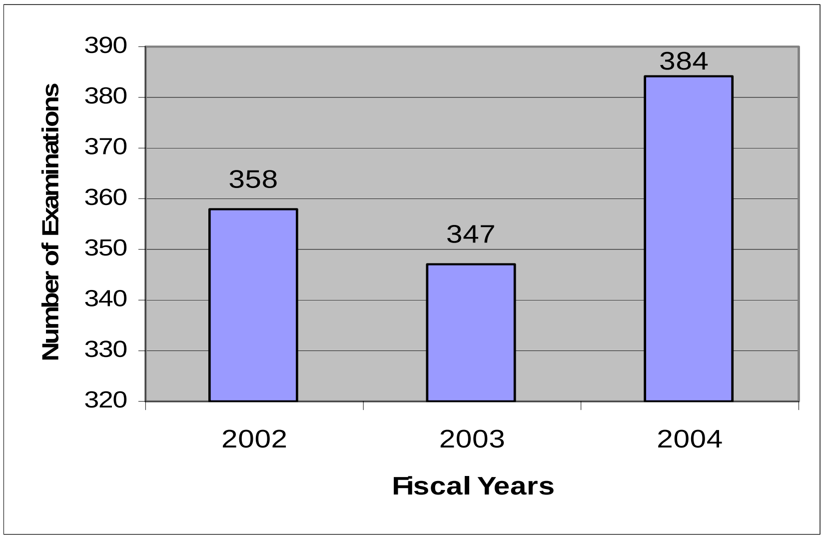
Total examinations conducted

There are several different statistics that can give an indication of the impact of the TEB office Examination Program on compliance. One statistic is the total number of examinations conducted each year. Chart 2 shows the TEB office closed more examinations in FY 2004 than

[6] *Internal Revenue Service: Assessment of Fiscal Year 2005 Budget Request and 2004 Filing Season Performance* (GAO-04-560T, dated March 2004).

in the prior 2 years. This was despite the fact that FTEs for the Examination Program remained consistent for the 3-year period.

Chart 2: Number of Closed Examinations by Fiscal Year (FY 2002 – FY 2004)



Source: Audit Information Management System (AIMS)[7] data for FY 2002 – FY 2004.

Prior to FY 2001, returns for tax-exempt bond issuances (Form 8038 series)[8] were controlled on the IRS Non-Master File. These returns were not included on the IRS Master File[9] as processed returns (i.e., Transaction Code 150). In January 2001, the TEB office began converting all the Form 8038 series returns to Master File Transaction Code 150 postings. TEB office management advised us that, when they converted the bond issuances to the Master File and opened examinations on the cases, they identified some issuances that contained incorrect or invalid information, such as an incorrect entity number or tax year. Return information for these cases had not been verified as being correct when originally input to the Non-Master File.

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[7] The AIMS is a computer system used by the TE/GE Division to control returns, input assessment/adjustments to the Master File, and provide management information reports. The Master File is the IRS database that stores various types of taxpayer account information, including individual, business, and employee plans and exempt organizations data.

[8] Information Return for Tax-Exempt Private Activity Bond Issues (Form 8038); Information Return for Tax-Exempt Governmental Obligations (Form 8038-G); Information Return for Small Tax-Exempt Governmental Bond Issues, Leases, and Installment Sales (Form 8038-GC); and Arbitrage Rebate, Yield Reduction and Penalty in Lieu of Arbitrage Rebate (Form 8038-T).

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

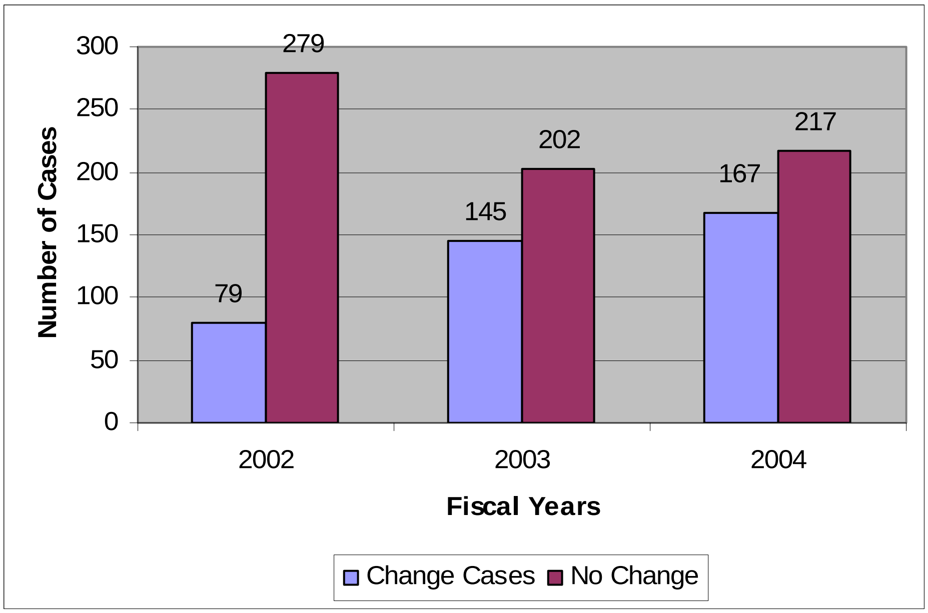
In 2002, the TEB office started deleting examinations containing incorrect or invalid information from the AIMS by the use of Disposal Code 33 (Error Return). These accounts were reestablished on the AIMS and Master File using correct and valid data. Because of this, we did not include in our analysis the 499 cases that had been removed from the AIMS as "Error Returns." We also did not verify that all the accounts had been correctly reestablished on the Master File. However, we plan to initiate an audit in this area in the future.

We also did not include 15 cases that were on the AIMS and closed as "Survey After Assignment." No examinations were actually initiated on these cases and no staff time was applied.

Examinations of noncompliant bonds

Another indication of the impact of the Examination Program is the percentage of closed cases that identified noncompliance with the I.R.C. (i.e., change cases). We determined this percentage significantly improved for the 3-year period, from 22 percent in FY 2002 to 43 percent in FY 2004. Chart 3 shows the number of cases where examinations identified some degree of noncompliance (change cases) versus examinations that determined the bonds were in compliance with the I.R.C. (no change cases).

Chart 3: Number of Examinations Identifying Noncompliant Versus Compliant Bond Issuances (FY 2002 – FY 2004)



Source: AIMS data for FY 2002 – FY 2004.

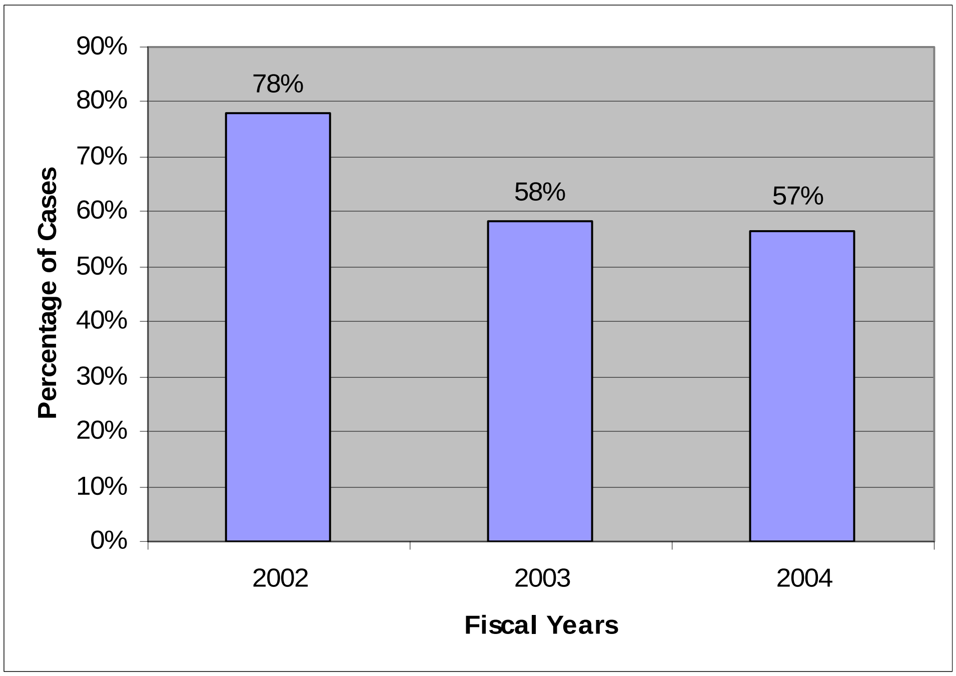
These change examinations included 22 bond issuances (4 in FY 2003 and 18 in FY 2004) for which the tax-exempt status was rescinded.

Examinations of compliant bonds

Although the TEB office has increased the number of examinations where noncompliance is identified, there is still a greater volume of examinations completed on what the IRS determines to be compliant bond issuers. This is indicated by the number of examinations closed on the AIMS without a change to the tax document (i.e., at the completion of the examination, the tax documents are accepted as filed without change).

Chart 4 reflects the percentage of examinations each year that are closed without identifying noncompliance for that bond issuance.

Chart 4: Percentage of Examinations Resulting in No Change to Compliance (FY 2002 – FY 2004)



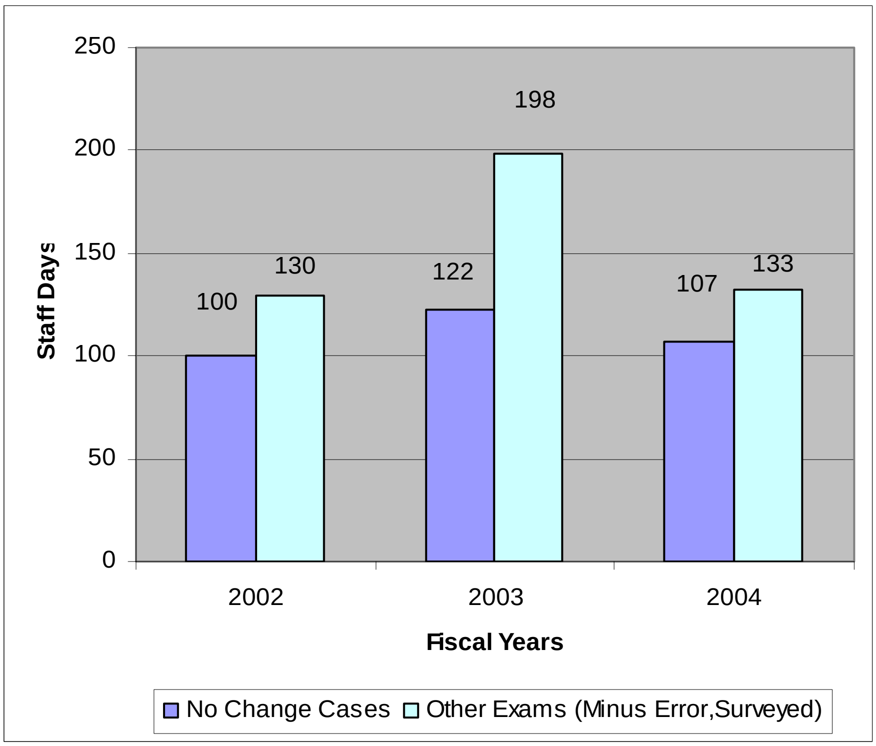
Source: AIMS data for FY 2002 – FY 2004.

TEB office management desires to make the best use of limited examination resources, which would be examinations of the noncompliant bond issues. The data indicate the examination selection process improved in FYs 2003 and 2004, but there is a need for further improvement. If TEB office management can identify any common characteristics for the noncompliant versus the no change bond examinations, this could be used to improve the process for selecting bonds with a high risk of noncompliance.

Time expended on no change examinations

Chart 5 shows the average time spent on no change cases remained relatively stable, while the average time on noncompliant examination cases increased in FY 2003 and decreased to FY 2002 levels in FY 2004.

Chart 5: Average Time Expended per No Change Examination (FY 2002 – FY 2004)



Source: AIMS data for FY 2002 – FY 2004.

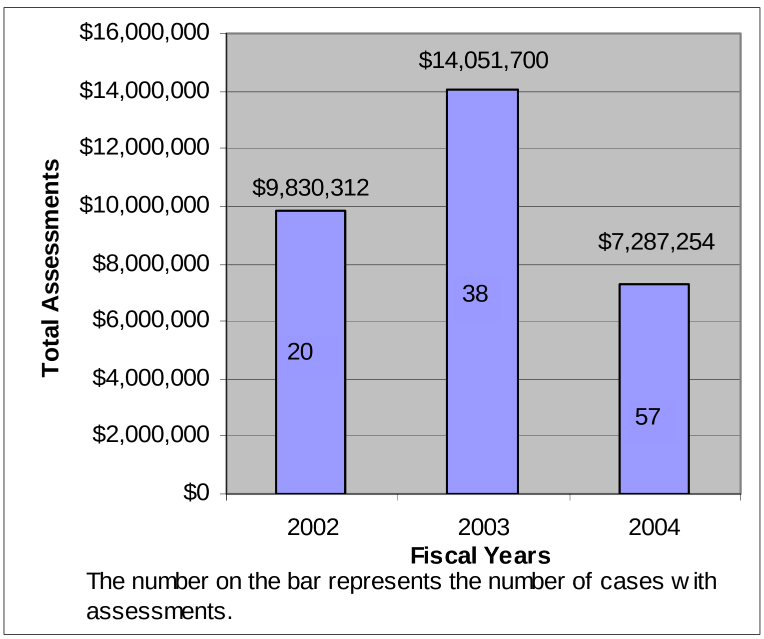
We did not determine the reason for the significant variance in staff hours for the examinations that identified some degree of noncompliance or if the amount of time spent on no change cases is appropriate.

Assessment amounts for noncompliant bonds

Another indicator of the success of the Examination Program is the amount assessed on the noncompliance identified during examinations. Charts 6 and 7 note the total and average assessments, respectively, for all noncompliance identified during examinations. These do not include amounts for claims for refund, bonds that are determined to be taxable, delinquent returns obtained, and changes made to related returns.

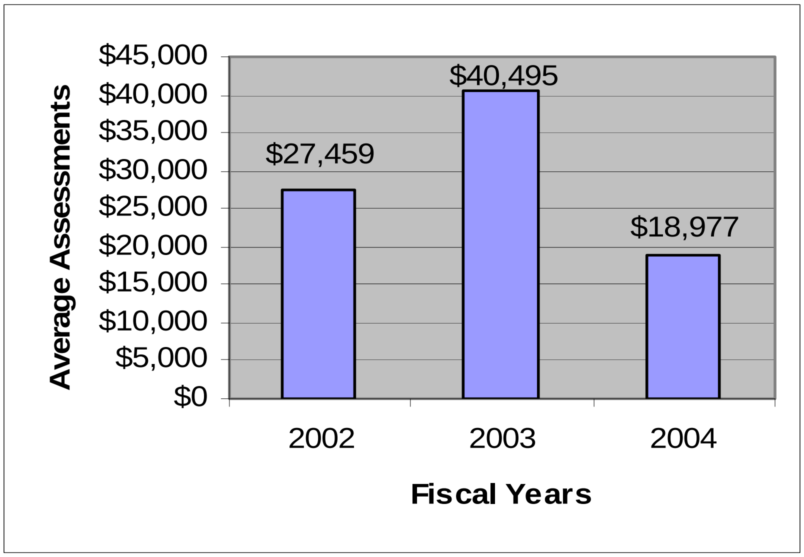
Charts 6 and 7 also do not include assessment amounts proposed by the TEB office but appealed by the bond participant. Although the AIMS data contained the proposed assessment amount for cases sent to the Office of Appeals for resolution, the proposed assessments were not consistently reported in the AIMS data, so we did not include these amounts in our analyses.

Chart 6: Total Examination Assessments per Fiscal Year (FY 2002 – FY 2004)



Source: AIMS data for FY 2002 – FY 2004.

Chart 7: Average Assessment per Examination (FY 2002 – FY 2004)



Source: AIMS data for FY 2002 – FY 2004.

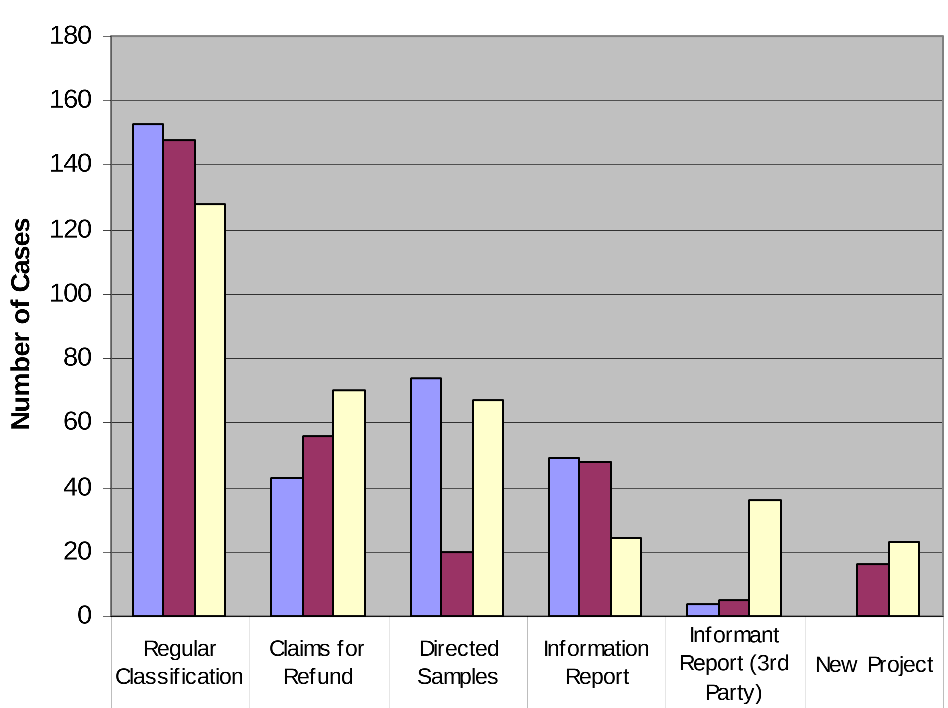
Because examination assessments are made only on cases with noncompliance, we compared Charts 3, 6, and 7. We observed the total number of bonds (from Chart 3) where noncompliance was identified increased each year. However, the average assessment per case fluctuated for the 3 years but decreased from FY 2002 to FY 2004, which indicates the degree of noncompliance identified during examinations was less in FY 2004 than it was in the prior 2 years.

Source of bond examinations

In the Examination Program, the TEB office works several different types of cases, including Form 8038 series claims for recovery of arbitrage payments,[10] information items, and referrals.[11] Chart 8 shows the top six sources of examinations for FY 2002 through FY 2004.

[10] Arbitrage is the profit that results from investing the proceeds from tax-exempt bonds in higher yielding taxable securities. Tax law generally requires a rebate of arbitrage profits to the United States Department of the Treasury.
[11] A document or other communication (e.g., telephone call) received from a source outside the IRS that alleges potential noncompliance with the tax law.

Chart 8: Sources of Examinations (FY 2002 – FY 2004)



	Regular Classification	Claims for Refund	Directed Samples	Information Report	Informant Report (3rd Party)	New Project
FY 02	153	43	74	49	4	0
FY 03	148	56	20	48	5	16
FY 04	128	70	67	24	36	23

Sources of Examinations

Source: AIMS data for FY 2002 – FY 2004.

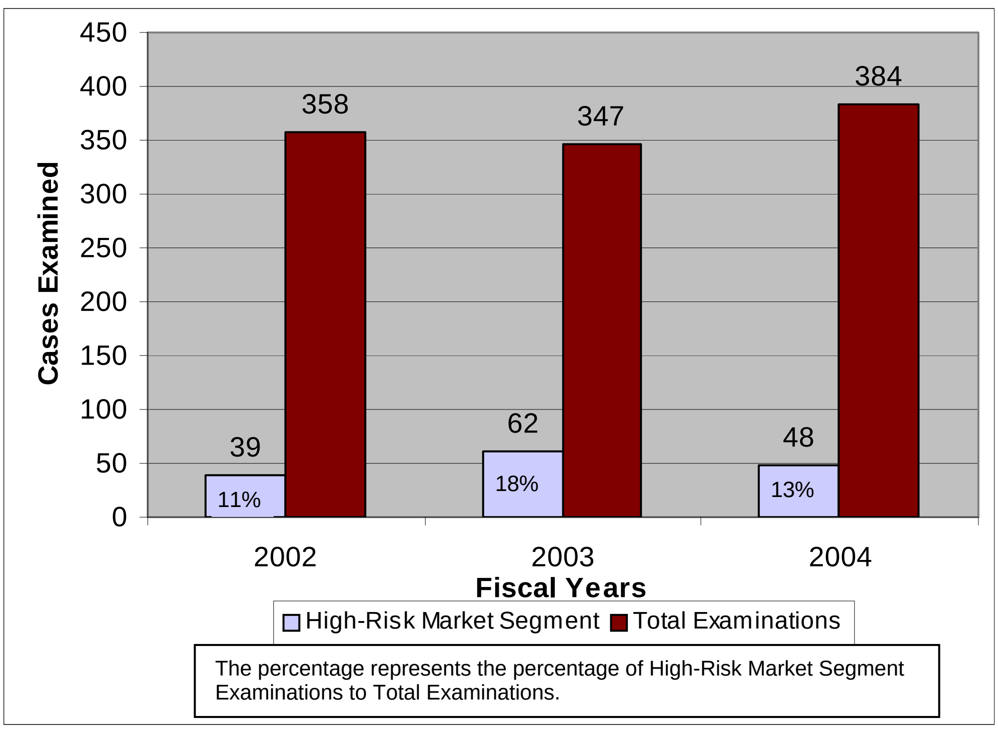
The analysis indicates Regular Classification was the main source of examination cases for all 3 years. Regular Classification is a process to determine whether cases should be examined and the priority of their selection. The second highest source was Claims for Refund, which are examinations of requests to refund arbitrage payments. The third highest source of bonds for examination was Directed Samples. Directed Samples are a selection of returns for specific Project Initiatives.[12]

[12] Project Initiatives are used to measure the noncompliance of a particular market segment or TEB office return population.

Examinations of high-risk market segments

The TEB office conducts a risk assessment process to identify market segments of the bond population where there may be a high risk for noncompliance. Bonds in those market segments are then selected for examination through a sampling process. The TEB office determined for the 3-year period, FY 2002 through FY 2004, that Solid Waste, Small Issue, and Housing were the market segments with the highest risk for noncompliance. However, Chart 9 shows high-risk market segment examinations were a small portion of the total examination inventory. For the 3-year period, high-risk market segment examinations were approximately 14 percent of the total closed examinations.

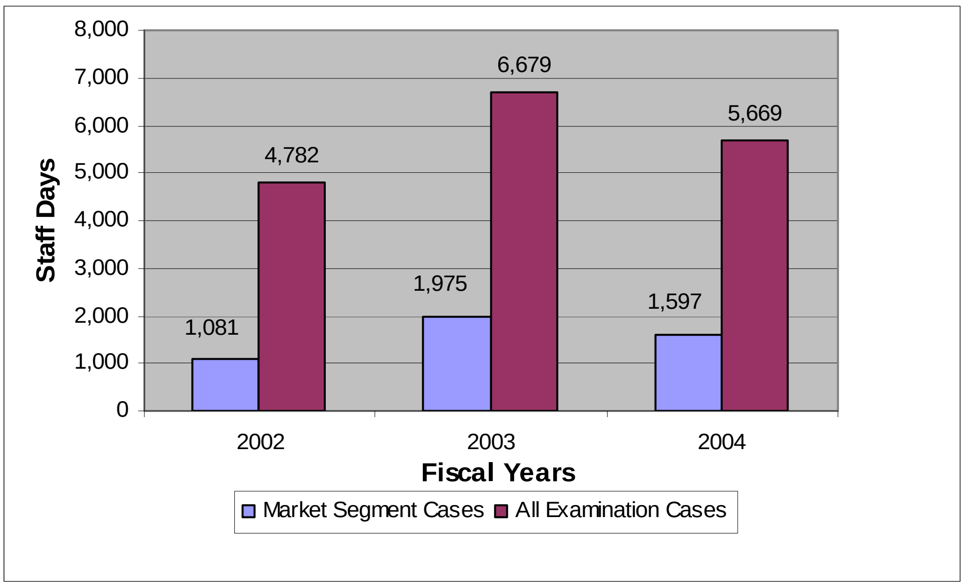
Chart 9: High-Risk Market Segment Examinations Compared to Total Examinations (FY 2002 – FY 2004)



Source: AIMS data for FY 2002 – FY 2004.

Chart 10 shows the time spent working high-risk market segment cases compared to the total examination time. For the 3-year period, the high-risk market segment examination staff days were 27 percent of the total examination staff days. Comparing Charts 9 and 10, the high-risk market segment examinations used proportionally more staff days. For example, the number of high-risk market segment examinations for FY 2002 was 11 percent of the total examinations but 23 percent (1,081/4782) of the total examination time. Similarly, the number of high-risk market segment examinations for FY 2004 was 13 percent of the total examinations but 28 percent (1,597/5,669) of the total examination time.

Chart 10: High-Risk Market Segment Examination Staff Days Versus Total Examination Staff Days (FY 2002 – FY 2004)



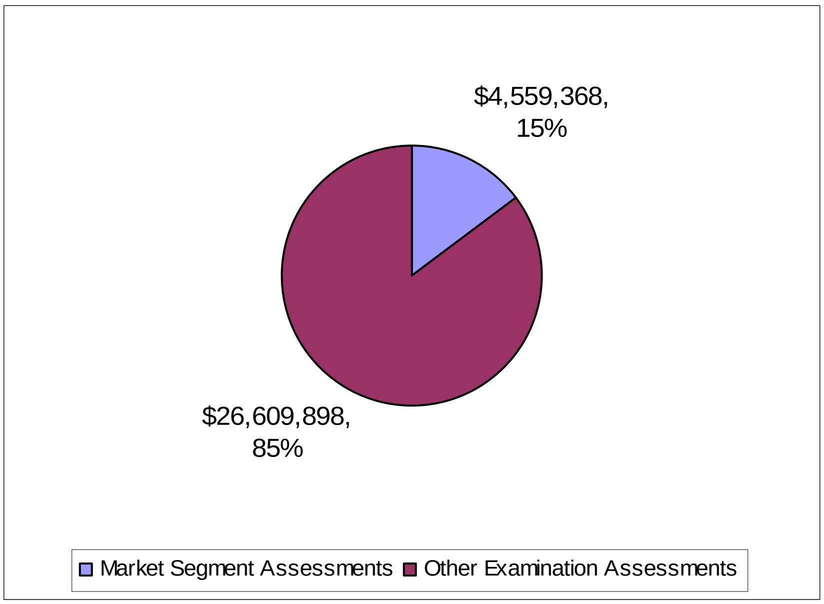
Source: AIMS data for FY 2002 – FY 2004.

Chart 16 shows the average staff days per high-risk market segment examinations, for the 3-year period, is more than twice the average staff days of other examinations.

Analyses of high-risk market segment examinations

Comparing Chart 9 to Chart 11, we noted high-risk market segment examinations resulted in approximately the same proportion of total assessment amounts when compared to other examinations. For the 3-year period FY 2002 through FY 2004, 14 percent of the total examinations were high-risk market segment examinations, and they yielded 15 percent of the total assessment amount. However, as shown in Chart 15, high-risk market segment examinations resulted in an 8 percent higher average assessment than other examinations.

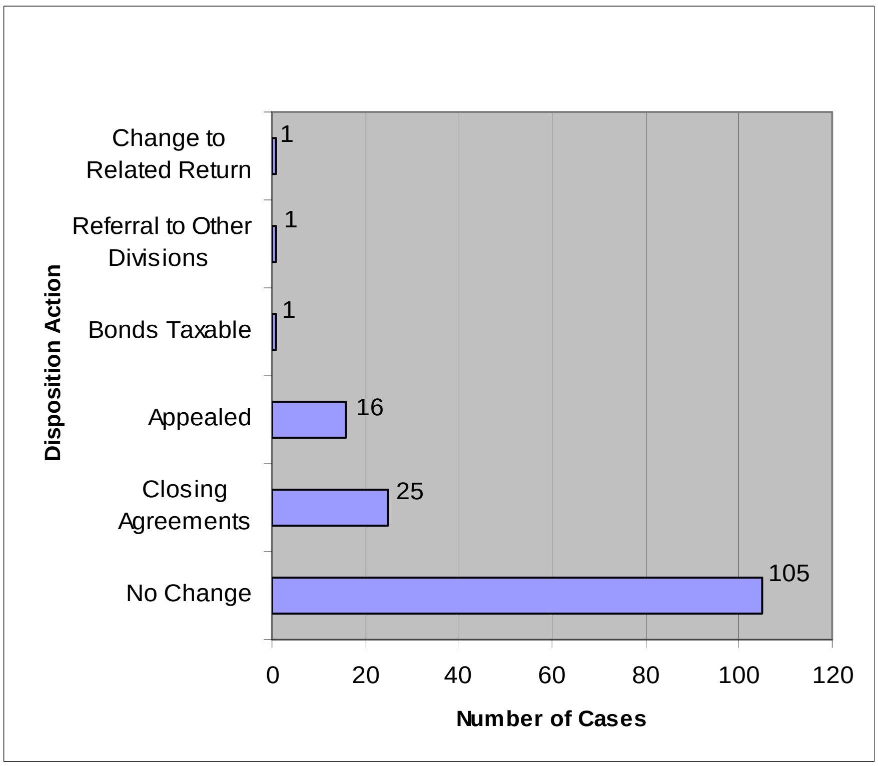
Chart 11: High-Risk Market Segment Examination Assessments Versus Other Examination Assessments (FY 2002 – FY 2004)



Source: AIMS data for FY 2002 – FY 2004.

Although the TEB office identified 3 market segments as having the highest risk of noncompliance, only 30 percent of the high-risk market segment examinations identified noncompliance. Chart 12 shows how the 149 high-risk market segment examinations were closed over the 3-year period (FY 2002 – FY 2004), with the majority of the closures resulting in no change to the bond issuance.

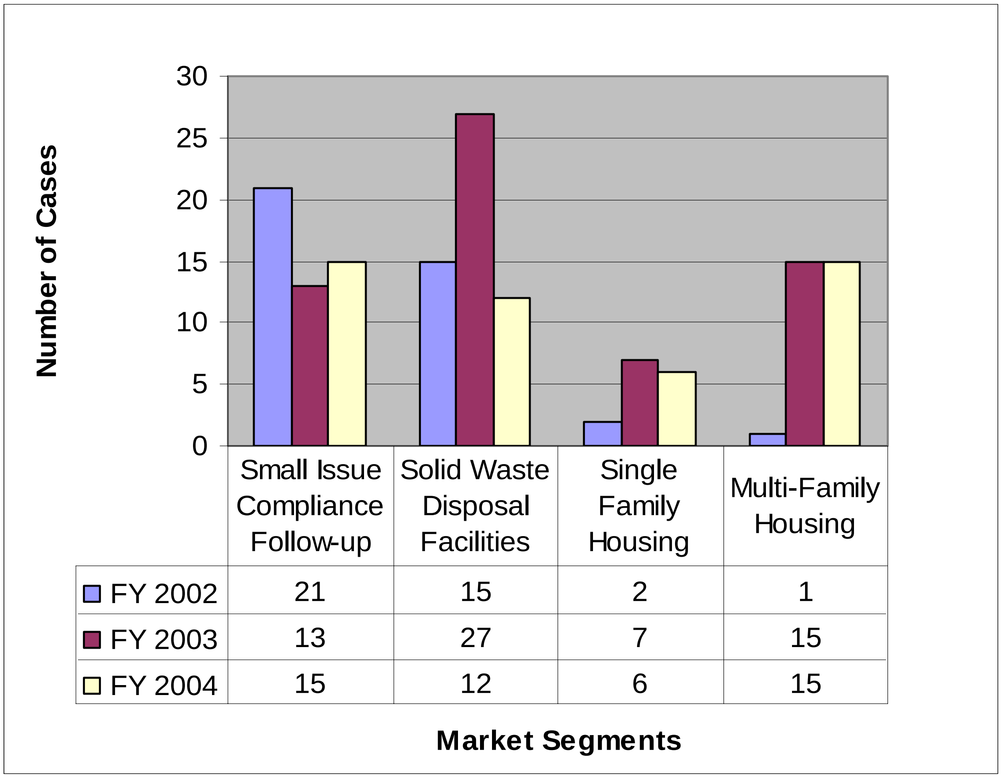
Chart 12: Disposition of High-Risk Market Segment Examinations (FY 2002 – FY 2004)



Source: AIMS data for FY 2002 – FY 2004.

Chart 13 shows the number of examinations completed within the three high-risk market segments (Housing is shown in single and multi-family categories) by fiscal year.

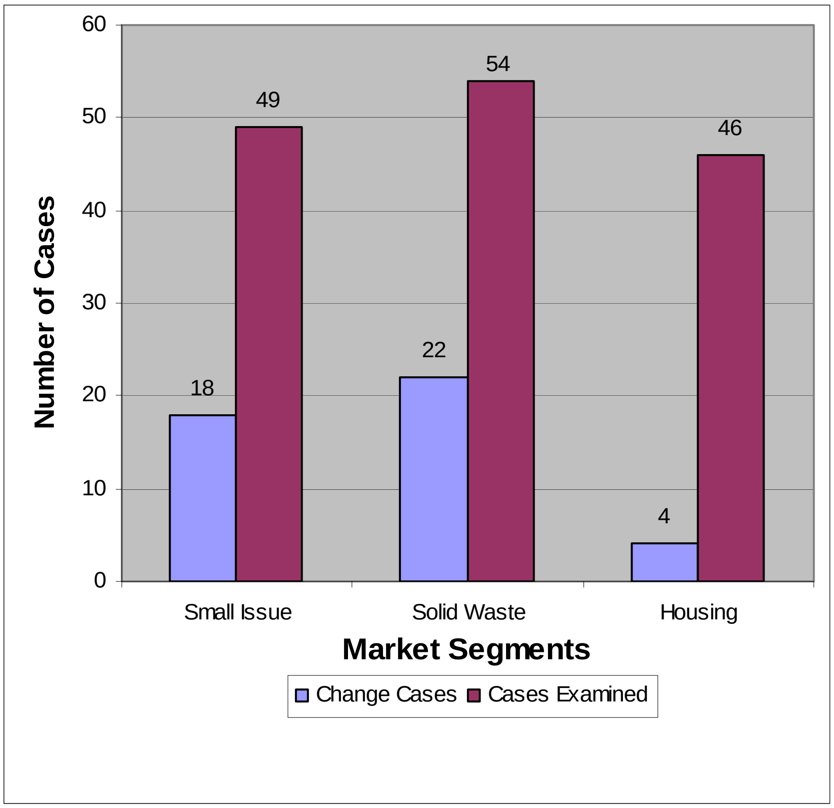
Chart 13: Examinations by High-risk Market Segment (FY 2002 – FY 2004)



Source: AIMS data for FY 2002 – FY 2004.

Chart 14 shows the Small Issue and Solid Waste Market Segments identified more noncompliance than the Housing Market Segment.

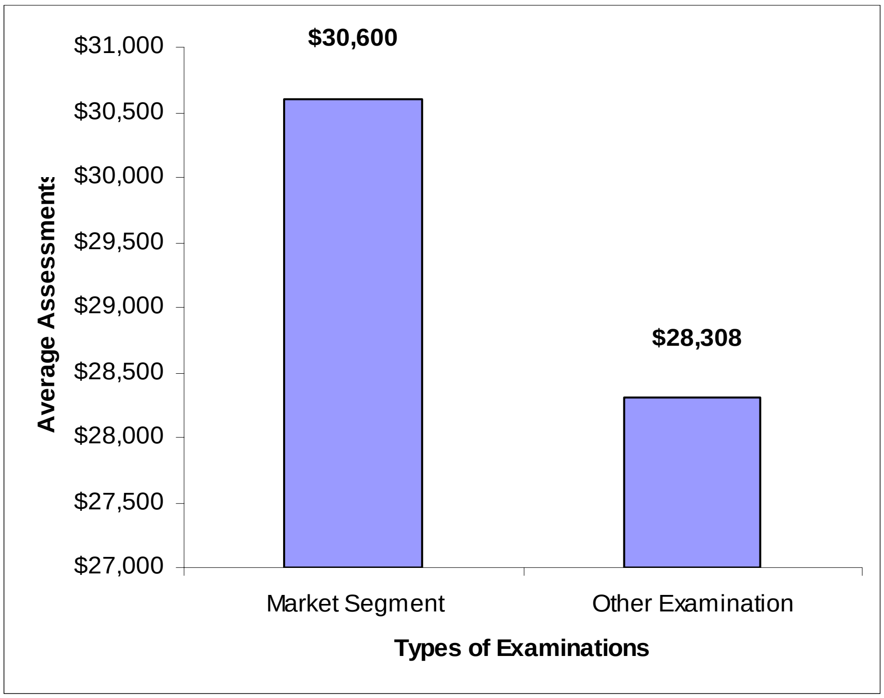
Chart 14: High-Risk Market Segment Examinations Identifying Noncompliance (FY 2002 – FY 2004)



Source: AIMS data for FY 2002 – FY 2004.

Chart 15 shows that the average assessment per case for high-risk market segment cases was slightly higher than the average for other examination cases.

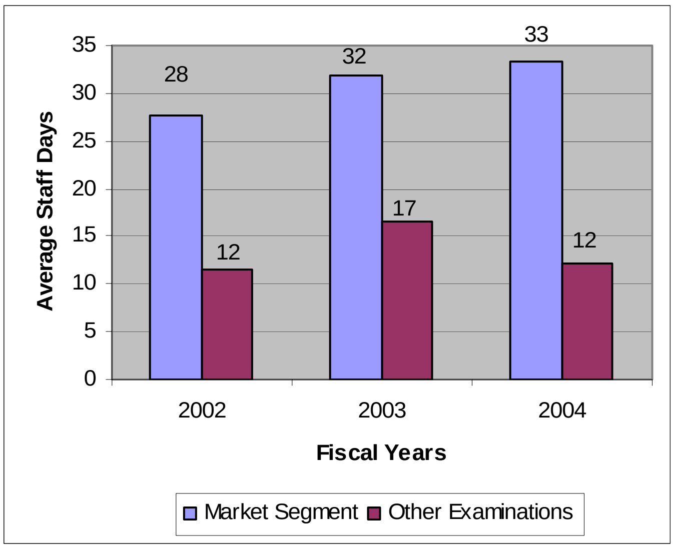
Chart 15: High-Risk Market Segment Average Assessment Versus Other Examination Average Assessment (FY 2002 – FY 2004)



Source: AIMS data for FY 2002 – FY 2004.

Chart 16 shows the average staff days expended per high-risk market segment examination versus the average staff days expended per other examination cases. We noted the average staff days per high-risk market segment case increased slightly over the 3 years of conducting these high-risk market segment examinations. Comparing Charts 14 and 16, we noted the majority of the examinations for all 3 high-risk market segments determined the bonds were compliant (70 percent were closed as no change), although the third year examinations took slightly more staff days to complete.

Chart 16: High-Risk Market Segment Average Staff Days Versus Other Examination Average Staff Days (FY 2002 – FY 2004)



Source: AIMS data for FY 2002 – FY 2004.

The high-risk market segment approach for selecting cases for examination appears not to be a more effective way to identify cases with the most potential for noncompliance. The average assessment amounts for high-risk market segment examinations are slightly more than the average assessment amounts for other examination cases. However, the percentage of high-risk market segment examinations that identified noncompliance (30 percent) is less than the percentage of noncompliance identified in other examinations (37 percent), and the average staff days to complete examinations of high-risk market segment cases is more than twice that of other types of examinations.

I.R.C. § 6700 examinations related to misconduct

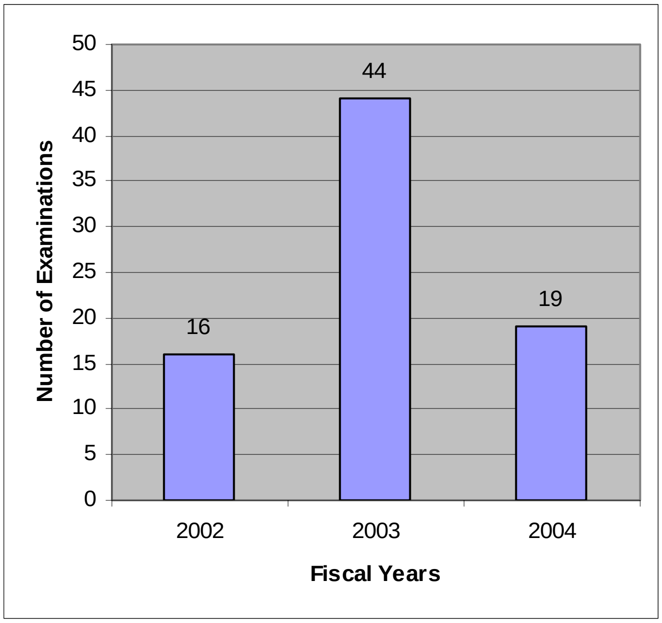
Examinations related to I.R.C. § 6700 are performed to determine if a bond promoter engaged in misconduct (e.g., misleads or causes others to be misleading about material matters) in promoting the issuance of a tax-exempt bond under a specific I.R.C. section and, if so, whether a penalty is warranted. I.R.C. § 6700 examinations can be started after a bond examination is underway and potential misconduct is identified or can be opened as a new examination. If misconduct is identified, a penalty can be assessed against the bond promoter under I.R.C. § 6700. If the level of misconduct does not warrant an I.R.C. § 6700 penalty, a miscellaneous penalty can be assessed using the same basis for calculating the I.R.C. § 6700 penalty (i.e., the penalty amount may be the same for an I.R.C. § 6700 penalty and a miscellaneous penalty).

The TEB office assessed penalties under I.R.C. § 6700 on 5 cases totaling $15.5 million from FY 2002 through FY 2004. We verified these assessments by tracing them to the IRS Master File. In addition, miscellaneous penalties were assessed in the amount of $29.2 million. We did not verify these miscellaneous penalties because they are not recorded as an assessment on the bond account of the issuer but are assessed against the bond promoter. These payments are not entered on the Master File because they are not assessable to the taxpayer's account but are instead entered on a special IRS general ledger account. The payments can be manually transferred to the Master File at the request of TEB office management. Because we could not readily trace these payments to ensure they were properly posted to the correct account, we plan to review this area in a future audit.

For the purpose of this report, the information below includes all penalty amounts related to misconduct (I.R.C. § 6700 penalties and miscellaneous penalties).

Chart 17 shows the number of I.R.C. § 6700 examinations closed each year.

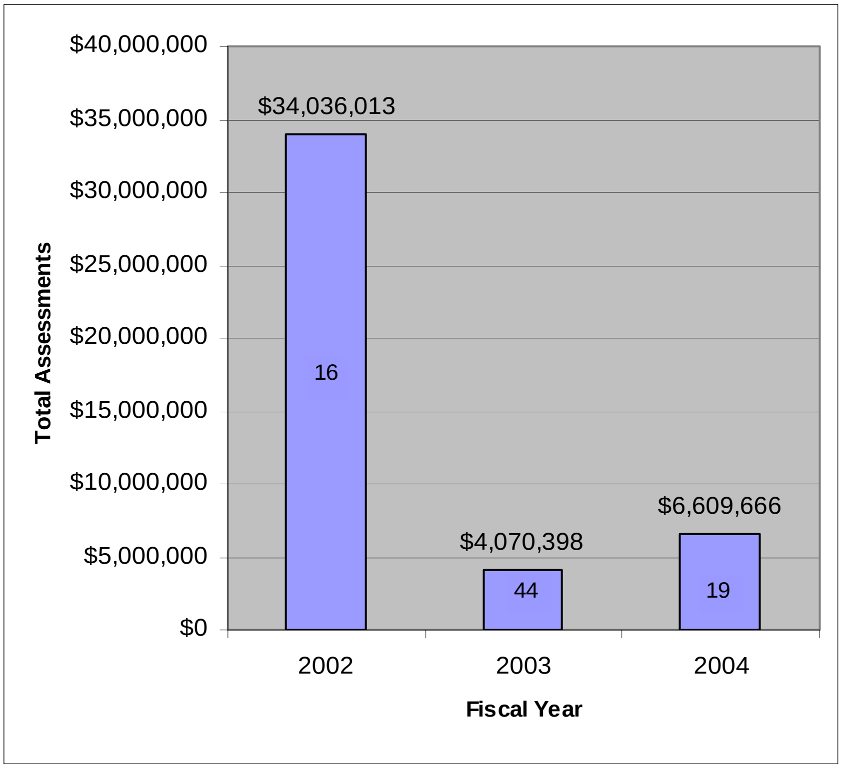
Chart 17: Total I.R.C. § 6700 Examinations Closed (FY 2002 – FY 2004)



Source: I.R.C. § 6700 manual records.

Chart 18 shows the number of I.R.C. § 6700 examinations closed each year with the related assessment amounts.

Chart 18: Total I.R.C. § 6700 Assessments (FY 2002 – FY 2004)

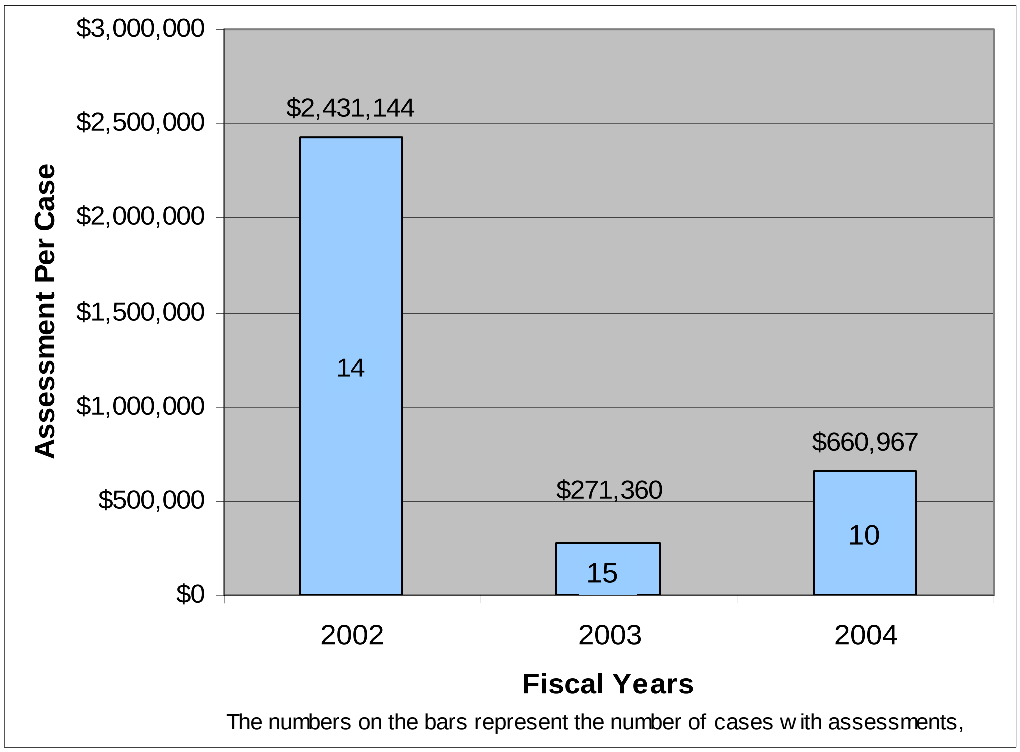


Source: I.R.C. § 6700 manual records.

Of the 79 I.R.C. § 6700 examinations closed, 39 cases had assessments totaling $44,716,077 for misconduct from FY 2002 through FY 2004. However, in FY 2002, 1 entity's assessment totaled over $26 million. If that entity's assessment was removed for the purpose of comparing trends over the 3 years, the remaining assessments for FY 2002 (approximately $8 million) would be more consistent with those of the other 2 years.

Chart 19 shows the average misconduct assessments for each fiscal year. The same trend as in Chart 18 would result if the one high dollar FY 2002 assessment was removed.

Chart 19: Average I.R.C. § 6700 Penalty Assessments for Cases With Assessments (FY 2002 – FY 2004)

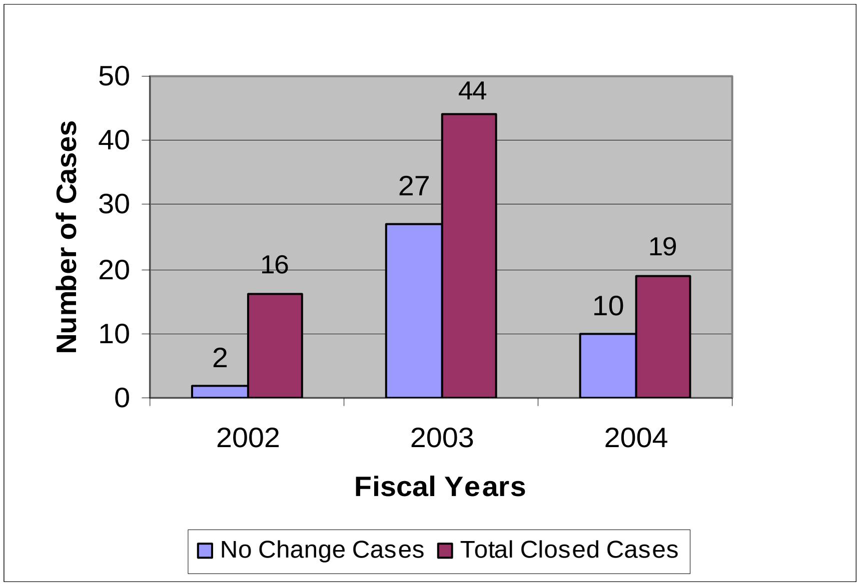


Source: I.R.C. § 6700 manual records.

We did not compare the average assessments from I.R.C. § 6700 examinations to the average assessments for regular bond examinations because the I.R.C. § 6700 assessments are penalties for promoter misconduct while the regular bond examination assessments are for bond noncompliance with the I.R.C.

Chart 20 shows the number of I.R.C. § 6700 investigations that resulted in a no change compared to total closures.

Chart 20: I.R.C. § 6700 No Change Versus Total Closures (FY 2002 – FY 2004)

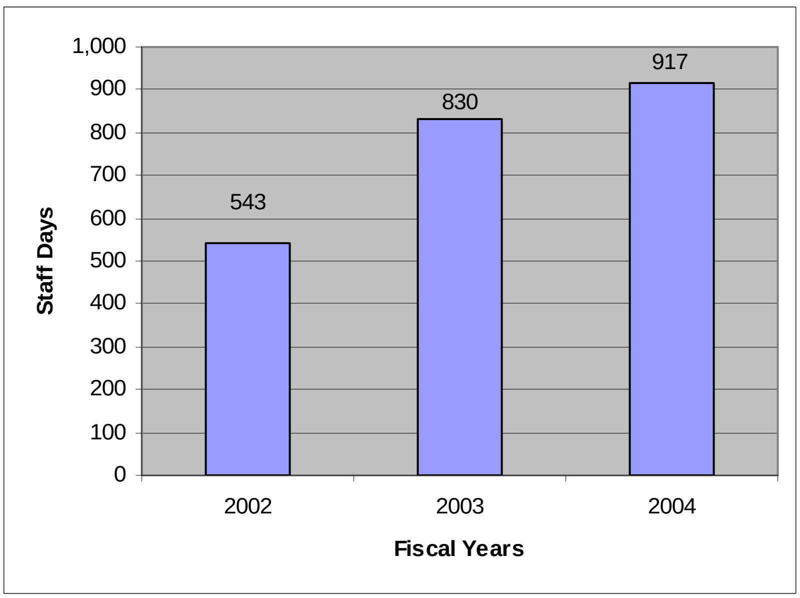


Source: I.R.C. § 6700 manual records.

The higher no change rates in FYs 2003 and 2004 are an indication that either the cases are not as productive as they were in FY 2002 or the method for identifying potential misconduct cases for examination needs improvement.

Chart 21 shows the total staff days expended to work I.R.C. § 6700 examinations increased between FY 2002 and FY 2004. Staff days included in this analysis include all staff days expended on I.R.C. § 6700 examinations for the 3 fiscal years (not just the 79 closed cases). Management information system limitations prevented us from identifying time expended only on closed cases.

Chart 21: Total Staff Days Expended to Work I.R.C. § 6700 Examinations (FY 2002 – FY 2004)



Source: TE/GE Division Technical Time Reporting System.

For FYs 2002 – 2004, a comparison of Charts 18 and 19 shows 49 percent (39 of 79) of the I.R.C. § 6700 examinations resulted in assessments (in the amount of $44,716,077) or a referral to another IRS division for further review. It is interesting to note the percentage of I.R.C. § 6700 examinations that resulted in penalty assessments decreased from a high of 88 percent in FY 2002 to 34 percent in FY 2003 and 53 percent in FY 2004. Although the overall 49 percent assessment rate is higher than for regular bond examinations (36 percent), there are still opportunities for the TEB office to select more productive I.R.C. § 6700 examinations.

In 1993, the GAO reported (see Appendix IV for the report findings and recommendations) the IRS did not use return information to identify probable noncompliance and target enforcement efforts, lacked the ability to levy appropriate sanctions and penalties to discourage abuse in the tax-exempt bond area, and could use I.R.C. § 6700 examinations to target those responsible for noncompliance if they were involved in promoting a bond as an abusive tax shelter.

The charts in this report indicate the TEB office is now using the tools identified in the GAO report to improve noncompliance with the I.R.C. However, there is room for improvement in the TEB office's efforts to ensure compliance for tax-exempt bonds. With the IRS Commissioner's increased emphasis on compliance, there is a need for the TEB office to reevaluate the way it uses its enforcement resources to have the biggest impact on compliance.

The analyses in this report indicate the following:

- The number of examinations increased, but more than one-half of the examinations are on compliant bond issues.
- Average examination assessment amounts have fluctuated but decreased over the 3-year period of analysis.
- The market segment method of selecting high-risk cases results in more than twice the average staff days to complete examinations and slightly higher average assessment amounts.
- Approximately one-half of the I.R.C. § 6700 examinations and more than one-half of the regular bond examinations result in no change.

These are indications the TEB office needs to better select bonds for examination and for misconduct examinations under I.R.C. § 6700. Selecting cases where there is a high risk of noncompliance may increase productivity and enable the TEB office to improve compliance within the tax-exempt bond population.

Management's Response: The Commissioner, TE/GE Division, generally agreed with our statistical portrayal and noted that the data usefully illuminate aspects of the TEB office's operations and will be considered as the TEB office continues to pursue a focused, ambitious compliance program. However, the Commissioner, TE/GE Division, believes some statements in the report–those that seem to equate success in compliance with dollars assessed–were misdirected and incomplete and some conclusions may have been reached too casually. The Commissioner's response provided examples of additional types of data showing the TEB office's impact on compliance, particularly rebates collected, bonds redeemed, and revenue protected in future years.

Office of Audit Comment: Our review was based on the data provided by the TEB office during our fieldwork, and we believe our results are representative of the data provided. While we agree the additional types of data the Commissioner, TE/GE Division, referred to in the response are important measures, the data were not included in the TEB office's databases or records provided to us. Also, it was never intended that our analysis include all TEB office program information. We concentrated on the TEB office enforcement data resulting directly from the TEB office Enforcement Program.

Appendix I

Detailed Objectives, Scope, and Methodology

Our overall objectives were to review relevant statistical data of the Tax Exempt Bonds (TEB) office's enforcement activities for Fiscal Years (FY) 2002 - 2004 and analyze the data for trends. To accomplish our objectives, we:

I. Reviewed data relating to the TEB office's enforcement activities.

   A. Obtained Tax Exempt and Government Entities Division Technical Time Reporting System data from the Director, TEB, for FYs 2001 through 2004 to determine the time applied to examination and Internal Revenue Code (I.R.C.) Section (§) 6700 (2004) investigations.

   B. Obtained Statistics of Income Data from the Treasury Inspector General for Tax Administration Data Warehouse for Calendar Years 1996 through 1999 to determine the numbers of bonds issued in the various market segments.

   C. Obtained an Audit Information Management System (AIMS)[1] extract from the Director, TEB, to identify all examinations controlled on the AIMS since its inception.

   D. Obtained quarterly field reports and Inventory Spreadsheets from the Director, TEB, to determine the results of the enforcement activities within the TEB office.

II. Analyzed the available data for trends in enforcement activities.

   A. Determined sources for examinations by fiscal year.

      1. Number by referrals.

      2. Number by information item.

      3. Number by Regular Classification.

   B. Determined staffing metrics by fiscal year.

      1. Average hours/days per case.

      2. Average hours/days per type of case.

[1] The AIMS is a computer system used by the Tax Exempt and Government Entities Division to control returns, input assessment/adjustments to the Master File, and provide management information reports. The Master File is the Internal Revenue Service database that stores various types of taxpayer account information and including individual, business, and employee plans and exempt organizations data.

C. Determined examination results by fiscal year.

1. Number of examinations.
2. Average assessment/penalties/sanctions per examination, as well as the range for all examinations.
3. Average assessment/penalty/sanction per type (market segment) of examination, as well as the range for all examinations.
4. Number/percentage of examinations that resulted in I.R.C § 6700 referrals.
5. Number/percentage of examinations that resulted in criminal referral (to the Internal Revenue Service Criminal Investigation function or other government agencies).
6. Number/percentage of cases that resulted in closing agreements.
7. Number/percentage of cases that resulted in a discrepancy adjustment requiring revocation of tax-free interest income to bondholders.

III. Compared the results of the TEB office market segment analysis to examinations opened to determine if examination trends follow the areas of highest risk identified by the market segment analysis.

Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

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Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Tax Exempt and Government Entities Division SE:T
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Audit Liaison: Director, Communications and Liaison, Tax Exempt and Government Entities Division SE:T:CL

Appendix IV

Government Accountability Office Report: Improvements for More Effective Tax-Exempt Bond Oversight – May 1993 Report Findings and Recommendations

Findings

In 1993, the Government Accountability Office (GAO) report stated:

- The Internal Revenue Service (IRS) does not use the return information to spot probable noncompliance and target enforcement efforts.
- The Expanded Bond Audit Program has pursued cases identified through tips and other outside sources. A more proactive effort that includes reviews of some more current bond issues would enhance the IRS' knowledge of current compliance problems and better position the IRS to determine whether it is obtaining an acceptable deterrent effect from its enforcement presence.
- Revenue agents assigned to the Expanded Bond Audit Program have not received final guidance providing current procedures to detect noncompliance and address abuses. Current staffing and training practices, which were established so the Expanded Bond Audit Program could investigate a specific group of abuses, may not be appropriate for these broader efforts. Agents have limited opportunities in which to apply their training and have not been trained on the many other tax-exempt bond requirements they would need to know to recognize other forms of noncompliance.
- The IRS' tax-exempt bond efforts do not have objectives or strategies to identify and resolve key tax-exempt bond oversight issues.
- The basic sanction available to the IRS is to tax interest earned by bondholders on abusive bonds. The IRS has been reluctant to use this sanction because it punishes investors rather than responsible parties directly, is complex to administer, and is often disproportionately severe. In about 70 cases since 1981, the IRS used a closing agreement–a mechanism to settle various tax disputes–to negotiate a settlement with an issuer of a bond the IRS considered noncompliant. However, according to an IRS official, such agreements are not designed to promote voluntary compliance. For example, according to IRS officials, closing agreements are typically much smaller than profits from the noncompliance. Thus, they provide little incentive to comply. Despite

the IRS' reluctance to tax interest in cases in which bonds do not comply with tax-exemption requirements, it has recently begun considering this sanction.

- Another potential penalty, clarified to be applicable to tax-exempt bonds in 1989, is the penalty in Internal Revenue Code (I.R.C.) Section (§) 6700 for promoting abusive tax shelters, which would target those responsible for noncompliance if they were involved in promoting a bond as an abusive shelter of income for tax purposes. This penalty requires the IRS to prove that someone intentionally promoted a bond through which investors could illegally shelter income and avoid paying taxes. Because the IRS has not actually tried to apply this penalty in the area of tax-exempt bonds, it is not known how difficult it will be to prove such intent for complex tax-exempt bond transactions.
- If information about tax-exempt bond enforcement actions could be released, such as information on the types of bonds the IRS has found to be abusive or the identities of participants in abusive bonds, the market participants the IRS relies on to ensure compliance with bond requirements could make more reasoned judgments about tax-related compliance risks.

Recommendations

The GAO recommended the Commissioner of the Internal Revenue Service:

- Partially redirect existing Expanded Bond Audit Program efforts to include active testing of current market compliance; identify and make better use of information to detect noncompliance and direct enforcement efforts; provide final guidance for tax-exempt bond enforcement; and reassess program staffing levels, locations, and training needs in light of the Program's future.
- Develop and implement a plan to guide efforts throughout the IRS to make more effective use of resources to promote voluntary compliance in the tax-exempt bond industry. This plan should establish clear objectives and coordinated, proactive strategies to achieve the objectives; assess staff and information needs to carry out the strategies; and set measurable goals.
- Test the use of the I.R.C. § 6700 penalty for promoting abusive tax shelters in tax-exempt bond enforcement.

The GAO also recommended Congress may want to consider several options to enhance tax-exempt bond voluntary compliance.

- First, Congress may want to consider the adoption of other penalties for specific kinds of noncompliance.
- Second, Congress may want to consider whether permitting the disclosure of some tax-exempt bond-related tax information, with appropriate safeguards, would improve overall compliance incentives in the industry.

Appendix V

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 23 2005

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Steven T. Miller
Commissioner, Tax Exempt and Government Entities

SUBJECT: Draft Audit Report – Statistical Portrayal of the Tax Exempt Bonds Office's Enforcement Activities From Fiscal Year 2002 Through Fiscal Year 2004 (Audit # 200510006)

We appreciate your statistical portrait of our Tax Exempt Bonds function's examination program.

We think the vigorous examination program being carried out by Tax Exempt Bonds is succeeding, and in this regard agree with your observation that "…TEB is now using the tools identified in the [1993] GAO report to improve compliance with the I.R.C."

As you note, management of the Tax Exempt Bonds program has succeeded in increasing the number of exams it is conducting, and in shifting a greater portion of its resources into enforcement.

TEB's aim, of course, is a compliant Tax Exempt Bond sector. In this regard, we believe that some statements in the report -- those that seem to equate success in compliance with dollars assessed – are misdirected and incomplete.

Such a standard, even by its own terms, does not take into account the amount of arbitrage rebate TEB collects, the amount of redemptions undertaken as the result of negotiated settlements, cases taken to Appeals, or adjustments made by other business results which flow from TEB's work.

For example, in FY 2004, required redemptions exceeded $539 million in bonds, the highest year ever. In addition, issuers redeemed $2 to $3 billion in bonds early, while we were in the process of examining them. The revenue protected as a result of these activities alone totals more than $100 million for each remaining year of bond maturity.

We also believe that some conclusions in the report, such as the statement that "[a]lthough the overall 49 percent assessment rate [for I.R.C. section 6700 examinations] is higher than for regular bond examinations (36 percent), there are still opportunities ... to select more productive I.R.C. section 6700 examinations," may have been reached too casually. Nothing in the report supports a finding that higher assessment rates should be expected or that discovered noncompliance should be higher.

Nonetheless, you have compiled data that usefully illuminates aspects of TEB's operations. We will consult this work and other data about the tax exempt bond sector as we continue our work in this area. Although leaders of the tax exempt bond industry have told TEB management that, in their view, compliance has increased since the reorganized TEB office stood up, we have not yet seen compelling evidence that this is so, and we will continue to pursue a focused, ambitious compliance program, in which examinations will play a prominent role.

If you have any questions please contact Mark Scott at (202) 283-9820, or Preston Butcher at (202) 283-9738.

cc: Director, Government Entities, SE:T:GE
Director, Tax Exempt Bonds, SE:T:GE:TEB