RECOVERY ACT

Observations About Annual Dollar Limits for American Recovery and Reinvestment Act of 2009 Bonds

January 8, 2010

Reference Number: 2010-11-016

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HIGHLIGHTS

WHY TIGTA DID THE AUDIT

The American Recovery and Reinvestment Act of 2009 (Recovery Act) contains both spending and tax provisions of $787 billion over 10 years. The Recovery Act authorizes the issuance of additional tax-exempt bonds and greatly expands the market for tax credit bonds. The overall objective of this review was to report observations identified during the Review of Private Activity Tax-Exempt Bond Volume Cap Compliance that relate to the Recovery Act.

IMPACT ON TAXPAYERS

The Recovery Act authorizes State and local governments to issue more than $45 billion in new bonds, some with tax incentives to bond issuers or bondholders, and some with volume caps on the dollar amounts that can be issued. The Tax Exempt Bonds 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. Due to the challenging economic times the country is facing, it is even more important that the Internal Revenue Service (IRS) remain vigilant in ensuring that dollar limitations for bonds are not exceeded as the Federal Government works to stimulate the economy.

WHAT TIGTA FOUND

In a previous audit, TIGTA determined that the IRS needed to improve its monitoring of tax-exempt private activity bonds to ensure these bonds are not issued in excess of annual dollar limits, known as volume caps. The Recovery Act also includes volume caps for new and expanded tax credit and tax-exempt bonds.

The Tax Exempt Bonds office believes it has considered the recommendations of the prior TIGTA audit and has taken steps to ensure it is adequately monitoring the volumes of Recovery Act bonds. TIGTA did not conduct any additional audit work to evaluate the differences between how the IRS processes and monitors Recovery Act bonds versus private activity bonds or whether the new controls are effective. Due to the large amount of money involved, it will be important that the Tax Exempt Bonds office monitor Recovery Act bonds to ensure these bonds do not exceed legislative limits.

RECOMMENDATIONS AND IRS RESPONSE

There are no recommendations in this report. Tax Exempt and Government Entities Division management reviewed the report before it was issued and offered clarifying comments and suggestions, which have been taken into account.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

January 8, 2010

MEMORANDUM FOR COMMISSIONER, TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION

Allan R. Duncan

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

SUBJECT: Final Audit Report – Observations About Annual Dollar Limits for American Recovery and Reinvestment Act of 2009 Bonds (Audit # 200910135)

This report presents the observations identified during the Review of Private Activity Tax-Exempt Bond Volume Cap Compliance that relate to the American Recovery and Reinvestment Act of 2009 (Recovery Act).[1] This report is consistent with Office of Management and Budget guidance to identify high-risk programs and create quicker turnaround reporting. This review was conducted as part of the Treasury Inspector General for Tax Administration Fiscal Year 2010 Annual Audit Plan related to 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 (IRS) programs. This audit was conducted using Recovery Act funds.

We did not make any recommendations in this report. Tax Exempt and Government Entities Division management reviewed the report and offered clarifying comments and suggestions, which we have taken into account.

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

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

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Abbreviations

IRS	Internal Revenue Service

Background

The American Recovery and Reinvestment Act of 2009[1] (Recovery Act) was enacted on February 17, 2009. The Act contains both spending and tax provisions of $787 billion over 10 years. The Federal Government estimates the Act will result in the creation or saving of 3.5 million jobs by the end of September 2010.

The Recovery Act includes multiple bond provisions that are intended to promote the stated goals of stimulating employment, improving infrastructure, and providing fiscal relief to State and local governments. The Recovery Act authorizes the issuance of additional tax-exempt bonds and greatly expands the market for tax credit bonds.

Tax-exempt bonds are bonds that are issued by State or local governments, where the interest paid by the bond issuer to bondholders is not taxable. Tax credit bonds differ from traditional tax-exempt bonds. If bonds are issued as tax credit bonds, bondholders claim as taxable income a Federal tax credit equal to a percentage of the bond's face value for a limited number of years.

In Calendar Year 2006, State and local governments issued $428.3 billion in tax-exempt bonds.[2] Prior to the Recovery Act, tax credit bonds were a small part of the bond market. The Recovery Act increased tax-exempt bond financing by $17 billion by creating Recovery Zone Facility Bonds ($15 billion) and Tribal Economic Development Bonds ($2 billion).[3] As shown in Figure 1, tax credit bonds were significantly increased by at least $28.4 billion. However, this figure could be much higher because one type of tax credit bond, known as Build America Bonds, was not given a limit.

[1] Pub. L. No. 111-5, 123 Stat. 115 (2009).
[2] This information was published by the Internal Revenue Service's Statistics of Income Division and was the latest year available. Since the accuracy of this Internal Revenue Service-provided statistic did not affect the accomplishment of our audit, we did not verify its accuracy.
[3] Tribal Economic Development Bonds can also be issued as a direct payment bond.

Figure 1: Key Tax Credit Bonds and Increases in the Amounts That Can Be Issued

Bond Name	Additional Bonds That Can Be Issued Based on the Recovery Act
Qualified School Construction Bonds	$22 billion
Qualified Energy Conservation Bonds	$2.4 billion
Qualified Zone Academy Bonds	$2.4 billion
New Clean Renewable Energy Bonds	$1.6 billion
Build America Bonds	No limit
Total increase in tax credit bonds	**$28.4 billion**[4]

Source: Treasury Inspector General for Tax Administration Analysis of the Recovery Act.

Prior to the passage of the Recovery Act, we initiated an audit[5] concerning how the Internal Revenue Service (IRS) was ensuring certain tax-exempt bonds were not issued in excess of annual dollar limitations. Any bonds issued above the maximum yearly dollar limit would be taxable. As this audit came to its conclusion, we noted that our findings may also relate to Recovery Act bonds. Consistent with Office of Management and Budget guidance[6] to identify high-risk programs and create quicker turnaround reporting, this report provides observations concerning bond provisions that were uncovered in this recent audit that may have implications for the IRS in ensuring Recovery Act bonds are issued in compliance with the legislation.

This review was performed at the Tax Exempt and Government Entities Division Tax Exempt Bonds Headquarters office in Washington, D.C., during the period September through November 2009. Since this report includes observations based only on a prior report, this audit was not conducted in accordance with generally accepted government auditing standards and was significantly reduced in scope. While additional audit work was not performed, this report includes statements made by Tax Exempt and Government Entities Division management as to the applicability of our previous findings to Recovery Act bonds. Under the Recovery Act, inspectors general are expected to be proactive and focus on prevention. We believe this report is responsive to this intent. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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[4] The total increase listed in Figure 2 does not include Build America Bonds since the Recovery Act does not provide a dollar limitation for these bonds.
[5] *Future Tax Revenues Are at Risk Because Certain Tax-Exempt Bonds May Exceed Annual Dollar Limits Without Detection* (Reference Number 2009-10-097, dated September 14, 2009).
[6] *Updated Implementing Guidance for the American Recovery and Reinvestment Act of 2009* (Memorandum Number M-09-15, dated April 3, 2009).

Results of Review

In a previous audit, we determined that the IRS needed to improve its monitoring of tax-exempt private activity bonds to ensure these bonds are not issued in excess of annual dollar limits, known as volume caps. The Recovery Act includes authorization for the issuance of a large amount of new bonds, but also includes annual volume cap limits. Tax Exempt and Government Entities Division management believes they can better monitor Recovery Act bonds in comparison to private activity bonds. Due to the large amount of money involved, it will be important that the Tax Exempt Bonds office monitor Recovery Act bonds to ensure these bonds do not exceed legislative limits.

Future Tax Revenues May Be at Risk if the Tax Exempt Bonds Office Does Not Closely Monitor Recovery Act Volume Caps

The Tax Exempt Bonds 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. We did not perform testing of Recovery Act bonds, but a recent Treasury Inspector General for Tax Administration audit identified the following for private activity bonds, which also have volume cap limits:

- The Tax Exempt Bonds office compliance program for private activity bonds is based on determining whether individual bond issues are compliant with applicable regulations and not on determining whether aggregate bond issues exceeded yearly volume cap dollar limits.
- The IRS did not regularly receive all the information it needed to verify volume cap compliance.
- Private activity bond data was not always accurately entered into IRS computer systems. We identified more than $11 billion in transcription errors between amounts submitted on bond returns[7] and bond carryforward returns[8] and amounts entered into IRS computer systems.

As a result of our audit, we recommended the IRS develop and implement processes to identify and address bonds that exceed annual dollar limitations, ensure bond documentation is received, and identify and implement a methodology to ensure transcription errors for bond documentation are detected. In responding to our report, the IRS stated that by January 2011, it plans to identify

[7] Information Return for Tax-Exempt Private Activity Bond Issues (Form 8038).
[8] Carryforward Election of Unused Private Activity Bond Volume Cap (Form 8328).

approaches to identify and address compliance with tax-exempt private activity bond volume caps, improve guidance for processing bond information returns, and identify errors for previously processed bond information returns.

The Recovery Act also includes volume caps (annual dollar limits) for new and expanded tax credit and tax-exempt bonds. In addition, any unused volume cap can be carried forward to future years. Figure 2 presents the Recovery Act bonds that have provisions for volume caps and carryforwards.

Figure 2: Bond Provisions Within the Recovery Act

Recovery Act Section Number	Bond Name	Bond Type	Bond Description	Includes Volume Cap Provisions?	Includes Carryforward Provisions?
1111	New Clean Renewable Energy Bonds	Tax Credit	These bonds are used to finance renewable energy projects involving wind, tidal energy, ocean energy, etc.	Yes	No
1112	Qualified Energy Conservation Bonds	Tax Credit	These bonds are used to finance energy efficient capital expenditures in public buildings, mass commuting facilities that reduce energy consumption, etc.	Yes	No
1401	Recovery Zone Economic Development Bonds	Direct Payment	These bonds are used to finance projects in a recovery zone with significant poverty, unemployment, general distress or home foreclosures and designated as an empowerment zone or renewal community.	Yes	No
1401	Recovery Zone Facility Bonds	Tax-Exempt	These bonds are used to finance projects in a recovery zone with significant poverty, unemployment, general distress or home foreclosures and designated as an empowerment zone or renewal community.	Yes	No
1402	Tribal Economic Development Bonds	Tax-Exempt or Direct Payment	These bonds are used to finance projects for economic development, but can not be for gaming facilities or involve work outside of an Indian reservation.	Yes	No
1521	Qualified School Construction Bonds	Tax Credit	These bonds can be used for new school construction.	Yes	Yes
1522	Qualified Zone Academy Bonds	Tax Credit	These bonds can be used for repairing public schools, development of course materials, etc.	Yes	Yes

Recovery Act Section Number	Bond Name	Bond Type	Bond Description	Includes Volume Cap Provisions?	Includes Carryforward Provisions?
1531	Build America Bonds	Tax Credit or Direct Payment[9]	Build America Bonds (tax credit) can be issued to finance any governmental purpose for which tax-exempt governmental bonds (excluding private activity bonds) can be issued. The eligible uses of proceeds and types of financing for Build America Bonds (direct payment) are more limited than for Build America Bonds (tax credit).	No	Yes

Source: Treasury Inspector General for Tax Administration analysis of the Recovery Act.

In response to a draft version of our report, Tax Exempt and Government Entities Division management stated that they can better control and monitor volume cap compliance for Recovery Act bonds in comparison to private activity bonds, for several reasons. For example:

- Certain Recovery Act bonds require the issuer to request an allocation of a portion of the volume cap. In the request, the issuer must supply details about the proposed bond issuance. In contrast, the volume cap for private activity bonds is allocated by individual States and the IRS is not initially aware of any allocations that are made.
- Due to the need for transparency regarding Recovery Act bonds, the Tax Exempt Bonds office has instituted new controls to research and report on the amount of Recovery Act bonds that have been issued based on information returns that are filed with the IRS. This control is not in place for private activity bonds.

The Tax Exempt Bonds office believes it has considered the recommendations of the prior Treasury Inspector General for Tax Administration audit and has taken steps to ensure it is adequately monitoring the volumes of Recovery Act bonds. This will be key due to the more than $45 billion[10] in new bonds included in the Recovery Act.

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[9] Direct Payment Build America Bonds provide a Federal subsidy through a refundable tax credit paid to State or local governmental issuers by the Department of the Treasury and the IRS in an amount equal to 35 percent of the total coupon interest payable to investors in these taxable bonds.
[10] This amount includes increases to tax credit ($28.4 billion) and tax-exempt bonds ($17 billion), but does not include Build America Bonds since the Recovery Act does not provide a dollar limitation for these bonds.

We did not conduct any additional audit work to evaluate the differences between how the IRS processes and monitors Recovery Act bonds versus private activity bonds or whether the new controls are effective. Due to the challenging economic times the country is facing, it is even more important today that the IRS remain vigilant in ensuring that bond dollar limitations are not exceeded as the Federal Government works to stimulate the economy.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective was to report observations identified during the Review of Private Activity Tax-Exempt Bond Volume Cap Compliance that relate to the Recovery Act. To accomplish the objective, we:

I. Reviewed the Recovery Act to identify bond-related provisions.

II. Reviewed the Treasury Inspector General for Tax Administration audit report *Future Tax Revenues Are at Risk Because Certain Tax-Exempt Bonds May Exceed Annual Dollar Limits Without Detection*[1] to identify process weaknesses that would also relate to Recovery Act bonds.

[1] Reference Number 2009-10-097, dated September 14, 2009.

Appendix II

Major Contributors to This Report

Nancy A. Nakamura, Assistant Inspector General for Audit (Management Services and Exempt Organizations)
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Appendix III

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