



## RECOVERY ACT

*Initial Build America Bond  
Subsidy Payments Were Processed  
Accurately and Timely*

**July 14, 2010**

**Reference Number: 2010-11-083**

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.



## HIGHLIGHTS



### **INITIAL BUILD AMERICA BOND SUBSIDY PAYMENTS WERE PROCESSED ACCURATELY AND TIMELY**

## Highlights

**Final Report issued on July 14, 2010**

Highlights of Reference Number: 2010-11-083 to the Internal Revenue Service Commissioner for the Tax Exempt and Government Entities Division.

### **IMPACT ON TAXPAYERS**

The American Recovery and Reinvestment Act of 2009 (Recovery Act) created a new type of bond, known as the Build America Bond, for which the Federal Government will partially offset the State and local governments' cost of paying bond interest. As of September 2009, State and local governments received almost \$26.4 billion in funding for capital improvements through 315 Build America Bond issuances. Generally, all complete requests for payment of Build America Bond Federal subsidies were processed accurately, timely, and without indications of fraudulent or erroneous disbursement. As a result, the public has assurance that Federal subsidy payments reduced the cost of financing, as intended by Congress, by more than \$110 million.

### **WHY TIGTA DID THE AUDIT**

The Recovery Act authorized the issuance of \$17 billion in additional tax-exempt bonds and greatly expanded the market for tax credit bonds by at least \$28.4 billion. Proceeds from these bonds are intended to provide State and local governments funding for capital projects such as construction of highways, bridges, or schools. The overall objective of this review was to assess whether the Tax Exempt Bonds office had developed and implemented controls to assure the direct subsidies for Build America Bonds (direct payment option) were accurate and timely and whether controls prevented disbursement of erroneous payments.

### **WHAT TIGTA FOUND**

TIGTA determined that, generally, all complete requests for payment of the Build America Bond Federal subsidies were processed accurately, timely, and without indications of fraudulent or erroneous disbursement. The total amount of Federal subsidy payments was more than \$110 million for the 80 bond issuances requesting payment by the time of our review.

To achieve this, Internal Revenue Service management provided instructions for using Information Returns for Build America Bonds, created the Subsidy Request Form for bond issuer use in requesting Federal subsidy payments, updated processing for Build America Bond forms, created manual processes, and programmed computer systems to process the Federal Subsidy payments. While minor problems were encountered when processing the initial Information Returns, the problems were identified and corrected, and all State and local governments submitting complete Subsidy Request Forms from May 2009 through September 2009 received the correct Federal subsidy payments.

### **WHAT TIGTA RECOMMENDED**

TIGTA made no recommendations in this report. Tax Exempt and Government Entities Division management reviewed the report prior to issuance and agreed with the facts and conclusions presented.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

July 14, 2010

**MEMORANDUM FOR** COMMISSIONER, TAX EXEMPT AND GOVERNMENT ENTITIES  
DIVISION

*Michael R. Phillips*

**FROM:**

Michael R. Phillips  
Deputy Inspector General for Audit

**SUBJECT:**

Final Audit Report – Initial Build America Bond Subsidy Payments  
Were Processed Accurately and Timely (Audit # 200910136)

This report presents the results of our review of the Internal Revenue Service's processing of Build America Bond Federal subsidy payments under the American Recovery and Reinvestment Act of 2009 (Recovery Act).<sup>1</sup> The overall objective of this review was to assess whether the Tax Exempt Bonds office had developed and implemented controls to assure the direct subsidies for Build America Bonds (direct payment option) were accurate and timely and whether controls prevented disbursement of erroneous payments. This review was conducted as part of the Treasury Inspector General for Tax Administration Office of Audit Fiscal Year 2010 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.

We did not make any recommendations in this report. However, Tax Exempt and Government Entities Division management reviewed it prior to issuance and agreed with the facts and conclusions presented.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report finding. 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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<sup>1</sup> Pub. L. No. 111-5, 123 Stat. 115 (2009).



*Initial Build America Bond Subsidy Payments Were  
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## *Initial Build America Bond Subsidy Payments Were Processed Accurately and Timely*



### *Background*

The American Recovery and Reinvestment Act of 2009<sup>1</sup> (Recovery Act) was enacted on February 17, 2009, and authorized the issuance of \$17 billion in additional tax-exempt bonds<sup>2</sup> and greatly expanded the market for tax credit bonds<sup>3</sup> by at least \$28.4 billion.<sup>4</sup> In contrast, during Calendar Year 2006, State and local governments issued \$428.3 billion in tax-exempt bonds,<sup>5</sup> and tax credit bonds were only a small part of the bond market.

Build America Bonds were created by the Recovery Act 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 were unable to easily obtain funding for capital projects such as construction of highways, bridges, or schools.

To alleviate this situation and potentially lessen the costs of borrowing, the Recovery Act introduced Build America Bonds to provide State and local governments with the option of accessing the corporate<sup>6</sup> taxable bond market to obtain funding for capital improvements. Bond investors earn interest income on their Build America Bond investment, which is paid by the State or local government that issued the bonds. Unlike tax-exempt bonds, Build America Bond bondholders must claim this interest income on their tax returns for the bond interest payments. Build America Bonds can be issued with a direct payment option or a tax credit option.

***Build America Bonds are attractive to bond issuers because issuers can choose to have the Federal Government pay part of the cost of bond financing.***

<sup>1</sup> Pub. L. No. 111-5, 123 Stat. 115 (2009).

<sup>2</sup> Tax-exempt bonds are issued by State or local governments, and the interest income paid by the bond issuer to bond investors is not taxable by the Federal Government.

<sup>3</sup> Tax credit bonds are issued by State or local governments, and an investor must include the total interest income received in gross income. The amount of the tax credit available to a bondholder on each credit date is a percentage of the credit rate multiplied by the outstanding face amount of the bond.

<sup>4</sup> This figure could be much higher because one type of bond, known as Build America Bonds, was not limited in the total dollar amount that can be issued through December 31, 2010.

<sup>5</sup> This information was published by the Internal Revenue Service 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 objective, we did not verify its accuracy.

<sup>6</sup> Corporate bonds are debts issued by industrial, financial, and service companies to finance capital investment and operating cash flow.



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*Initial Build America Bond Subsidy Payments Were Processed Accurately and Timely*

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- **Direct Payment Option** – Under the direct payment option, the Department of the Treasury pays either the bond issuer or a designated third party 35 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 that can be applied against their Federal income tax liability equal to 35 percent of the bond coupon interest.

Recovery Zone Economic Development Bonds are a special type of Build America Bond that provides incentives for State and local governments to promote job creation and economic recovery in areas particularly affected by increases in unemployment. These bonds provide a larger Federal subsidy under the direct payment option by paying the issuers an amount equal to 45 percent (rather than 35 percent) of the cost of the bond interest. Recovery Zone Economic Development Bonds have a limitation of \$10 billion that may be issued through December 31, 2010.

For the period April through September 2009, 315 Information Returns for Tax-Exempt Governmental Obligations (Form 8038-G),<sup>7</sup> hereafter referred to as Information Returns, were filed by State and local governments notifying the Internal Revenue Service (IRS) of the issuance of Build America Bonds.<sup>8</sup> For the same time period, 80<sup>9</sup> Returns for Credit Payments to Issuers of Qualified Bonds (Form 8038-CP), hereafter referred to as Subsidy Request Forms, were filed requesting Federal subsidy payments.

Bond issuers pay interest to bond investors on dates that are predetermined at the time the bond is issued. Subsidy Request Forms must be filed at least 45 calendar days before, but not earlier than 90 calendar days before, the issuer's interest payment date. Issuers should expect to receive requested Federal subsidy payments within 45 calendar days of the date that a complete<sup>10</sup> Subsidy Request Form is filed with the IRS. If the IRS receives an incomplete or incorrect Subsidy Request Form, minor information such as an address will be corrected. However, the form will be returned to the issuer for significant inaccuracies such as no signature or bond issue price.

The Tax Exempt Bonds office within the Tax Exempt and Government Entities Division is responsible for administering the new Recovery Act bonds. All bond forms are filed at the

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<sup>7</sup> Information Returns must be filed on or before the 15<sup>th</sup> day of the 2<sup>nd</sup> calendar month after the close of the calendar quarter in which the bond is issued.

<sup>8</sup> This includes Recovery Zone Economic Development Bonds.

<sup>9</sup> One additional Subsidy Request Form was not complete when received and was returned to the bond issuer for completion.

<sup>10</sup> A complete Subsidy Request Form has all required information and is ready for processing by the IRS.



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## *Initial Build America Bond Subsidy Payments Were Processed Accurately and Timely*

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Ogden Campus<sup>11</sup> and processed by IRS Wage and Investment Division employees. This audit occurred at a time when IRS controls over Build America Bond payment processing were evolving. Therefore, this report reflects processing controls that were in effect when Information Returns and Subsidy Request Forms were filed as of September 30, 2009. As a result, this report may not reflect the current status of IRS procedures related to processing Build America Bond forms.

This review is the Treasury Inspector General for Tax Administration's third audit related to the IRS' implementation of tax-exempt and tax credit bond Recovery Act provisions. Our first audit concluded that the IRS will need to be vigilant to ensure that Recovery Act bonds are not issued in excess of annual limits or the Federal Government risks losing future tax revenue because excess bonds may not be eligible for tax credits or may be taxable. The Tax Exempt Bonds office believes it has taken steps to ensure it is adequately monitoring the volumes of Recovery Act bonds.<sup>12</sup> Our second audit concluded that the initial guidance published by the IRS in the form of notices<sup>13</sup> was complete,<sup>14</sup> accurate, and consistent with the tax-exempt and tax credit bond requirements of the Recovery Act.<sup>15</sup> A future audit is planned to assess the IRS' process for identifying Build America Bonds with a potential for noncompliance.

This review was performed at the Tax Exempt and Government Entities Division Headquarters Office in Washington, D.C., and the Tax Exempt and Government Entities Division Business Systems Planning Submission Processing office located at the Ogden Campus in Ogden, Utah, during the period September 2009 through April 2010. 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 objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. 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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<sup>11</sup> The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

<sup>12</sup> *Observations About Annual Dollar Limits for American Recovery and Reinvestment Act of 2009 Bonds* (Reference Number 2010-11-016, dated January 8, 2010).

<sup>13</sup> Notices are public pronouncements by the IRS that contain guidance involving substantive interpretations of the Internal Revenue Code or the law.

<sup>14</sup> The Treasury Inspector General for Tax Administration defines complete as addressing all Recovery Act bond provisions. This is not an indication that the current guidance is final and that additional guidance will not be issued. The IRS can issue additional guidance as issues arise or when interpretations of the law are needed. In addition, the Tribal Economic Development Bonds Notice did not contain the effective date of the Recovery Act provision. This notice was not considered to be incomplete because it is an interpretation of laws already in effect.

<sup>15</sup> *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).



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*Initial Build America Bond Subsidy Payments Were  
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## *Results of Review*

### ***Federal Direct Subsidy Payments for Build America Bonds Were Accurate, Timely, and Did Not Have Indications of Fraud***

Our review determined that, generally, all complete requests for payment of the Build America Bond Federal subsidies were processed accurately, timely,<sup>16</sup> and without indications of fraudulent or erroneous disbursement. State and local governments received almost \$26.4 billion in funding for capital improvements through 315 bond issuances. The Federal subsidy payment reduced the cost of financing, as intended by Congress, by more than \$110 million for 80 bond issuances requesting payment by the time of our review.

To achieve this, IRS management provided instructions for using Information Returns for Build America Bonds, created the Subsidy Request Form for use in requesting Federal subsidy payments, updated IRS processing for Build America Bond forms, created manual processes, and programmed IRS computer systems to process the Federal subsidy payments.<sup>17</sup> While minor problems were encountered when processing the initial Information Returns, the problems were identified and corrected and all State and local governments submitting complete Subsidy Request Forms from May 2009 through September 2009 received Federal subsidy payments.

#### **Federal subsidy payments for Build America Bonds were accurate**

Controls and procedures developed and implemented by the IRS assured all 80 Federal subsidy payments that had completed processing by the time of our review were accurate. For the purpose of this report, accurate is defined as the correct subsidy payment amount paid to the correct recipient. To verify the accuracy of the payments, we reviewed all 80 Subsidy Request Forms, associated Information Returns, and related IRS records. We then recalculated the Federal subsidy payments to ensure the payments were processed in the correct amount and checked to ensure that the payments were made to the correct recipients.

- **Controls assured that all 80 payment requests were from known bond issuers.** The bond issuers requesting payment through submission of the Subsidy Request Forms were the same as those listed on the Information Returns and the IRS Master File.<sup>18</sup> In

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<sup>16</sup> One Federal subsidy was not paid timely because it appeared to be a potential duplicate request and required further review.

<sup>17</sup> See Appendix IV for additional information on Build America Bond processes.

<sup>18</sup> The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.



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*Initial Build America Bond Subsidy Payments Were  
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addition, research was performed by the Tax Exempt Bonds office<sup>19</sup> prior to releasing the Federal subsidy payments to verify that the filers of the Information Returns and the Subsidy Request Forms were known bond issuers. This ensures Federal subsidy requests are from established bond issuers and the requests are valid.

- **Controls assured all 80 subsidy payments were issued to the correct recipients.** Fifty-four (68 percent) of the 80 Federal subsidy payments were made to the bond issuers. The remaining 26 Subsidy Request Forms designated that the Federal subsidy payment should be sent to a third party. Bond issuers can enter into agreements with third parties, such as trustee banks, for the third party to make the periodic interest payments to bond investors instead of the bond issuers.
  - 22 of 26 designated Federal subsidy payments were sent to trustee banks to make the issuer's interest payments.
  - 4 of 26 designated Federal subsidy payments were sent to a different office within the same State or local government that issued the bonds.

Based on this information, we determined that sending the 26 payments to designated third-party addresses was reasonable. Currently, the IRS does not send confirmation to the bond issuer when a payment is made to a third party on its behalf. IRS management stated that beginning in July 2010, a notice will be sent to each Build America Bond filer to acknowledge receipt of the Subsidy Request Form. The notice will show the credit interest payment and suggest the third-party filer provide a copy of the notice to the bond issuer.

- **Controls assured all 80 Federal subsidy payment amounts were correct.** All 80 Federal subsidy payments processed by the IRS were correct based on our recalculations.<sup>20</sup> To verify the subsidy payment amounts are correct, IRS employees and computer systems recalculate Federal subsidy payment amounts submitted by bond issuers when processing Subsidy Request Forms. IRS employees and computer systems identified the following errors.
  - Two Subsidy Request Forms had the bond interest calculated incorrectly by the bond issuers on the Subsidy Request Form. Tax Exempt Bonds office personnel identified this condition and contacted the bond issuers and obtained agreement for correction of errors prior to processing the Federal subsidy payments.

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<sup>19</sup> Tax Exempt Bonds office employees access the Internet web site "Electronic Municipal Market Access," which contains municipal bond trading statistics and trends. The Electronic Municipal Market Access web site provides a snapshot of daily trade data based on municipal bond characteristics such as trade type, size, sector, maturity, source of repayment, and type of coupon.

<sup>20</sup> For six cases, we determined the payment was different than the subsidy amount requested because the subsidy was reduced by the amount of prior tax obligations or the IRS paid interest on late subsidy payments.



## *Initial Build America Bond Subsidy Payments Were Processed Accurately and Timely*



- One Subsidy Request Form included a transposed number in the Federal subsidy payment amount. This error was corrected by IRS computer systems while processing the Federal subsidy payment.

The Internal Revenue Manual permits correction of the Subsidy Request Forms by processing employees or by Tax Exempt Bonds office agents if minor errors are identified. When dollar value errors are identified, Tax Exempt Bonds office agents forward a document to the bond issuer explaining the error and requesting that the issuer sign and return the document signifying agreement to the change. Tax Exempt Bonds office management provides instructions to the Government Entities Compliance Unit to make the appropriate correction and to attach the document signed by the bond issuer to the Subsidy Request Form for completion of processing and payment.

### **Federal subsidy payments for Build America Bonds were timely**

Controls and procedures developed and implemented by the IRS assured that 79 of 80 Federal subsidy payments processed by the time of our review were timely. We reviewed all 80 complete Subsidy Request Forms that were received by the IRS and related IRS records for the Federal subsidy payments to ensure the payments were processed within the IRS' 45-calendar day time standard. We determined the dates that Subsidy Request Forms were received by the IRS and the dates the Federal subsidy payment transactions were posted to the IRS Master File and identified the following:

- 79 of the 80 Federal subsidy payments were made within 45 calendar days after receipt of complete Subsidy Request Forms. Eight of the 79 initially appeared to have been paid late, but further review determined the forms were received incomplete and returned to the issuers for correction. After receipt of the corrected forms, all 8 payments were paid within the 45-calendar day standard.
- 1 of the 80 Federal subsidy payments was paid more than 45 calendar days after receipt of the Subsidy Request Form. This payment was systemically identified as a potential duplicate payment request and was rejected by the IRS' computer system. IRS employees performed research to ensure the payment request was not fraudulent or erroneous, determined the form was not a duplicate, and processed the payment manually to ensure the fastest payment possible. However, the payment was made 53 calendar days after receipt of the Subsidy Request Form, thereby exceeding the 45-calendar day standard. Because payment guidelines were exceeded, the IRS paid interest to the customer for making the payment 8 calendar days late. Eight additional Subsidy Request Forms had similar characteristics and could have been systemically identified as potentially duplicate payment requests; however, they were corrected timely and paid within the 45-calendar day standard. Therefore, we viewed the one late payment as an isolated incident.



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*Initial Build America Bond Subsidy Payments Were  
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**No indications of fraudulent or erroneous disbursements were identified for initial Build America Bond subsidy payments**

The Government Accountability Office reported that when assessing risks, agencies receiving funds for Recovery Act programs should consider whether their internal controls are sufficient to decrease the risk of fraud, waste, and abuse. Also, in recent testimony before Congress, the Government Accountability Office stated,

*Our work has shown that building internal controls in up front is of the utmost importance and that fraud prevention is the most efficient and effective means to minimize fraud, waste, and abuse. Once Federal dollars are disbursed fraudulently or improperly, the Government is only likely to recover a few pennies on the dollar. Thus, preventive controls are the most important component of a fraud prevention system. These controls prevent ineligible individuals and questionable firms from gaining access to Government funds in the first place.*

We determined there were no indications of fraudulent or erroneous disbursements in the 80 initial Federal subsidy payments that the IRS processed. To test for potentially fraudulent or erroneous disbursements, we reviewed areas vulnerable to fraud or mistakes, such as inappropriate address changes, amended and duplicate returns, and manually processed payments. The IRS had designed preventive controls to reduce the chances of fraudulent or erroneous disbursements.

- **Address changes were reasonable.** The filing of a Change of Address form<sup>21</sup> followed by the filing of a Subsidy Request Form could be an indication that someone is trying to divert funds to a new address inappropriately. Address changes occurred for 7 (9 percent) of 80 Federal subsidy payment requests within 3 weeks of the Federal subsidy payment date. However, none of the address changes indicated any potential for fraudulent or erroneous disbursement of the Federal subsidy payment.
  - For three of seven address changes, the bond issuer and the recipient were the same entity. Rather than indicating a potential fraudulent or erroneous disbursement, these address changes indicate that the addresses were changed to ensure the Federal subsidy payments were sent to the correct department of the entity.
  - For four of seven address changes, the recipients were large banks or trusts, or departments within a State government. The address changes were reasonable because State and local governments often enter into agreements with trustee banks to make their periodic interest payments to investors. In addition, departments within State and local governments other than those that file Information Returns may make the periodic interest payments to investors.

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<sup>21</sup> Change of Address (Form 8822).



## *Initial Build America Bond Subsidy Payments Were Processed Accurately and Timely*



The IRS has reduced the chance of fraudulent or erroneous disbursements associated with address changes by implementing controls to verify that the correct recipient and address are being used for each Federal subsidy payment before the payments are disbursed, as discussed previously in this report.

- **Amended or duplicate payment requests were not submitted.** Amended or duplicate Subsidy Request Forms can be filed in an attempt to change the payment amount or to obtain a duplicate payment. Duplicate Subsidy Request Forms could also be filed inadvertently. Our review of IRS Master File data and Subsidy Request Forms did not identify any duplicate or amended payment requests. However, the IRS reduced the chance of making an improper payment due to receipt and processing of amended or duplicate requests. This is accomplished by reviewing every Subsidy Request Form that is filed and by maintaining a database that has information on Subsidy Request Form filings to allow verification of the payment requests.
- **Controls assured manually processed payments were reasonable.** Payments that are processed manually have an increased risk of fraud because an IRS employee could potentially change the payee or the address and redirect the manual payment for his or her personal use. In addition, manual procedures are subject to human error. The IRS manually processed 10 (13 percent) of 80 Federal subsidy payments (the remaining payments were computer generated) according to IRS guidelines in place when the Subsidy Request Forms were received. In July 2009, IRS guidelines were changed to allow processing of computer-generated Federal subsidy payments up to \$10 million due to the expected large volume of subsidy payment requests. Payments processed before and after the guidelines change were processed properly, according to the guidelines in place at the time.<sup>22</sup> All 10 manual payments appeared to be reasonable and correct, without suspicious activity such as address changes or redirected payments.

The IRS has reduced the chance of fraudulent or erroneous disbursements related to manually processed refunds by implementing the following controls for all manual payments.<sup>23</sup> All manual payment requests must be reviewed and approved by a manager who is an authorized signer for manual payments. After approval by the manager, another employee reviews the forms and the customer account on the IRS Master File to identify any outstanding tax obligations and to ensure the credit is available<sup>24</sup> for payment. All requests for manual payments must be controlled and monitored on the IRS' computer systems by the initiator (or other

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<sup>22</sup> Two Federal subsidy payments more than \$10 million were processed correctly as manual payments and 8 additional Federal subsidy payments less than \$10 million were processed manually because they were either in jeopardy of being paid late or were processed prior to the IRS decision to computer generate payments less than \$10 million.

<sup>23</sup> A manual payment is a payment that is not generated through normal IRS Master File processing.

<sup>24</sup> A credit in the amount of the subsidy payment must be input to the customer account before payment can be made.



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employee designated by management) to prevent duplicate or erroneous refunds. Each month, random reviews of manual payment requests are performed to detect and deter inappropriate adjustment activities.

Based on our review of how address changes, amended or duplicate returns, and manual payments associated with the 80 requests were processed, we believe the IRS has established controls that are reasonable to prevent erroneous or fraudulent disbursement of Federal subsidy payments on Build America Bonds.



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**Appendix I**

*Detailed Objective, Scope, and Methodology*

Our overall objective was to assess whether the Tax Exempt Bonds office had developed and implemented controls to assure the direct subsidies for Build America Bonds (direct payment option) were accurate and timely and whether controls prevented disbursement of erroneous payments. To accomplish our objective, we:

- I. Determined whether the Tax Exempt Bonds office developed and implemented controls for Build America Bond (direct payment option) payment processing.
  - A. Determined whether procedures were implemented to identify and associate (when filed) the Build America Bond Information Returns and Subsidy Request Forms.
  - B. Determined whether procedures were implemented for timely processing of Build America Bond subsidy payments.
  - C. Determined whether procedures were implemented for accurately issuing Build America Bond direct subsidy payments, including the receipt of amended and duplicate requests.
- II. Obtained paper and electronic data for Build America Bond Information Returns and Subsidy Request Forms.
  - A. Obtained an extract of Build America Bond Information Returns and Subsidy Request Forms from the IRS Master File.<sup>1</sup> From the extract we identified 315 Information Returns filed between April and September 2009, and 80 Subsidy Request Forms filed between May and September 2009. We validated the data extract by comparing the data to the scanned images of the filed Information Returns and Subsidy Request Forms, comparing the data to information on the Integrated Data Retrieval System,<sup>2</sup> and recalculating the subsidy payment dollar amounts.
  - B. Obtained copies of Information Returns and Subsidy Request Forms related to the data extract as of September 30, 2009.

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<sup>1</sup> The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

<sup>2</sup> The IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.



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- III. Determined whether the controls established to process Build America Bond direct subsidies were working as intended.
- A. Determined the accuracy of the Build America Bond direct subsidy payments.
    - 1. Obtained and reviewed the guidelines developed for employees to verify the accuracy of Build America Bond direct subsidy payments.
    - 2. Determined whether the bond issuer listed on the Information Return was also listed as the issuer on the Subsidy Request Form and whether a payment recipient was designated on the Subsidy Request Form.
    - 3. Determined whether the correct subsidy payment amounts were processed for Build America Bonds by identifying (and recalculating) the payment amount calculated by the issuer on the Subsidy Request Form and comparing it to payment information on the IRS Master File.
  - B. Determined whether Build America Bond subsidy payments were made within 45 calendar days of receipt of complete Subsidy Request Forms by identifying the IRS receipt date of the form and comparing it to the IRS Master File payment transaction date.
  - C. Assessed the risk of fraud occurring for Build America Bond direct subsidy payments.<sup>3</sup>
    - 1. Performed Integrated Data Retrieval System research to determine if a change of address of record occurred immediately prior to receipt of Subsidy Request Forms requesting payment.
    - 2. Determined whether direct subsidy payments of \$10 million and less were processed as computer-generated payments.
    - 3. Determined whether direct subsidy payments of greater than \$10 million were processed manually. If so, we determined if subsidy payments were issued to the original name and address on the Subsidy Request Forms.
    - 4. Identified whether any amended or duplicate returns were processed and if erroneous payments were made.

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<sup>3</sup> Absolute assurance that subsidy payments are not being redirected cannot be attained due to the nature and characteristics of fraud. For example, two or more individuals acting in collusion can compromise any system of internal controls.



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**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 objective: the Internal Revenue Code, the American Recovery and Reinvestment Act of 2009,<sup>4</sup> and Tax Exempt Bonds office policies and procedures for developing and implementing controls to assure the direct subsidies for Build America Bonds (direct payment option) are accurate and timely to prevent fraudulent or erroneous disbursements. We evaluated these controls by interviewing management and reviewing Information Returns, Subsidy Request Forms, and other applicable documentation.

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<sup>4</sup> Pub. L. No. 111-5, 123 Stat. 115 (2009).



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## **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  
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Carol A. Rowland, Auditor  
Brian W. Hattery, Information Technology Specialist



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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  
Deputy Commissioner, Tax Exempt and Government Entities Division SE:T  
Director, Government Entities, Tax Exempt and Government Entities Division SE:T:GE  
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## Appendix IV

### *Build America Bond Processes*

In response to the American Recovery and Reinvestment Act of 2009,<sup>1</sup> new forms and instructions were developed for bond issuers, and procedures and controls were implemented by the IRS to process Build America Bond returns and Federal subsidy payments.

- **Creating instructions for notifying the IRS when Build America Bonds are issued.** An Information Return for Tax-Exempt Governmental Obligations (Form 8038-G),<sup>2</sup> hereafter referred to as Information Return, is filed by issuers of tax-exempt governmental obligations<sup>3</sup> to: 1) notify the IRS that a bond has been issued; 2) provide the issuer's name, address, and Employer Identification Number; and 3) provide information about the bond issuance, including a debt service schedule.<sup>4</sup> However, the Information Return was designed for other types of bonds. To allow for quick bond issuance and notification to the IRS, the Tax Exempt Bonds office used this existing form for Build America Bonds and provided instructions for bond issuers to add information on a specific line of the form to identify the bond as a Build America Bond. The IRS has since created a new bond information return to be used for Build America Bonds (presented later in this Appendix).
- **Creating a form for bond issuers to request direct subsidy payments.** The Return for Credit Payments to Issuers of Qualified Bonds (Form 8038-CP), hereafter referred to as Subsidy Request Form, was created in April 2009 for bond issuer use when requesting Federal subsidy payments.
- **Processing Build America Bonds to the IRS Master File.**<sup>5</sup> Instructions were developed to enable employees in the Ogden Submission Processing Center to recognize the Information Return as a Build America Bond from the additional information added by bond issuers. Also, processing changes were implemented for employees at the

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<sup>1</sup> Pub. L. No. 111-5, 123 Stat. 115 (2009).

<sup>2</sup> Information Returns must be filed on or before the 15<sup>th</sup> day of the 2<sup>nd</sup> calendar month after the close of the calendar quarter in which the bond is issued.

<sup>3</sup> Tax-exempt obligations are used for such capital improvements as the construction of airports, hospitals, and schools. However, tax-exempt government obligations can not be issued as private activity bonds. Private activity bonds are municipal securities where the proceeds are used by private entities such as housing authorities or community development authorities.

<sup>4</sup> A schedule that generally provides details about the issuer's periodic interest payment dates, the total interest payable, and the total principal outstanding.

<sup>5</sup> The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.



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*Initial Build America Bond Subsidy Payments Were  
Processed Accurately and Timely*

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Ogden Submission Processing Center to code Information Returns on the IRS Master File as Build America Bonds.

- **Verifying that subsidy requests are valid.** Subsidy Request Forms, when received by the IRS for processing, are forwarded to the Government Entities Compliance Unit where they are scanned and forwarded to the Tax Exempt Bonds office. The Tax Exempt Bonds office verifies the bond issuance is valid and performs research to provide assurance that the Federal subsidy payment amount is correct and not fraudulently disbursed.
- **Processing subsidy payments.** Generally, Federal subsidy payments less than \$10 million are automatically generated by IRS systems, and payments greater than \$10 million are manually processed by IRS employees.

When a Federal subsidy payment is processed on the IRS' computer systems, a transaction is systemically generated based on information from the Subsidy Request Form to allow the subsidy payment to be paid. The tax account for the subsidy payment will identify the issuer, recipient address, type of bond issuance, and subsidy payment amount processed. The subsidy payment amount is validated by the IRS' computer systems based on the information from the Subsidy Request Forms.

- **Improving on initial processes.** Subsidy Request Forms were updated in January 2010 so that Build America Bond issuers could request a direct deposit of the Federal subsidy payment rather than a check. In addition, the Information Return initially used for Build America Bonds and Recovery Zone Economic Development Bonds (Form 8038-G) was replaced by the Information Return for Build America Bonds and Recovery Zone Economic Development Bonds (Form 8038-B), which was developed specifically for filers of Build America Bonds to provide required information to the IRS.