TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Office of Inspections and Evaluations

RECOVERY ACT

Review of Section 1603 Grants In Lieu of Energy Investment Tax Credit

December 17, 2013

Reference Number: 2014-IE-R006

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.

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TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

December 17, 2013

MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND ENFORCEMENT

FROM: R. David Holmgren R. David Holmgren
Deputy Inspector General for Inspections and Evaluations

SUBJECT: Final Inspection Report – Review of Section 1603 Grants in Lieu of Energy Investment Tax Credit (IE-13-003-A)

This report presents the results of our inspection to determine if the Internal Revenue Service (IRS) has established a permanent process to identify taxpayers that have received American Recovery and Reinvestment Act of 2009 (Recovery Act)[1] Section 1603 grants.[2]

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 IRS programs. This inspection was conducted using Recovery Act funds.

Synopsis

The IRS has not developed a permanent process to identify taxpayers that have received Section 1603 grants and that may have erroneously claimed one of two investment tax credits, the Energy Production Tax Credit[3] or the Energy Investment Tax Credit,[4] on the same property. In addition to other restrictions, taxpayers, upon accepting the Section 1603 grant, elect not to claim an investment tax credit for qualifying facilities placed into service on or after

[1] Pub. L. No. 111-5, 123 Stat. 115 (2009).
[2] Taxpayers upon accepting the Section 1603 grants elect not to claim the energy tax credits under Internal Revenue Code (I.R.C.) Section (§) 48 of the renewable electricity production tax credit under I.R.C. § 45 with respect to otherwise qualifying facilities placed into service on or after January 1, 2009.
[3] I.R.C. § 45.
[4] I.R.C. § 48.

January 1, 2009.[5] As of May 10, 2013, the Department of the Treasury has awarded 9,016 grants totaling $18.5 billion.

The IRS is currently conducting a Compliance Initiative Project (CIP)[6] on taxpayers that received Section 1603 grants primarily during 2009.[7] During our review period, an extension of the time period for the CIP was requested and approved for June 30, 2015. Although the CIP was in process during our review, tentative results were available. The Large Business and International Division[8] selected and examined 16 taxpayers and reportedly identified significant issues in eight. Similarly, the Small Business/Self-Employed Division[9] selected 83 taxpayers for examination and identified changes for 51. Although the results are not final and cannot be predicted, the IRS's recent justification to extend the CIP stated, "Anecdotes from the Service [IRS] staff attending industry and practitioners' discussions suggest that some practitioners are encouraging the use of leasing transactions because that allows fair market value to be overstated to increase the grant amount." This statement and the apparent noncompliance issues identified in the CIP may indicate the need for further oversight of the $18.5 billion distributed through this grant program.

Recommendation

We recommended that the Commissioners for Large Business and International Division and Small Business/Self-Employed Division evaluate the feasibility of establishing an indicator on taxpayer accounts that received Recovery Act Section 1603 grants. This indicator could be established and updated based on the Section 1603 grant recipient file sent by the Department of the Treasury quarterly and annually. This indicator would provide permanent notice on the IRS files that this taxpayer had received a Section 1603 grant and therefore caution should be taken in processing any amended returns that claim an investment tax credit.

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[5] There are other adjustments to computing future taxability that the taxpayer agrees to when receiving the Section 1603 grant.

[6] A CIP is any activity involving contact with specific taxpayers and collection of taxpayer data within a group, using either internal or external data to identify potential areas of noncompliance within the group, for the purpose of correcting the noncompliance. A CIP Part 2 authorizes examinations of 50 or more taxpayers.

[7] The CIP has been expanded to include Tax Years 2010 and 2011.

[8] The Large Business and International Division is an operating division within the IRS that serves corporations, subchapter S corporations, and partnerships with assets greater than $10 million. These businesses typically employ large numbers of employees, deal with complicated issues involving tax law and accounting principles, and conduct business in an expanding global environment.

[9] The Small Business/Self-Employed Division is an operating division within the IRS that serves small business and self-employed taxpayers by helping them to understand and meet their tax obligations.

Response

IRS management agreed with the recommendation. The Commissioners for Small Business/ Self-Employed Division and Large Business and International Division plan to evaluate the feasibility of establishing an indicator on taxpayers' accounts that received Recovery Act Section 1603 grants. If they determine that establishing the proposed indicator is not feasible or practical, they will consider other effective alternatives. Management's complete response is included as Appendix V.

If you have any questions, please contact me at (202) 927-7048 or Kevin P. Riley, Director, Office of Inspections and Evaluations, at (972) 249-8355.

Table of Contents

Abbreviations

CIP	Compliance Initiative Project
IRS	Internal Revenue Service
ITC	Investment Tax Credit

Background

The American Recovery and Reinvestment Act of 2009 (Recovery Act),[1] enacted on February 17, 2009, contained both spending and tax provisions, including the allocation of $787 billion over 10 years to stimulate the national economy. One of the stated goals of the Recovery Act is to "…foster unprecedented levels of accountability and transparency in government spending." To do so, the Recovery Act created the Recovery Accountability and Transparency Board[2] with two goals: to provide transparency of Recovery Act expenditures and to prevent and detect fraud, waste, and mismanagement.

The Internal Revenue Service (IRS) is responsible for administering the tax law changes contained in the Recovery Act. In April 2009, the IRS received an appropriation of Recovery Act funds totaling $202 million.[3] These funds were required to implement the necessary tax changes resulting from provisions of the Recovery Act. The changes included, but were not limited to, reprogramming the IRS computer systems, updating related tax forms and publications, and providing customer service to assist taxpayers in obtaining their Recovery Act benefits.

Section 1603 of the Recovery Act contains provisions that impact the IRS's administration of the tax laws. The purpose of a Section 1603 grant is to reimburse eligible applicants for a portion of the cost of installing a specific energy property used in a trade or business or for the production of income. Section 1603 of the Recovery Act authorizes the Department of the Treasury to make payment to individuals or companies that place specific types of energy properties into service on or after January 1, 2009, provided certain conditions are met. This cash payment to an individual or company is made instead of an investment tax credit (ITC), either the Energy Production Tax Credit[4] or the Energy Investment Tax Credit.[5] The Department of the Treasury forwards a file containing the Section 1603 recipients' information quarterly and annually to the IRS for information.

[1] Pub. L. No. 111-5, 123 Stat. 115 (2009).
[2] Eleven Inspectors General from various Federal agencies serve with the chairman on the Recovery Accountability and Transparency Board. The Recovery Accountability and Transparency Board issues quarterly and annual reports to the President and Congress and, if necessary, "flash reports" on matters that require immediate attention.
[3] This appropriation included $80 million for Fiscal Years 2009 through 2010 to implement the Health Coverage Tax Credit program. The IRS also received $123 million for supporting tax provision changes cited in the Recovery Act. The Department of the Treasury retained $1 million for administrative oversight, resulting in the IRS receiving $202 million.
[4] Internal Revenue Code Section 45.
[5] Internal Revenue Code Section 48.

As of May 10, 2013, the Department of the Treasury has awarded 9,016 grants totaling $18.5 billion.[6] Figure 1 shows the growth of the program by year in terms of the number of grants awarded and amounts awarded.

Figure 1: Total Amount and Number of Grants Awarded by Year

Year	Total Number of Grants	Grant Amount
2009	148	$1.6 billion
2010	1,396	$3.1 billion
2011	2,584	$4.7 billion
2012	4,084	$6.5 billion
2013	804	$2.7 billion
Total	**9,016**	**$18.5 billion**[7]

Source: Department of the Treasury's Recovery Act website as of May 10, 2013.

While these grants have been given to a variety of energy property types, wind and solar properties have received the majority of the funds, totaling $12.6 billion and $4.4 billion respectively. Appendix IV provides a more detailed overview of the amounts awarded to each type of energy property.

This review was performed at the IRS National Headquarters in Washington, D.C., and the Office of the Deputy Commissioner, Domestic, Large Business and International Division, in Houston, Texas, during the period April through August 2013. We conducted this inspection in accordance with the Council of the Inspectors General for Integrity and Efficiency Quality Standards for Inspections. Detailed information on our objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

[6] The Department of the Treasury regularly publishes a list of Section 1603 grants awarded on its website and sends quarterly and annual reports on this program to the IRS.
[7] Grant amounts in this column do not sum exactly to $18.5 billion due to rounding.

Results of Review

The Internal Revenue Service Does Not Have a Permanent Process to Identify Taxpayers That Received Section 1603 Grants and May Have Erroneously Claimed an Investment Tax Credit

In May 2011, the IRS initiated a Compliance Initiative Project (CIP) of some taxpayers that received Section 1603 grants primarily during 2009.[8] The CIP was originally scheduled to be completed in June 2013 and was subsequently extended (in May 2013) to include additional returns and to be completed by June 30, 2015. A CIP is an executive-approved study involving a population of taxpayers with a unique tax issue. These projects traditionally are approved for a set period of time, but they can be reconsidered and reapproved with an adjusted scope and new completion period. CIPs involve examinations of specific taxpayers within the group using internal and/or external data to identify potential areas of noncompliance, many times done by selecting a sample of taxpayers from the population. The purpose of a CIP is to identify and correct areas of noncompliance. This particular CIP seeks to study and improve compliance by taxpayers that received Section 1603 grants from the Department of the Treasury.

While this CIP is still ongoing, we reviewed the CIP's preliminary results as of July 17, 2013. The Small Business/Self-Employed Division examined a sample of returns where the dollar value of the grant was greater than or equal to **2c***, a threshold that encompassed the majority of the grants attributed to small business and self-employed taxpayers. The Small Business/Self-Employed Division examined 83 taxpayers and identified changes in 51 (61 percent).[9] The Large Business and International Division examined returns where the dollar value of the grant was greater than or equal to **2c***. According to the CIP Status Report, the Large Business and International Division conducted 16 examinations and identified potential significant issues resulting in changes in eight examinations (50 percent).[10]

When the Recovery Act became law, one of the commitments by Congress to the American people was to ensure that the funds being distributed would be subject to unprecedented Government and public transparency and that these funds would be subject to the highest degree of protection to prevent or identify fraud, waste, abuse, and mismanagement. In light of this

[8] The CIP has been expanded to include Tax Years 2010 and 2011. A tax year is a 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.
[9] As of July 12, 2013.
[10] As of September 17, 2012.

commitment, the noncompliance issues identified in the CIP may indicate the need for further oversight of the $18.5 billion distributed through this grant program.

While the CIP shows that the IRS has provided some initial oversight, CIPs have an established completion date and therefore, to remain open, they must periodically be reconsidered and reapproved. The IRS needs a process to identify taxpayers that receive Section 1603 grants as well as ITC benefits from the same property. The current CIP is an excellent way to identify a sample of returns for examination. However, this is a relatively short-term effort considering that the Internal Revenue Code allows qualified taxpayers to use ITC's for up to five years prior and 20 years after the ITC was original claimed. A taxpayer may initially comply with the program rules and requirements and subsequently file amended tax returns claiming the ITC. The IRS has no indicator to identify that the taxpayer had received a Section 1603 grant for that or similar property and that the amended return may need additional review to ensure an ITC was not incorrectly claimed.

Recommendation

Recommendation 1: We recommended that the Commissioners for the Small Business/ Self-Employed Division and Large Business and International Division evaluate the feasibility of establishing an indicator on taxpayers' accounts for taxpayers that received Recovery Act Section 1603 grants. This indicator could be established and updated based on the Section 1603 grant recipient file sent by the Department of the Treasury quarterly and annually. This indicator would provide permanent notice on the IRS files that this taxpayer has received a Section 1603 grant and therefore caution should be taken in processing any amended returns that claim the ITC.

Management's Response: IRS management agreed with the recommendation. The Commissioners for Small Business/Self-Employed Division and Large Business and International Division plan to evaluate the feasibility of establishing an indicator on taxpayers' accounts that received Recovery Act Section 1603 grants. If they determine that establishing the proposed indicator is not feasible or practical, they will consider other effective alternatives, such as continuing to expand the CIP.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine if the IRS has established a permanent process to identify taxpayers that have received Recovery Act,[1] Section 1603 grants.[2]

To accomplish this objective, we:

I. Documented the procedures used to identify taxpayers that received the Section 1603 grants and are claiming an ITC.

II. Verified the functionality of any system or processes put in place by the IRS to track or identify taxpayers claiming an ITC that may have erroneously received Section 1603 grants.

III. Determined whether the IRS has established effective controls to track, identify, record, and report list of recipients for ITC claims.

[1] Pub. L. No. 111-5, 123 Stat. 115 (2009).
[2] Taxpayers, upon accepting the Section 1603 grants, elect not to claim the energy tax credits under Internal Revenue Code Section 48 of the renewable electricity production tax credit under Internal Revenue Code Section 45 with respect to otherwise qualifying facilities placed into service on or after January 1, 2009.

Appendix II

Major Contributors to This Report

Kevin P. Riley, Director, Inspections & Evaluations
Stanley Rinehart, Supervisory Evaluator
Joseph Wolemonwu, Program Analyst
Lindsay Steward, Program Analyst

Appendix III

Report Distribution List

Acting Commissioner C
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Commissioner for Operations Support OS
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Large Business and International Division SE:LB
Small Business/Self-Employed Division SE:S

Appendix IV

Overview of Section 1603 Grants Awarded

Figure 2: Grant Amounts Awarded to Each Type of Energy Property

Energy Property Type	Grant Amount
Wind	$12.6 billion
Solar	$4.4 billion
Geothermal Heat Pump	$573.5 million
Biomass	$390.5 million
Hydropower	$155.5 million
Landfill gas	$146.8 million
Fuel Cell	$145.0 million
Trash Facility	$28.2 million
Combined Heat & Power	$14.1 million
Marine	$9.1 million
Microturbine	$1.4 million
Total	**$18.5 billion**

Source: Department of the Treasury's Recovery Act website as of May 10, 2013.

Appendix V

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

COMMISSIONER
LARGE BUSINESS AND
INTERNATIONAL DIVISION

November 7, 2013

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR INSPECTIONS AND EVALUATIONS

FROM: Heather C. Maloy
Commissioner, Large Business and International Division

SUBJECT: Draft Inspection Report – *Review of Section 1603 Grants in Lieu of Energy Investment Tax Credit* (IE-13-003-A)

We reviewed your draft report entitled, *Review of Section 1603 Grants in Lieu of Energy Investment Tax Credit* (number IE-13-003-A). As your report indicates, the IRS is currently conducting a Compliance Initiative Project (CIP)[1] on taxpayers who received Section 1603 grants from 2009 to 2011. The IRS is using the CIP as its process to identify taxpayers who have received Section 1603 grants and who may erroneously claim one of the two Investment Tax Credits (Energy Production Tax Credit or Energy Investment Tax credit) on the same property. To date, the CIP findings have shown potential for examination changes. As a result, the CIP was extended until June 30, 2015. The IRS will continue to examine returns during this period.

We agree with TIGTA's recommendation to evaluate the feasibility of establishing an indicator on taxpayers' accounts that received Recovery Act Section 1603 grants. If, after evaluation, we determine that establishing an account indicator is not feasible, we will consider other alternatives to help us effectively identify returns with potential issues related to section 1603 grants.

Attached is our action plan outlining the corrective actions the IRS will take to address your recommendation. If you have any questions, please contact Kathy J. Robbins, Director, Natural Resources and Construction Industry at (713) 209-3704.

Attachment

[1] A CIP is any activity involving contact with specific taxpayers and collection of taxpayer data within a group, using either internal or external data to identify potential areas of noncompliance within the group, for the purpose of correcting the noncompliance. A CIP Part 2 authorizes examinations of 50 or more taxpayers.

2

Attachment

RECOMMENDATION 1:

TIGTA recommends that the Commissioners for Small Business/Self-Employed (SB/SE) Division and Large Business and International (LB&I) Division evaluate the feasibility of establishing an indicator on taxpayers' accounts that received Recovery Act Section 1603 grants. This indicator could be established and updated based on the Section 1603 grant recipient file sent by the Department of the Treasury quarterly and annually. This indicator would provide permanent notice on the IRS files that this taxpayer had received a Section 1603 grant and therefore caution should be taken in processing any amended returns, which claim the ITC.

CORRECTIVE ACTIONS:

The Commissioners for Small Business/Self-Employed Division and Large Business and International Division agree to evaluate the feasibility of establishing an indicator on taxpayers' accounts that received Recovery Act Section 1603 grants. If, after evaluation, we determine that establishing the proposed indicator is not feasible or practical, we will consider other effective alternatives, such as continuing to expand our CIP.

IMPLEMENTATION DATE:

October 31, 2014

RESPONSIBLE OFFICIAL(S):

Director, Natural Resources and Construction Industry, LB&I:NRC
Director, Exam Planning and Delivery, SE:SB:Examination

CORRECTIVE ACTION(S) MONITORING PLAN:

The Internal Control Coordinators in LB&I and SB/SE Divisions will use the Joint Management Enterprise System to monitor the progress of the implementation of corrective actions to ensure actions are implemented timely.