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Report to the Chairman, Subcommittee on Human Resources and Intergovernmental Relations, Committee on Government Operations, House of Representatives

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TAX POLICY AND ADMINISTRATION

Improvements for More Effective Tax-Exempt Bond Oversight

GAO/GGD-93-104

GAO

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The Honorable Edolphus Towns
Chairman, Subcommittee on Human
Resources and Intergovernmental Relations
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

This report, prepared for the Subcommittee in response to a former Chairman's request, discusses (1) the Internal Revenue Service's (IRS) role in ensuring compliance with tax-exempt bond provisions in the Internal Revenue Code and how its efforts can be improved and (2) policy changes that could enhance IRS' ability to increase compliance with these provisions. It also contains recommendations to the Commissioner of Internal Revenue and matters for congressional consideration to improve tax-exempt bond oversight.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies to interested parties and make copies available to others upon request.

The major contributors to this report are listed in appendix III. Please contact me on (202) 512-5407 if you or your staff have any questions concerning this report.

Sincerely yours,

Jennie S. Stathis

Jennie S. Stathis
Director, Tax Policy and
Administration Issues

Executive Summary

Purpose

Outstanding long-term tax-exempt bond volume doubled from 1968 to 1990, to about $796 billion, while forgone related federal tax revenues grew proportionately, exceeding $20 billion in 1990. Coinciding with this growth, bond financings became more complex. Congress became concerned about this growth, not only because of forgone revenues but also because of the increasing use of tax-exempt bonds to benefit private parties and issuers earning profits by investing bond proceeds in securities at higher interest rates. In response, Congress expanded restrictions on tax-exempt bonds.

Given these changes, the Subcommittee on Human Resources and Intergovernmental Relations, House Committee on Government Operations, asked GAO to review the Internal Revenue Service's (IRS) role in ensuring compliance with tax-exempt bond provisions and to determine whether improvements were needed.

Background

About 39,000 state and local governments and thousands of special authorities and governmental districts can issue tax-exempt bonds. In 1990, issuers sold 11,500 issues and raised $162.3 billion. The bonds can be used, within limits, to finance public-purpose projects, certain nonprofit organizations' projects, and certain private for-profit activities. Tax-exempt bonds provide a federal subsidy to issuers because investors accept lower interest rates to obtain income exempt from federal tax. Thus, issuers' costs are lower. However, bond issuers must comply with an extensive array of Internal Revenue Code provisions. (See app. I.) Issuers generally rely on bond counsels—attorneys specializing in tax-exempt bonds—to ensure that proposed bonds comply with federal laws and regulations. IRS is responsible for overseeing that tax-exempt bonds comply with these requirements.

Results in Brief

IRS relies to a large extent on voluntary compliance with tax-exempt bond requirements, as it does for other Internal Revenue Code requirements. As a key component of its overall strategy to promote voluntary compliance with tax requirements, IRS relies on deterring the abuse of these requirements through traditional enforcement approaches to detect and punish noncompliance. However, IRS' principal tax-exempt bond enforcement effort, the Expanded Bond Audit Program, has concentrated almost exclusively on possible noncompliance cases that were identified by others and that were part of an alleged surge in abusive bonds issued in anticipation of the stricter requirements in the Tax Reform Act of 1986.

Although resolving these cases is important, a more balanced oversight effort that includes current market activity would provide a better understanding of current compliance problems. IRS has recognized that its tax-exempt bond oversight efforts need to be improved, and initiatives are either under way or planned. As IRS moves forward, several areas merit particular attention.

First, IRS has not used tax-exempt bond return information to monitor issuers' compliance. The Expanded Bond Audit Program's effectiveness could be improved if it were to use information collected from issuers for its oversight efforts. This information could help IRS determine whether current staffing and training practices, which were designed to address specific abuses, are effective for a continuing Expanded Bond Audit Program. Second, IRS' plan for improving its tax-exempt bond oversight, while a positive step, does not provide a clear direction for integrating tax-exempt bond efforts throughout IRS. Developing and executing a plan that includes all these efforts and uses its established planning principles would focus IRS' attention on identifying and resolving key issues that affect tax-exempt bond compliance and set a clear direction for its efforts.

While IRS can take such administrative actions to improve its oversight of tax-exempt bonds, Congress can also take actions to enhance IRS' ability to provide a deterrent to abusive use of tax-exempt bonds. Although IRS does not know the current extent of noncompliance in this area, it is reasonable to assume that some degree of noncompliance exists. For example, the tax-exempt bond market is approaching $800 billion, and IRS' presence has been limited given IRS' allocation of constrained resources across a range of priorities. Nevertheless, IRS has discovered some cases of noncompliance. But the basic sanction available to IRS—collecting taxes on interest earned by bondholders—is inadequate to deter noncompliant behavior by those who are most responsible for abusive transactions. That is, this sanction applies to the innocent purchasers of the bond but not to the bond's issuer and the specialists the issuer relies on to provide legal, financial, and other services. This aspect of the sanction is contrary to a commonly accepted theory that to provide the best deterrence, a penalty should be targeted to those responsible for the noncompliance. Legislation would be needed to develop better-targeted penalties.

As another way to enhance IRS' ability to provide a deterrent to abusive use of tax-exempt bonds, Congress may wish to explore options for bringing market forces to bear against abusers by modifying the present disclosure prohibitions. These provisions are based on, among other things, a respect

for citizens' privacy, a judgment that violating privacy would be detrimental to voluntary compliance, and a fear of possible inappropriate use of taxpayer information for political purposes. If IRS could, in some way, disclose limited information about the results of its tax-exempt bond enforcement activities, market participants would be in a better position to make judgments about the potential consequences of doing business with specific parties. Such disclosure should also enhance the present incentives for voluntary compliance. Thus, Congress may wish to consider the issue of whether governmental participants in the tax-exempt bond market should continue to be afforded the same degree of privacy as individual taxpayers.

Principal Findings

IRS' Principal Program Is Reactive

IRS' tax-exempt bond oversight relies heavily on voluntary compliance and the checks and balances provided by the reviews of bond counsels at issuance. Overall, IRS considers traditional enforcement activities to be a key element in encouraging compliance and its Expanded Bond Audit Program—IRS' principal tax-exempt bond enforcement program—provides this element for tax-exempt bond oversight. (See pp. 25-26.)

Although the Expanded Bond Audit Program has taken steps to establish a more active enforcement presence, it has, as have earlier IRS tax-exempt bond efforts, primarily pursued cases identified through tips and other outside sources. Also, the program's enforcement efforts have focused on an alleged surge in abusive bonds issued in anticipation of the stricter requirements in the Tax Reform Act of 1986. Resolving these old cases and following up on tips is important. However, a more proactive effort that includes reviews of some more current bond issues would enhance IRS' knowledge of current compliance problems and better position IRS to determine whether it is obtaining an acceptable deterrent effect from its enforcement presence. (See pp. 26-29.)

Additional Improvements Needed in Current Program

Although IRS has collected information from tax-exempt bond returns for about 10 years, it does not use the return information to spot probable noncompliance and target enforcement efforts. Officials recently have begun considering how information could be more effectively used in tax-exempt bond oversight. (See pp. 29-31.)

Revenue agents assigned to the Expanded Bond Audit Program have not received final guidance providing current procedures to detect noncompliance and address abuses. In addition, program officials say that the program will be permanent and become more active in identifying and investigating other types of abuses. However, current staffing and training practices, which were established so that 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. (See pp. 31-35.)

Better Planning Needed

GAO found that IRS' tax-exempt bond efforts do not have objectives or strategies to identify and resolve key tax-exempt bond oversight issues. IRS has adopted an overall planning process that focuses on setting objectives and strategies so that its resources are used effectively. IRS could apply elements similar to those used in its overall planning process in developing its tax-exempt bond plan. Doing so would provide better direction by identifying ways for IRS to achieve its objectives for encouraging voluntary compliance; defining the roles of all IRS organizations involved with tax-exempt bonds; determining methods to test for, identify, and pursue tax-exempt bond abuses; determining staffing and information resource requirements; and establishing goals to adequately measure IRS' progress. IRS' Tax-Exempt Bond Committee has prepared a draft action plan for tax-exempt bonds, but this draft plan does not provide a clear direction for tax-exempt bond efforts. However, IRS officials recognize the need to develop in-depth action items, strategies, resources, and other details for a final plan. (See pp. 36-38.)

Penalties to Promote Compliance

Penalties are intended to deter noncompliant behavior. To be effective, such penalties need to be known to, and applied to, the individual(s) responsible for the noncompliant behavior. They also need to be consequential enough to deter noncompliance yet proportionate to the severity of an infraction. Such is not the case for the tax-exempt bond area.

The basic sanction available to IRS is to tax interest earned by bondholders on abusive bonds. 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, IRS has used a closing agreement—a mechanism to settle various tax disputes—to negotiate a settlement with an issuer of a bond IRS considers 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 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 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 that IRS prove that someone intentionally promoted a bond through which investors could illegally shelter income and avoid paying taxes. Because 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. (See pp. 44-48.)

Disclosure Options Could Promote Compliance

In the tax-exempt bond market, market forces can create incentives to cause compliance. But an important requirement for a properly functioning market is access by market participants to information about the risks of investments—information that is not directly available to tax-exempt bond investors and other participants. Prohibitions in the tax law preclude IRS from revealing any information that could directly or indirectly identify any parties to a noncomplying tax-exempt bond transaction.

If information about tax-exempt bond enforcement actions could be released, such as information on the types of bonds IRS has found to be abusive or the identities of participants in abusive bonds, the market participants that IRS relies on to ensure compliance with bond requirements could make more reasoned judgments about tax-related compliance risks. Thus, these market participants could penalize those presenting such risks, for example, by not doing business with them. Some of the rationales for prohibiting disclosure may not apply as strongly for tax-exempt bonds as for other protected information. For example, an expectation of privacy might be viewed as applying less to governmental bodies who are accountable to the citizens they represent than to the lives

of individuals. In addition, it may be possible to alleviate some concerns about disclosure for tax-exempt bonds by designing a disclosure provision that would limit the types and amount of information disclosed and the timing of disclosures. Nevertheless, removing the disclosure prohibition, even in a limited sense, must be carefully considered because of the seriousness of the concerns relating to disclosing information. (See pp. 48-55.)

Recommendations

GAO recommends that the Commissioner of Internal Revenue:

- 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 and locations and training needs in light of the program's future.
- Develop and implement a plan to guide efforts throughout 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.

GAO also recommends that the Commissioner test the use of the penalty for promoting abusive tax shelters in tax-exempt bond enforcement.

Matters for Congressional Consideration

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, it also 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.

Agency Comments

In oral comments on a draft of this report, IRS officials generally agreed with GAO's recommendations to IRS. Their comments are discussed at the ends of chapters 2 and 3. (See pp. 41-42 and p. 61.) Several technical changes were also suggested, which were included as appropriate.

Contents

Abbreviations

IRC	Internal Revenue Code
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
PAB	Private Activity Bond

Introduction[1]

For almost 80 years, since the 1913 federal income tax law was passed, interest earned from state and local government bonds generally has been tax exempt. Congress intended that the federal subsidy resulting from this tax exemption would allow state and local governments to finance public-purpose projects at less cost because investors would be willing to accept lower interest rates to obtain tax-exempt income. Since the 1960s, however, issuers increasingly have used tax-exempt bonds to finance activities that also have benefited private parties and organizations.

Concerned about the growth in tax-exempt bonds used to finance private activities, forgone tax revenues associated with such financings, and incidents of abusive transactions, Congress began adding restrictions in the late 1960s to redirect and target the use of tax-exempt bonds to better serve the public good. As restrictions were added, tax-exempt bond provisions became more numerous and complex. Similarly, the bond financings became more complex.

Federal Authority for and Types of Tax-Exempt Bonds

The Internal Revenue Code (IRC) allows state and local governments to issue bonds that provide investors with interest income that is exempt from federal income tax. State and local governments can then finance public-purpose projects (e.g., schools, roads, and water and sewer facilities) at lower interest rates, because investors are willing to accept these rates to obtain tax-exempt income. State and local governments also may issue tax-exempt bonds on behalf of certain nonprofit organizations (i.e., charitable organizations specified under IRC section 501(c)(3)) and private for-profit persons or organizations if the bonds are used for certain activities that are specified in the IRC. In addition, state or local law may establish special authorities and districts to issue tax-exempt bonds.

Depending on the source of revenue that backs the issue, tax-exempt bonds can be classified as either general obligation bonds or revenue bonds. General obligation bonds are guaranteed by the full faith, credit, and taxing power of the issuing government. Revenue bonds are backed by a source of revenue, such as proceeds from a particular tax or from the project being financed.

Tax-exempt bonds also can be classified by the type of entity using the proceeds as either governmental or private activity bonds. In general, governmental bonds are those bonds in which 90 percent or more of the

[1]Much of the background information contained in this chapter is based on information included in Tax Policy: Internal Revenue Code Provisions Related to Tax-Exempt Bonds (GAO/GGD-91-124FS, Sept. 27, 1991).

proceeds are used by governmental entities. In general, private activity bonds are bonds in which (1) more than 10 percent of the proceeds are used by a nongovernmental private entity and more than 10 percent of the principal or interest is paid directly or indirectly from, or secured by, revenues from a private trade or business or (2) the lesser of more than 5 percent of the proceeds or $5 million is used for loans to private persons. The IRC restricts the type and, in some cases, the size of activity that can be financed with tax-exempt private activity bonds. In addition, the amount of private activity bonds that can be issued in a state during any calendar year cannot exceed that state's volume cap.

Tax-Exempt Bond Issuance Process

Issuing tax-exempt bonds can be a complex process. Specialized services generally are needed to help issuers plan the bond issue and sell the bonds. Although some of these services can be obtained in-house, the less in-house expertise that is available to an issuer, the more the issuer has to rely on private firms to handle tax-exempt bond issuances.

Planning a tax-exempt bond issue requires legal and financial services. Generally, bond counsels prepare pertinent legal documents and ensure that the proposed sale is consistent with local, state, and federal laws and regulations. Financial advisors may help issuers determine such details as the size of the issue, the bonds' maturity, and the security pledged for payment of the debt. These advisors also may help issuers determine the best method to sell the bonds to underwriting firms, which in turn sell the bonds to investors.

Issuers may use other specialists, such as rating agencies, bond insurers, trustees, accountants, consultants for feasibility studies, and printing and advertising firms. Rating agencies evaluate the creditworthiness of the bonds. Bond ratings provide information on the creditworthiness of the offering to potential investors. Bond insurance protects the investor against default. A trustee is the custodian of a bond's funds and the official representative of bondholders in their contract with the issuer.

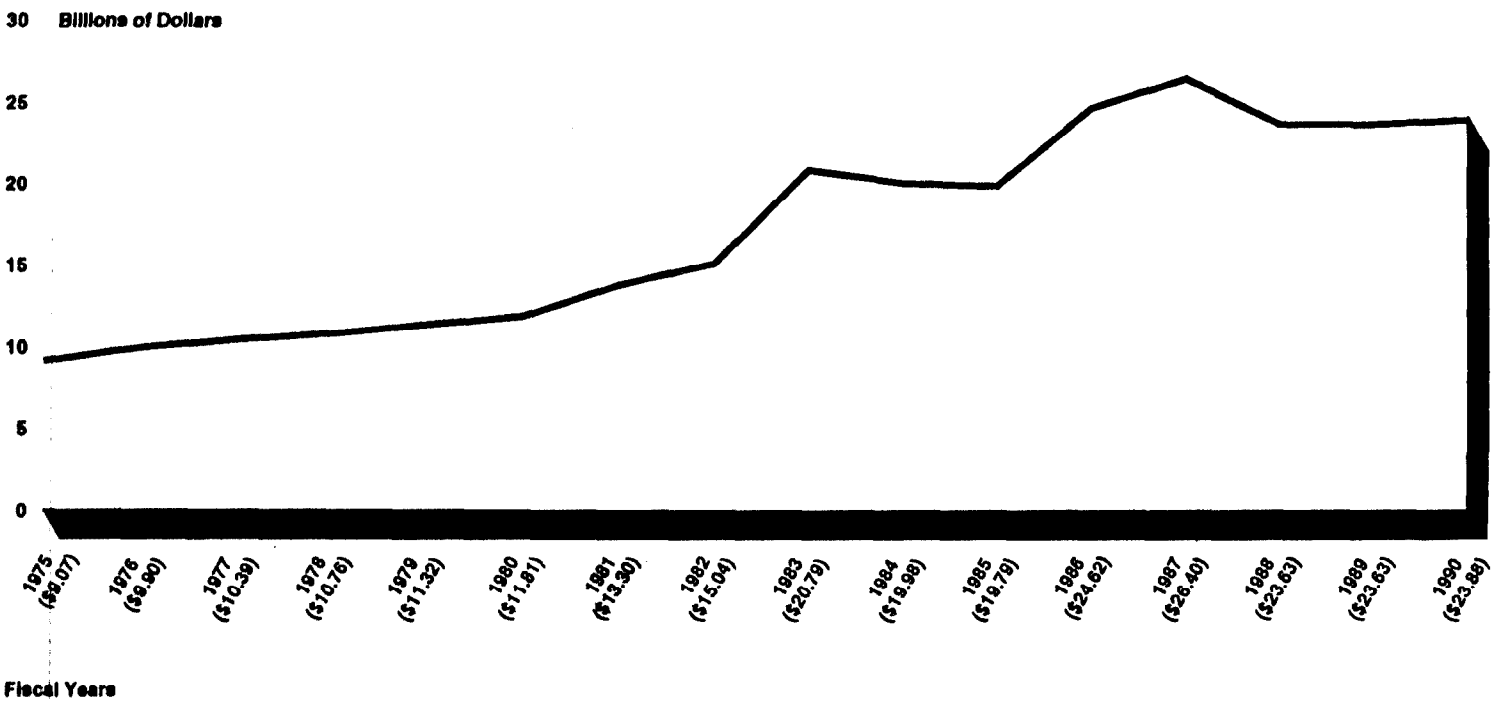
Changes in the Tax-Exempt Bond Market and Increased Congressional Concerns With Tax-Exempt Bond Usage

Since 1968, state and local government use of tax-exempt bond financing has increased substantially. The Federal Reserve Board of Governors' data showed that in 1968 the volume of outstanding long-term tax-exempt bonds was about $114 billion,[2] whereas at the end of 1990, the volume of these bonds had increased to about $796 billion. As the use of tax-exempt bonds grew, estimated federal tax expenditures for the activities funded by the bonds also grew.[3] Figure 1.1 shows the changes in estimated tax expenditures related to outstanding tax-exempt bonds from 1975 through 1990 in 1990 dollars.

[2]Using the gross national product price deflator, $114 billion in outstanding tax-exempt bonds is equivalent to about $398 billion in 1990 dollars.

[3]The Congressional Budget Act of 1974 identifies tax expenditures as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of liability." However, as explained in the United States Budget, tax expenditure estimates, including those for tax-exempt bonds, do not exactly reflect the increase in federal receipts that would accompany the repeal of the special provisions. For example, if tax-exempt provisions related to municipal bonds were eliminated, some investors might use other methods to make their income tax exempt; consequently, the net increase in federal receipts would be smaller. Additionally, excluding the interest received from tax-exempt bonds lowers a taxpayer's taxable income, which can reduce the value of other tax expenditures, such as the deduction for charitable contributions. If the interest exclusion alone were repealed, some taxpayers could be thrust into higher tax brackets, which would automatically increase the value of charitable contributions and their budget cost, even if taxpayers did not make larger contributions. However, if both the interest exclusion and the deduction for charitable contributions were repealed simultaneously, the increase in tax liability, and thus federal receipts, would be greater than the sum of the two separate tax expenditures because each is estimated assuming that the other remains in force.

Figure 1.1: Changes in Estimated Tax Expenditures Related to Outstanding Tax-Exempt Bonds in 1990 Dollars, 1975-1990



Note: In calculating estimated tax expenditures for tax-exempt bonds, the United States Budget breaks these expenditures out by the type of activity funded. Tax expenditures for each type of tax-exempt bond are calculated assuming the other IRC provisions remain the same. Summing the tax expenditures for each type of tax-exempt bond can only provide a gross estimation of totals for each year's tax expenditures related to tax-exempt bonds because the exact effects of the interactions among tax expenditures discussed in footnote 3 cannot be determined.

Sources: Office of Management and Budget, Special Analyses, Budget of the United States Government, 1977-1978 and 1980-1990, and Budget of the United States Government, 1991-1992.

The growth in tax-exempt bond issuances over the years concerned Congress, not only because of the forgone tax revenue, but particularly because an increasing volume of tax-exempt bonds were issued primarily to benefit private parties and organizations (such as private recreational facilities and fast food restaurants) rather than to fulfill traditional government purposes. According to the Federal Reserve Board of Governors' data, the percentage of long-term outstanding tax-exempt

bonds used for private activities gradually increased from 5 percent in 1975 to a peak of about 33 percent in 1985.

Congress was also concerned that issuers were issuing tax-exempt bonds primarily to earn profits by investing the proceeds in taxable securities at interest rates higher than the tax-exempt bond rate. This type of profit is referred to as arbitrage. These profits represented a federal subsidy for state and local governmental expenditures without any federal controls on how the money could be used. Because earning arbitrage profits entailed almost no direct costs to issuers, incentives to issue bonds to earn these profits were great. Congress was concerned that as more of these bonds were issued, forgone federal revenues would increase.

As a result of its concerns, Congress passed a number of laws intended to better target the use of tax-exempt bonds for public purposes by restricting their use for nonpublic purposes and to deter issuers from earning arbitrage profits. These restrictions began in the late 1960s and have continued through 1990.[4] For example, Congress first restricted the use of tax-exempt bonds for private activities in 1968. Basically, this restriction provided that interest on bonds that were issued to benefit private persons was generally taxable unless the proceeds were used for purposes specified in the IRC, such as sports facilities, sewage and solid waste facilities, airports, parking facilities, and small-issue bonds (initially, bonds issued for $1 million or less) for private activities. In 1969, Congress limited the ability of state and local governments to issue tax-exempt bonds to earn arbitrage profits.

Over the following 15 years, Congress continued to revise the tax-exempt bond laws. In some cases, Congress expanded permissible uses by specifying additional types of private activity projects that would be eligible for tax-exempt bond financing (e.g., certain mass-commuting vehicles) and increasing the dollar limit for the small-issue exception under certain situations. In most cases, however, Congress added restrictions to help eliminate what it believed to be inappropriate uses of tax-exempt bond financing and to reduce the volume of tax-exempt private activity bonds.

For example, in 1982, Congress eliminated the tax exemption for certain small-issue private activity bonds in which more than 25 percent of the bond proceeds went to finance activities such as fast food facilities and

[4]See Dennis Zimmerman, The Private Use of Tax-Exempt Bonds (Washington, D.C.: The Urban Institute, 1990), pp.175-191, for a more detailed discussion of the changes to the tax-exempt bond laws.

car dealerships. Congress also eliminated the tax exemption if any bond proceeds were used to finance specified recreational facilities, such as racetracks, golf courses, and skating rinks. In 1984, Congress further restricted small-issue tax-exempt bonds issued for private purposes and placed a volume cap limiting the issuance of tax-exempt bonds for certain private activities and student loans within a state. Moreover, Congress added further arbitrage restrictions including a requirement that certain tax-exempt bonds for private activities earning arbitrage profits on obligations not acquired to carry out the purpose for which the bonds were issued be rebated to the federal government.

The Tax Reform Act of 1986 further targeted tax-exempt bond financing to recognized public rather than private purposes. For example, Congress prohibited tax-exempt private activity bonds for certain uses, such as sports and parking facilities. The act placed more types of private activity bonds under a volume cap and reduced the dollar limit of the cap. Again, new arbitrage restrictions and procedures were added, including requirements that generally meant that arbitrage profits earned from all tax-exempt bonds had to be rebated to the federal government.

Congressional restrictions that have been placed on tax-exempt bond financing appear to have reversed the growth in outstanding long-term tax-exempt bonds issued for private activities. Since 1985, when about 33 percent of these outstanding long-term tax-exempt bonds were for private activities, the Federal Reserve Board of Governors' data show that the proportion gradually decreased to about 23 percent in 1990.

IRS Has Primary Responsibility for Administering the Tax-Exempt Bond Laws

The IRC authorizes the Secretary of Treasury to establish regulations to administer and enforce the IRC. Treasury delegates most responsibilities for administering and overseeing federal tax-exempt bond provisions to the Internal Revenue Service (IRS). Tax-exempt bond regulations, which are issued by Treasury, usually are developed jointly with IRS.

In addition, IRS issues revenue rulings and letter rulings related to tax-exempt bonds. The revenue rulings interpret tax-exempt bond statutes and regulations for taxpayers, IRS personnel, and other concerned individuals as related to a particular tax issue. These rulings do not have the force and effect of regulations. However, they are published to provide precedents for disposing of other cases. IRS employees and taxpayers, among others, rely on the revenue rulings in determining the tax treatment of various types of transactions. IRS also issues tax-exempt bond-related

letter rulings. Letter rulings are applicable only to the specifics of one case and cannot be generalized to other situations. Nonetheless, letter rulings provide insight into IRS' position on a particular type of bond or transaction.

IRS' Expanded Bond Audit Program, within the Office of Examination Programs, Office of the Assistant Commissioner (Examination), is currently IRS' primary effort to oversee the tax-exempt bond market. This program began informally in March 1989 when IRS' Office of the Assistant Chief Counsel (Financial Institutions and Products), which at that time was leading a joint oversight effort with Examination, asked Examination to take the lead. The Assistant Commissioner of Examination formally authorized the Expanded Bond Audit Program in November 1990 to extend through 1993 to gather information on and review industrial development bond issuances to determine whether they should retain their tax-exempt status. However, program officials said that this program would continue to be IRS' ongoing tax-exempt bond compliance effort.

According to program officials, since 1990 the Expanded Bond Audit Program has had up to 27 Examination revenue agents located in 24 districts assigned to work on the program intermittently. In 1991, agents spent approximately 2 staff years total on tax-exempt bond examinations. Under the Expanded Bond Audit Program, district revenue agents are responsible for pursuing tax-exempt bond cases identified by the Office of Chief Counsel and Examination's National Office as well as identifying, developing, and reviewing related new cases. Specifically, revenue agents are responsible for determining and gathering the information needed to resolve cases and making initial compliance determinations. According to IRS officials, the primary considerations in assigning priority to a case are the significance of the abuse and whether counsel can support the government's position in litigation.

The tax-exempt bond-related efforts of other IRS organizations are subsidiary to their primary functions. Employee Plans and Exempt Organizations conducts tax-exempt bond oversight and enforcement efforts in conjunction with its oversight of tax-exempt organizations. Employee Plans and Exempt Organizations has a coordinated examination program for tax-exempt organizations that have substantial income or assets. As part of these examinations, the organizations' tax-exempt bond financing is reviewed. In addition, Employee Plans and Exempt Organizations reviews applications by organizations seeking tax-exempt status. Employee Plans and Exempt Organizations revised this process to

consider more carefully whether such organizations intend to make use of tax-exempt financing and, if so, whether the planned use complies with tax-exempt bond requirements.

Although they do not have actual tax-exempt bond enforcement and oversight responsibilities, some other IRS organizations perform activities that potentially contribute to enforcement and oversight. The Criminal Investigation Division investigates suspected criminal activities related to the IRC, which can include activities related to tax-exempt bonds. In addition, the Philadelphia Service Center processes tax-exempt bond information returns and arbitrage rebates, the Statistics of Income Division analyzes tax-exempt bond information returns data for volume and use trends, Tax Forms and Publications develops the forms and publications issuers use, and Information Systems Management designs automated support systems.

Mechanisms IRS Uses for Dealing With Tax-Exempt Bond Noncompliance

Noncompliance with tax-exempt bond law may occur unintentionally because the individuals involved do not understand federal tax requirements. In other cases, bond participants might take new approaches, such as using sophisticated financing strategies, that IRS subsequently may judge to violate the IRC or Treasury regulations. Other cases of noncompliance may be deliberate. For example, some parties involved in the bond issue may know that the planned project is not feasible but nevertheless they portray it as feasible in bond documents. If it identifies any noncompliance, IRS has the authority to impose certain sanctions or negotiate closing agreements with the issuer.

IRS Can Penalize Noncompliant Bond Participants

The basic sanction for a bond that IRS determines does not satisfy federal requirements for tax exemption is for IRS to tax interest earned by bondholders from the bond. This severe sanction is generally available for any violation, including those that might be considered minor. IRS can impose this sanction by determining who the bondholders are and recomputing their taxes by including interest income received from the bond that was formerly considered to be tax exempt. Issuers of such bonds, however, are not barred from issuing bonds in the future.

When a bond is issued accompanied by a materially misrepresentative certification that the bond is not reasonably expected to earn arbitrage, Treasury regulations give IRS the authority to disqualify an issuer from certifying future bond issuances. Although the regulations state that IRS

would then publish a notice in the Internal Revenue Bulletin that the abusive issuer is disqualified from certifying tax-exempt bond issues in the future, a letter we received on September 17, 1992, from IRS' Chief Counsel stated that "[c]onsistent with the position that bond compliance data is confidential return information," the provision allowing IRS to publish a notice of an issuer's disqualification in the Internal Revenue Bulletin "has little vitality." However, because the issuer's future bond offerings would not include the usual certifications assuring investors that the bonds were not reasonably expected to earn arbitrage, if such an issuer were able to continue to sell tax-exempt bonds, it presumably would be at a higher cost.

For certain types of noncompliance, IRS also can impose less severe sanctions. For example, the IRC requires operators of qualified residential rental projects financed with tax-exempt bonds to certify annually that the project continues to rent a certain percentage of units to low-income tenants. If an operator fails to file the certification, the operator must pay a penalty.[5] The penalty is $100 for each failure to file.

Another less severe sanction is the penalty in lieu of loss of tax exemption. This penalty provides that when issuers of governmental and qualified 501(c)(3) tax-exempt bonds fail to rebate to the Treasury any arbitrage due, issuers can avoid retroactive taxation of bondholders if they pay the arbitrage rebate owed and a penalty. The penalty is 50 percent of the rebate owed plus interest on the rebate.[6] IRS also can use IRC section 6700 to penalize parties who knowingly promote abusive tax shelters, including abusive tax-exempt bonds.

IRS Can Negotiate Closing Agreements to Settle Tax-Exempt Bond Cases

IRS has the option to resolve tax-exempt bond noncompliance by negotiating a closing agreement with the issuer that may require the issuer to pay IRS an agreed-upon amount. According to the Internal Revenue Manual's (IRM) Closing Agreement Handbook, such an agreement can be used by IRS to settle tax disputes if "there appears to be an advantage in having the case permanently and conclusively closed, or if good and sufficient reasons are shown by the taxpayer for desiring a closing agreement and it is determined by the Commissioner that the United

[5]Failure to comply with this certification requirement does not affect the tax-exempt status of the related bond.

[6]Treasury regulations also provide that a tax-exempt bond issue including a private activity bond other than a qualified 501(c)(3) bond can also qualify for a penalty in lieu of loss of tax exemption, but in this situation the penalty is 100 percent plus interest.

States will sustain no disadvantage through consummation of such an agreement."

According to IRS officials, IRS calculates a tax-exempt bond settlement offer on the basis of a variety of factors, including the amount of tax lost, the likelihood that IRS would win a court case, a determination of a fair offer, how much the issuer had benefited from the deal, the strength of IRS' position, and the cost of pursuing the bondholders. The amount of the closing agreement can be, and usually is, less than the amount of forgone tax and any other revenues lost because of the bond (e.g., illegal arbitrage not rebated to IRS). If a closing agreement can be reached, the bond issue retains its tax-exempt status and the retroactive taxation of interest paid to bondholders is prevented. If an acceptable closing agreement cannot be reached, IRS can require bondholders to pay taxes on interest earned from the bond.

Regulation of Tax-Exempt Bonds by Other Organizations

Besides IRS, other organizations also are involved in regulating securities. The Municipal Securities Rulemaking Board is an independent, self-regulatory body for municipal securities brokers and dealers. Its purpose is to prevent fraud, promote fair markets, and protect investors and the public interest. Although its rules have the force of law, the Municipal Securities Rulemaking Board has no inspection or enforcement powers. The National Association of Securities Dealers is a self-regulatory organization for its members that can take disciplinary actions against members for violating its rules or Municipal Securities Rulemaking Board rules.

The Securities and Exchange Commission has broad regulatory responsibilities over the securities markets; organizations within the securities markets, including the Municipal Securities Rulemaking Board and the National Association of Securities Dealers; and persons doing business in securities. Regulation of municipal securities dealers that are also banks ordinarily is provided by the appropriate bank regulatory agency.[7] The regulatory responsibilities of the above organizations for securities are not focused on tax-exempt bond tax law requirements.

States also provide some constitutional and statutory restrictions over tax-exempt bonds. Generally, state laws focus on protecting investors from fraud by (1) prohibiting specified fraudulent practices by market

[7]These include the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation.

participants, (2) requiring that persons and entities selling or offering securities be registered, and (3) requiring that securities be registered before public offering. For the most part, when state authorities review municipal tax-exempt bond issues they check for compliance with the state's constitution and statutes authorizing or limiting the issuance of debt obligations. The checks and balances these state efforts provide for tax-exempt bonds are focused on requirements other than those reflected in the IRC.

Objectives, Scope, and Methodology

At the request of a former Chairman of the Subcommittee on Human Resources and Intergovernmental Relations, House Government Operations Committee, we addressed issues related to IRS' oversight of tax-exempt bonds. Our objectives were to (1) review the Internal Revenue Service's (IRS) efforts to oversee compliance with tax-exempt bond requirements and determine whether they need to be improved and (2) determine whether policy changes would enhance IRS' ability to increase compliance with these requirements.

To accomplish our objectives we did the following:

- We identified and reviewed the tax-exempt bond provisions contained in the IRC as of the Tax Extension Act of 1991.
- We reviewed Federal Reserve Board of Governors' data to obtain information on the growth of tax-exempt bond usage and to calculate the percentage of outstanding tax-exempt bonds that were issued for private activities.
- We analyzed data contained in the Budget of the United States Government to obtain information on tax expenditures attributable to tax-exempt bonds.
- We reviewed existing literature on tax-exempt bonds to obtain information on how the tax-exempt bond market operates and on changes that have occurred in the market.
- We reviewed relevant congressional reports and other congressional documents and interviewed current and former congressional staff members who were involved in Congress' tax-exempt bond efforts to obtain information on Congress' views on tax-exempt bonds and to gain an understanding of how Congress reacted to changes in the usage of tax-exempt bonds.
- We interviewed program officials and other cognizant officials at IRS' National Office and the Department of the Treasury to obtain information on IRS' tax-exempt bond oversight practices, its role in ensuring

compliance with tax-exempt bond provisions, and potential improvements. Our discussions involved officials from the Department of Treasury's Offices of the General Counsel and Tax Analysis and the following IRS offices: Office of the Assistant Commissioner (Examination), Office of Examination Programs; Office of the Assistant Chief Counsel (Financial Institutions and Products); Office of the Assistant Chief Counsel (Employee Benefits and Exempt Organizations); Office of the Assistant Chief Counsel (Disclosure Litigation); Internal Audit Division; Statistics of Income Division; Office of the Assistant Commissioner (Criminal Investigation); Office of the Assistant Commissioner (Employee Plans and Exempt Organizations); Legislative Affairs Division; Office of Disclosure; Office of the Assistant Commissioner (Returns Processing); Office of the Assistant Commissioner (Taxpayer Services); and Office of the Assistant Chief Information Officer (Information Systems Management).

- We interviewed IRS officials and gathered documentation from IRS' Southeast and Southwest regions and Atlanta, Nashville, New Orleans, and Houston districts to obtain examples of the extent and nature of tax-exempt bond oversight activities in the field. We selected the Nashville, New Orleans, and Houston districts because revenue agents assigned to tax-exempt bond oversight in these districts were actively pursuing tax-exempt bond cases and because of either the significance or the number of open cases under review. The Atlanta District was included in our selection because two revenue agents were assigned to work in the District on tax-exempt bonds, whereas one revenue agent was assigned in most of the other districts.
- We reviewed judgmentally selected tax-exempt bond abuse cases closed by IRS' Office of Chief Counsel to obtain information on abuses involved and examples of closing agreements. We selected for review (1) cases with more recent closing dates to reflect IRS' more recent activities and (2) at least one case for each tax-exempt bond revenue ruling where closing agreements had been reached.
- We obtained and reviewed IRS tax-exempt bond program documentation to determine the nature and extent of IRS' tax-exempt bond oversight practices.
- We interviewed IRS officials and gathered documentation and Information Return for Tax-Exempt Bond Issues (Form 8038) data from IRS' Philadelphia Service Center and Statistics of Income Division to obtain information on IRS' processing and analysis of tax-exempt bond returns and their relationship to tax-exempt bond oversight.
- We interviewed various public and private sector tax-exempt bond representatives and experts to obtain information on the process used to issue tax-exempt bonds and their roles in the process, to obtain their

views on tax-exempt bond oversight and constraints faced by IRS, and to discuss possible options to enhance voluntary compliance. Our discussions involved officials from the Government Finance Officers Association; the National Association of Bond Lawyers; the National Association of State Auditors, Comptrollers, and Treasurers; the Public Securities Association; the state of Maryland; Howard County, Maryland; and the Securities and Exchange Commission. In addition, we spoke with a specialist in public finance at the Congressional Research Service of the Library of Congress.

- We interviewed and obtained documentation from state officials in three states coinciding with IRS districts we visited (Georgia, Tennessee, and Texas) to obtain information on their tax-exempt bond oversight roles.
- We interviewed selected bond counsels at the state level who were active in providing tax-exempt bond opinions and certified public accountants to obtain examples of their respective roles in tax-exempt bond oversight.
- We interviewed selected issuers who had been involved in negotiating tax-exempt bond closing agreements with IRS to obtain their perspectives on the process.

We did our review in accordance with generally accepted government auditing standards. We obtained oral comments from IRS, which we have included where appropriate.

Improvements Needed in IRS' Tax-Exempt Bond Oversight

IRS is responsible for overseeing a large and increasingly complex tax-exempt bond industry. Substantial federal revenues are forgone through the tax exemption for interest earned on these bonds. The tax expenditure for outstanding tax-exempt bonds was estimated at over $20 billion in 1990. Further, federal statutory and other requirements imposed on the tax-exempt bond market have grown substantially in number and complexity over the past 2 decades. Appendix I illustrates the extensiveness and complexity of these provisions.

To carry out its overall oversight responsibilities, IRS has adopted a corporate strategy of encouraging voluntary compliance and emphasizing efforts that make compliance easier for those wishing to comply. However, this strategy continues to rely heavily on the level of deterrence that IRS can provide through traditional enforcement approaches to detect and punish noncompliance. IRS' primary enforcement effort for tax-exempt bonds—the Expanded Bond Audit Program—employs these traditional enforcement approaches.

The Expanded Bond Audit Program can be improved in several respects to better promote voluntary compliance through enforcement efforts. To monitor compliance in the tax-exempt bond industry and to uncover potential cases of noncompliance, IRS has relied almost solely on others. For example, to monitor compliance, IRS relies primarily on the checks and balances provided by bond counsel's review of a bond at issuance. The Expanded Bond Audit Program also has concentrated almost exclusively on possible noncompliance cases for bonds that were issued 6 to 7 years ago and were referred to IRS through outside sources. Partially redirecting its existing efforts to proactively address current market activity could provide IRS a broader understanding of current compliance problems and may improve IRS' ability to determine if its enforcement presence is producing an acceptable deterrent effect.

The Expanded Bond Audit Program is evolving and officials are working to improve its performance. Program officials are considering using tax-exempt bond information that is currently collected to better detect and address potential compliance problems. However, IRS does not have systems and methods to extract and analyze this information so that it may be useful in recognizing noncompliance and targeting enforcement efforts. Also, IRS has not identified other information it needs for enforcement efforts. Although revenue agents assigned to this program have received some guidance, program officials have not completed final guidance that identifies the types of abuses to be investigated and provides steps on how

to investigate them. In addition, current staffing levels and locations as well as training, need to be reassessed in light of the evolving program. As IRS completes work on its inventory of old cases, it needs to determine whether the current approach, which consists of training staff who work in dispersed locations and have little opportunity to apply that training, is effective. Another option, more centralized staffing, may help agents gain greater expertise and investigative skills.

Although the Expanded Bond Audit Program is IRS' principal effort to oversee tax-exempt bonds, IRS officials have formed a committee to organize the efforts of various IRS functions to ensure compliance in this area. This committee could apply elements similar to those used in IRS' strategic management process, but on a scale commensurate with its tax-exempt bond oversight responsibilities, to focus IRS' attention on identifying and resolving key tax-exempt bond oversight issues. The use of such an approach would allow IRS to set a clear direction for its tax-exempt bond oversight efforts, move toward achieving it, and better apply its limited resources for tax-exempt bond oversight so that it can begin to gauge its effectiveness in enhancing voluntary compliance.

IRS Must Oversee a Large and Complex Market

The tax-exempt bond industry that IRS is responsible for overseeing has grown and become increasingly complex over the last 25 years. Both volume and uses of tax-exempt bonds have changed dramatically during that time. About 39,000 state and general purpose local governments can issue tax-exempt bonds, as can thousands of districts, authorities, and other entities specially authorized through state and local laws to do so. In 1990, issuers sold 11,500 issues and raised $162.3 billion.

The bond counsels that IRS primarily relies on to monitor tax-exempt bond compliance with federal statutes are dispersed among more than 900 different firms. In addition, numerous other individual participants, such as underwriters, consultants, and trustees, are involved in the issuance of tax-exempt bonds. Moreover, since the late 1960s, as both financial markets in general and federal tax-exempt bond statutes became more complex, the financial community began to use intricate financing mechanisms for tax-exempt bonds that would produce the greatest financial benefits while attempting to remain within the confines of the law.

These characteristics of the tax-exempt bond market create opportunities for noncompliance. For example, because tax-exempt bond law is so

complex, complying with the law is burdensome, which provides an incentive not to comply. Moreover, the complexity of financial transactions makes it more likely for mistakes to be made and more feasible to hide intentional abuse. Individuals involved in issuing tax-exempt bonds can benefit from noncompliance, such as by illegally earning and retaining arbitrage profits, and such illegal profits can be substantial. For example, in 1991, an industry newspaper reported that IRS was seeking to recover approximately $4 million of arbitrage from one issuer and over $23 million from another for bond issuances that IRS contended were not in compliance with the law. In addition, according to its officials, IRS typically has reached closing agreements with issuers in tax-exempt bond abuse cases that require the issuers to pay IRS less money than the profits earned from the noncompliant activities. Thus, the direct incentives for not complying generally have outweighed the consequences. The susceptibility of tax-exempt bonds to noncompliance on the basis of these factors underscores the need for effective IRS oversight.

IRS' Heavy Reliance on Bond Counsel for Compliance Is Not a Sufficient Safeguard

As with other taxes, IRS relies primarily on taxpayers—in this case bond issuers—to comply voluntarily with federal tax requirements. To monitor issuers' compliance, IRS relies to a large extent on the bond counsel's opinion that accompanies each tax-exempt bond. This opinion addresses compliance with federal laws at the time of bond issuance. Such an opinion is intended to give investors greater assurance that the bond's interest will be exempt from federal taxation.

Reliance on counsel's opinion may provide IRS with some greater assurance of compliance up to the bond's issuance and involves individuals who should have knowledge of the complex IRC tax-exempt bond provisions. The purpose of the opinions is to enhance investors' confidence in the tax-exempt status of bond issuances. Bond counsels have an incentive to ensure that their opinions on compliance are accurate because if, contrary to their opinions, bonds turn out to be taxable, issuers will be reluctant to rely on their opinions in the future.

However, reliance on bond counsels has limitations. Many tax-exempt bond provisions relate to the actual use of bond proceeds or other events that occur after the bond is issued. For example, bond counsel attests that the issue as structured would be compliant with restrictions on earning arbitrage at the time of issuance. However, bond proceeds actually are not invested and thus do not have the potential to earn arbitrage until after they are issued. Accordingly, even though bond counsel attests to

compliance when the bond is issued, compliance also depends on subsequent actions taken by the issuer. Additionally, bond counsels generally are expected to give fair, accurate, and honest opinions. However, as for anyone, other circumstances, ranging from intentional misrepresentation to unintentional mistakes, can also affect the compliance of bond counsels. According to one bond counsel we spoke with, tax-exempt bond compliance relies on the capabilities, competence, and integrity of the parties involved; however, because these factors vary greatly across the range of bond deals, they can affect the degree of compliance.

IRS' Expanded Bond Audit Program's Enforcement Efforts Have Been Reactive, Not Proactive

IRS considers traditional enforcement activities as one key component of its overall attempts to encourage voluntary compliance with the tax laws. To the extent that it has engaged in enforcement activities for tax-exempt bonds, IRS historically has selected tax-exempt bond cases to pursue on the basis of sporadic tips from informants, tax-exempt bond issuers themselves, and other outside sources, as well as information from other federal agencies such as the Securities and Exchange Commission. According to IRS documents, IRS has relied heavily on such sources for leads on potentially abusive bond issues. For example, as of June 1992, IRS had reached approximately 70 closing agreements since 1981 with issuers on bonds it judged potentially taxable. About two-thirds of these closing agreements were reached over an 8-year period, as issuers voluntarily came to IRS. IRS did not independently identify these cases and did not obtain complete lists of bonds involving any common parties. Obtaining such lists potentially could have helped uncover additional similar abuses.

The Expanded Bond Audit Program, currently IRS' primary tax-exempt bond oversight program, has taken steps to establish a more active enforcement presence. However, the program has not actively tested bond issuances, either randomly or selectively, for compliance. Instead, the program has concentrated on approximately 30 cases, mostly identified through external sources. The program primarily has focused on the surge in tax-exempt bond issuances that occurred before the provisions in the Tax Reform Act of 1986 became effective and the alleged abuses that occurred to avoid the act's restrictive arbitrage provisions. Although these potential abuses merit attention, only a few more recent cases have been included on the Expanded Bond Audit Program's active enforcement list. Accordingly, the program may not recognize whether, and if so, how, new compliance problems are developing.

The possible benefits of a proactive enforcement approach are illustrated by recent Employee Plans and Exempt Organizations efforts. Employee Plans and Exempt Organizations recently began a coordinated examination program for tax-exempt organizations that have substantial income or assets; this program includes reviews of the organizations' tax-exempt bond financing. Preliminary work in this program has raised new concerns about whether some of these bonds satisfy IRC requirements.

In another example, after several abusive nursing home deals were publicized widely, in 1991 Employee Plans and Exempt Organizations began emphasizing the review of tax-exempt bond financing plans for organizations applying for tax-exempt status under section 501(c)(3) of the IRC. In a February 1992 presentation, the Director of Exempt Organizations Technical Division said that about 10 percent of the 110 to 115 organizations applying in recent months either withdrew their applications in response to IRS' questions about the proposed bond deals or refused to answer them. Another 10 percent did not have enough information about proposed bond-related transactions for IRS to decide whether tax-exempt status should be granted. The Director interpreted these results as indicating that the special review appears to be stopping potentially abusive tax-exempt bond transactions that were unidentified and unsuspected before revelations on the abusive nursing home deals.

Before the Expanded Bond Audit Program began, Examination tested issuers' and project managers' compliance with certain requirements for tax-exempt bonds used to finance low-income housing. According to its Manager, this one-time project began in 1988 as a result of a 1985 hearing before the Subcommittee on Oversight of the House Committee on Ways and Means and inquiries by the Subcommittee's Chairman about IRS' audit activities for tax-exempt bonds used to finance low-income housing.[1]

IRS has not released a formal report on the project's results. However, according to a summary provided at our request and statements made by the Assistant Commissioner of Examination on April 27, 1990, before the HUD/MOD Rehab Investigation Subcommittee of the Senate Committee on

[1]According to the project's Manager, IRS randomly selected 80 information returns filed for 1984 by issuers of multifamily housing bonds. Because 5 of the information returns could not be located, IRS reviewed 75 bonds. IRS revenue agents were directed to check for compliance with certain tax-exempt bond requirements such as whether issuers spent 90 percent of the bond proceeds within 3 years of the date of issuance and whether 20 percent of the project's units went to tenants certified to meet low-income criteria. We could not independently review the study's methodology or statistical validity or the strength of its findings because of a lack of documentation. Therefore, we do not know the extent to which IRS' results can be generalized to the universe of multifamily housing bonds.

Banking, Housing, and Urban Affairs, the preliminary results suggested a very high compliance rate with the requirements. Although it revealed few compliance problems, this project reflects the type of proactive enforcement that has been largely absent in the current Expanded Bond Audit Program and that could provide information on the level of compliance and how to target limited resources.

Key industry participants and observers believe that a more proactive IRS enforcement presence for tax-exempt bonds is necessary to promote compliance. For example, in an April 1989 statement to the Chairman of the Treasury, Postal Service, and General Government Subcommittee, Senate Committee on Appropriations, the National Association of Bond Lawyers said the following:

"The National Association of Bond Lawyers both supports evenhanded and vigorous enforcement of existing Federal Tax laws relating to state and local government finance and urges prompt adoption of clear, understandable and unambiguous amplifying regulations. This — not the enactment of new legislation — is in our view the best and most effective method of assuring compliance with those laws, of preventing abusive practices in the issue of state and local government bonds, in containing further increases in issuance costs and in providing much-needed stability in the law."

Association representatives reiterated this position in 1990 and 1991. Similarly, a former congressional staff member who was active in the development of tax-exempt bond legislative restrictions told us that if it does not pursue egregious abuses, IRS actually encourages noncompliance and when Congress perceives major compliance problems it steps in with additional restrictions.

In describing shortcomings in IRS' tax-exempt bond enforcement efforts, an Office of Chief Counsel internal memorandum dated November 4, 1991, was critical of IRS' lack of an effective tax-exempt bond audit program. The memorandum emphasized that IRS' enforcement efforts were limited in scope and effectiveness. For example, it stated the following:

- The enforcement effort had been largely limited to well-publicized abuses; there was some perception in the industry that issues that were not widely publicized were virtually immune from IRS scrutiny.
- This effort had addressed only a limited number of types of abuses; the closing agreements that were reached essentially addressed only six types of abuses.

- The bargaining position of IRS was weak because IRS was unable or unwilling to take enforcement actions other than reaching closing agreements.
- Closing agreements generally resulted from issuers approaching IRS and did not entail an active IRS audit effort.

Expanded Bond Audit Program officials have said they are pursuing the taxation of interest earned on some bonds that IRS considers abusive because the use of closing agreements may not be effective in promoting compliance. Most of the bonds this enforcement effort focuses on were issued during the surge preceding the 1986 Tax Reform Act's effective dates for related tax-exempt bond provisions and thus do not reflect market activity during the past 7 years. Moreover, almost all of the bonds under consideration were identified by external sources. Although such sources can provide valuable information about abuses in the market, IRS could obtain a broader understanding of current compliance problems by actively testing some more current issuances.

IRS' Expanded Bond Audit Program Needs to Make Better Use of Tax-Exempt Bond Return Information for Oversight

IRS has recognized information as an important element for its tax-exempt bond administration and enforcement efforts. However, it has not identified a practical way to monitor compliance of issuers by using the information contained in returns that tax-exempt bond issuers are required to file. This lack of a method to monitor compliance reduces IRS' ability to effectively target efforts to detect and punish noncompliance. It also reduces IRS' ability to develop and target methods other than enforcement to encourage voluntary compliance.

Issuers of tax-exempt bonds are required to file an information return for tax-exempt bond issues (Form 8038 and its variants) with IRS within a specified time after issuance. Form 8038 originally was developed to address the legislative requirement for information reporting on certain tax-exempt bonds in the Tax Equity and Fiscal Responsibility Act of 1982, and IRS has been receiving tax-exempt bond information returns for about 10 years. The report of the Senate Finance Committee on the act stated that the purposes of this requirement were to monitor the use of tax-exempt bonds for private activities and to help enforce other restrictions. Issuers file the information returns at the Philadelphia Service Center where they are processed and transcribed onto computer data tapes. The Statistics of Income Division analyzes the data from these tapes to prepare periodic reports on tax-exempt bond volume and use. These data tapes also are provided to the Joint Committee on Taxation, United

States Congress. However, IRS has not used these returns to enforce tax-exempt bond restrictions.

Issuers also are required to submit a Form 8038-T Arbitrage Rebate when they rebate arbitrage to IRS. Arbitrage payments must be sent to the Philadelphia Service Center at least once every 5 years while the bonds are outstanding. According to an IRS official, issuers rebated approximately $91 million of arbitrage to IRS in 1991.

In November 1990, a Tax-Exempt Bond Committee began meeting informally after concerns were expressed by the Philadelphia Service Center and problems were observed by Expanded Bond Audit Program officials regarding the processing of tax-exempt bond returns at the Philadelphia Service Center. The Committee was formally established in October 1991. According to an August 1991 memorandum from the Assistant Commissioner (Examination), the formation of the Committee was being sought because of "the importance of the Service's efforts in ensuring compliance in this area, the significant increase in the number and types of returns to review, and the current inability of the Service to effectively make use of existing information because of systemic problems."

Despite these initial efforts, IRS has not yet identified a practical way to monitor compliance of issuers using information contained in Forms 8038 and 8038-T tax-exempt bond returns. Expanded Bond Audit Program officials have discussed the possibility of using Statistics of Income Division's tapes and outside databases to identify or sample tax-exempt bonds to audit. Beyond these potential interim steps, program officials also have expressed interest in developing an automated system to identify issuers who may be abusing arbitrage rebate requirements. In an April 1991 memorandum, the Assistant Commissioner (Examination) requested that the Assistant Chief Information Officer, Information Systems Management, establish a project development team "to analyze the functional needs and the corresponding systems capabilities" relative to the tax-exempt bond returns received by IRS. This request was partially based on the work of the Tax-Exempt Bond Committee and proposed that the team

- determine if IRS' automated Master File could be modified to incorporate information from the tax-exempt bond returns to provide the capability of reviewing and retrieving that information;

- determine if a system could be developed to provide Examination, Chief Counsel, and Statistics of Income with the capability of reviewing/retrieving these data if the Master File could not be utilized to do this;
- assist in building a classification system to provide Examination with the capability to identify the cases that have the greatest potential for examination; and
- assist in developing a system to accurately compute the arbitrage rebate recorded on Forms 8038-T on the basis of other information contained on the forms.

In May 1991, Information Systems Management responded that it would form a team to analyze the functional needs for the Expanded Bond Audit Program, including looking at the possibility of adding tax-exempt bond return information to the existing Business Master File or creating a separate file at the service centers to provide the requested capabilities. However, according to Examination officials, as of July 1992, Information Systems Management had not responded to Examination's request for assistance, so Examination had again asked for assistance to develop a system that would use master file information to select bonds for audits.

IRS needs to determine how it can use information it collects from tax-exempt bond returns to identify potential abuse and enforce restrictions on tax-exempt bonds before it decides to set up a master file for that information. In addition, IRS should assess whether it needs other information that currently is not included on these returns. IRS could use this information to improve the ongoing Expanded Bond Audit Program and potentially to guide alternative methods of encouraging voluntary compliance. Once IRS decides what the required information will be and how to use it, systems and analytic methods can be designed to apply that information in identifying possible noncompliance and guiding enforcement efforts.

Guidance for the Expanded Bond Audit Program's Current Efforts Should Be Finalized

During training for the Expanded Bond Audit Program, some revenue agents received procedures drafted in May 1991; however, as of July 1992, these procedures had not been updated or finalized. All agents need final guidance that describes how the Expanded Bond Audit Program will operate and how to carry out their current responsibilities for determining compliance so that they have reliable procedures to detect noncompliance and consistently address potential abuses.

Revenue agents need written guidance on such things as a program's purpose and procedures. According to the former analyst for the Expanded Bond Audit Program in the National Office, monthly reports were prepared to inform district revenue agents of program developments. Although examples of these reports were provided to us for July and October 1989, these were primarily reports on the status of ongoing investigations and not guidance. Between June 1991 and July 1992, two memoranda were sent to the field regarding the Expanded Bond Audit Program. The first, in January 1992, prioritized IRS' highest priority cases and provided very specific guidance on the circumstances under which to terminate or continue nonpriority cases (e.g., depending on when statutes of limitations expired and whether negotiations for a closing agreement had begun). The second memorandum, in May 1992, contained technical procedures for closing a case based on the circumstances (e.g., whether to use 30-day letter procedures, when to issue statutory notices, which tax returns to obtain, what to do if a petition were filed with the Tax Court).

In May 1991, draft procedures for the Expanded Bond Audit Program were produced. This document contained some procedures for tax-exempt bond enforcement and was distributed in draft form to those revenue agents who took training in late 1991 and early 1992. These procedures provided a structure for revenue agents to follow in gathering information on arbitrage abuses. The draft also contains some guidance on how to determine whether the information they collect indicates that an abuse has occurred. As of June 1992, these draft procedures had not been updated or finalized.

The IRM is designed to serve as the single official compilation of IRS' policies, procedures, instructions, and guidelines and to communicate them to those who need to implement them. For example, in March 1988, the Department of Treasury and IRS issued an eight-page IRM supplement for Examination's low-income housing bond project that included purpose, scope, background, assignment of IRS management and implementation responsibilities, a check sheet, a list of 23 documents to request, at least 14 detailed steps to complete, and other practical aspects of the project. Since at least April 1989, Expanded Bond Audit Program officials have been planning to provide guidance for the program by expanding IRM materials to address the current program. However, as of July 1992, IRS had not issued an IRM supplement for the program. At that time, program officials said they were formulating a request to establish a task force to develop IRM provisions for the Expanded Bond Audit Program.

To ensure that all revenue agents have reliable procedures for detecting tax-exempt bond noncompliance and that potential abuses can be consistently addressed, IRS needs to complete and distribute final guidelines for the Expanded Bond Audit Program, either through the IRM or through other official means. At a minimum, these guidelines should include (1) information on the types of abuses involved; (2) the indicators of these abuses; (3) the specific steps to follow in performing a tax-exempt bond examination; and (4) the information to obtain, its potential sources, and how to use this information.

For fiscal year 1992, Exempt Organizations issued a Continuing Professional Education Technical Instruction for its field agents that contained a 49-page section on tax-exempt financing. Complex elements of tax-exempt bond financing relevant to examinations of tax-exempt organizations were clearly and thoroughly presented in this section, which was used as the basis for mandatory training of field agents and was also intended to provide guidance to these agents beyond that provided to them in the IRM. A similar document issued in conjunction with official guidelines for the Expanded Bond Audit Program and specifically related to tax-exempt bonds and the abuses the program is pursuing could help Examination revenue agents better understand and more effectively address this highly complex area.

Staffing and Training Approach for the Expanded Bond Audit Program Should Be Reassessed

Staffing decisions must take into account such details as how many staff members are needed, the type of skills they need, and where they should be located. Although the nature of IRS' principal tax-exempt bond oversight program has changed, a reassessment of staffing needs and the training provided to staff has not been made.

Under the Expanded Bond Audit Program, Examination originally anticipated that its involvement in tax-exempt bond oversight would not extend beyond 12 to 18 months. Therefore, revenue agents generally were assigned, when available, in locations where potential cases had been identified. These agents were given some training on the specific abuses suspected in the cases that they were to investigate. As the program evolved since 1989, up to 27 revenue agents located in 24 districts committed varying amounts of time to tax-exempt bond cases. In 1991, revenue agents spent a total of about 2 staff years on tax-exempt bond examinations.

The Expanded Bond Audit Program was formally authorized in November 1990. Although the authorization extends only through 1993, program officials stated that the program would continue to be IRS' principal ongoing tax-exempt bond compliance effort. Despite the change from a 12-to-18-month project to an established program, officials did not consider the number or location of revenue agents that such an ongoing program would require.

In 1991, Expanded Bond Audit Program officials had begun to consider the program's future and had divided the program into current and projected phases. At that time, program officials described the current phase as emphasizing known abusive transactions and the projected phase as including future improvements, such as a more proactive investigative style, quicker identification of abuses, better use of tax-exempt bond information return data, less dependence on Examination's National Office by district revenue agents, and more information and expertise at the district level.

IRS reevaluated current tax-exempt bond work priorities in November and December 1991 to ensure that the existing staff would be applied to priority cases. However, IRS did not consider the staffing needs if the program were to extend beyond these priority cases.

We do not know what level of staffing will be required for continuing tax-exempt bond enforcement efforts. This is a determination that IRS must make in light of its various enforcement responsibilities and judgments about the level of active enforcement that is needed both to counter existing tax-exempt bond abuse and to deter future abuse.

According to IRS officials, all revenue agents working on tax-exempt bond cases as of July 1992 had received training. The training focused on several specific types of complex arbitrage abuses that were, according to an IRS official, deliberately designed by participants to disguise the use of bond proceeds to earn arbitrage. IRS officials themselves refer to one of these abuses as a "black box" because of the difficulty in identifying all of the components of this financial structure and tracing the bond proceeds within that structure. IRS officials consider the arbitrage restrictions that apply to the abuses covered in the training, and the abusive transactions that had been designed to skirt those restrictions, to be among the most complex IRS faces. On November 4, 1992, Treasury issued about 150 pages of proposed rules on the IRC arbitrage restrictions that would substantially revise the existing rules of about 400 pages, according to an IRS official.

The attorneys handling arbitrage issues and abuses in IRS' Chief Counsel's office are assigned to a unit created to handle especially intricate financial cases.

Given the focus of the Expanded Bond Audit Program on certain types of abuses, the tax-exempt bond training has not included other types of potentially abusive transactions or most of the vast array of tax-exempt bond requirements in federal law. As shown in appendix I, the statutory requirements for tax-exempt bonds are extensive and have numerous thresholds, exceptions, and interrelationships that must be understood to judge compliance. In a November 1991 memorandum, Chief Counsel attorneys said that the scope and effectiveness of IRS' tax-exempt bond enforcement effort had been limited, partially because of the limited number of types of abuses that had been addressed. If a more proactive oversight approach is undertaken, as IRS officials are considering and as we support, revenue agents will need more comprehensive training to be able to detect and address other types of abuses.

One option for staffing the Expanded Bond Audit Program and training assigned agents would be to concentrate tax-exempt bond staff in fewer districts or centralize them in one location. This option may have advantages in developing expertise among revenue agents. Because of the complicated and specialized nature of tax-exempt bonds, providing adequate training to revenue agents in 24 districts who do not work full-time on tax-exempt bonds may not be cost-effective. Assigning fewer staff in selected districts or in one location as full-time agents or to spend a much greater proportion of their time devoted to tax-exempt bond cases could reduce training costs and generate greater expertise. More centralized staffing also would allow for greater interaction among staff, facilitating sharing of information and investigative techniques.

If in reassessing the tax-exempt bond enforcement effort IRS decides to pursue more centralized staffing, centralizing staff would not necessarily be costly. Only about 2 staff years were expended in total by field staff on the Expanded Bond Audit Program in 1991. If IRS decides to retain this level of effort, it could do so by having one or two districts assume full responsibility for this area with one or two revenue agents assigned close to full-time. If these districts are currently involved in the program, no moving costs would be incurred. On the other hand, some additional travel costs might result.

Tax-Exempt Bond Efforts Should Be Coordinated Through Multifunctional Planning

To make the best use of its overall resources to promote voluntary compliance in the tax-exempt bond area, IRS needs to develop and implement a multifunctional plan for its tax-exempt bond administration and oversight. This planning effort could apply elements similar to those used in IRS' strategic management process, but on a scale commensurate with its tax-exempt bond oversight responsibilities. In a 1991 report, we said that this strategic management process, including the planning components, was a good foundation for IRS to improve management direction and oversight.[2] We assessed IRS' tax-exempt bond efforts in relation to strategic planning elements similar to key elements included in IRS-wide planning. That is, we looked at these efforts as related to the following planning elements: (1) setting objectives, (2) developing strategies to achieve the objectives, (3) assessing resource needs in relation to strategies, and (4) measuring progress.

IRS Needs Objectives and Strategies to Establish Direction

IRS has not established objectives and strategies for its various tax-exempt bond efforts. Clear objectives are a necessary precursor to the construction of strategies to obtain the desired results. For example, IRS' Strategic Business Plan, which is part of its strategic management process, starts with identifying the objectives to be accomplished, then outlines the strategies for achieving the objectives. This process helps ensure that resources are used effectively.

The Tax-Exempt Bond Committee, which includes representatives of various components within IRS that have responsibilities related to tax-exempt bonds, is a potential vehicle to pull together such a plan that coordinates and directs the efforts of different functions within IRS. The Committee originally developed a draft action plan in November 1990 consisting of a list of activities developed from committee participants' suggestions. However, despite interim revisions, as of July 1992 this plan was still a draft that did not lay out a clear direction for IRS' tax-exempt bond efforts or specify ways to move toward achieving it. For example, it does not include an underlying oversight strategy; a rationale for the activities listed; an explanation for how the activities fit together to address key oversight issues; or methods, steps, and resources to use. IRS officials have explained that they intend to develop the in-depth action items, strategies, resources, and other items needed for a final plan.

[2]Managing IRS: Important Strides Forward Since 1988 but More Needs to Be Done (GAO/GGD-91-74, Apr. 29, 1991).

Identifying objectives will enable officials to plan and organize their efforts with more focus. Within IRS, a multifunctional Excise Tax Task Force followed such an approach during 1990 and 1991 to develop recommendations for improving IRS' excise tax efforts. For example, the Task Force incorporated IRS' broad Strategic Business Plan objectives (e.g., increasing voluntary compliance and reducing taxpayer burden) into its planning effort and developed excise tax-specific strategies for achieving those objectives. Using the identified objectives, the Task Force developed strategies for integrating not only Examination efforts but also those of other organizations, such as Legislative Affairs, Taxpayer Service, and Tax Forms and Publications. As of September 1992, Examination had begun implementing the strategies that affected only Examination and was preparing to obtain public comment on strategies that affected other IRS components and taxpayers.

IRS needs to develop cohesive proactive strategies for its tax-exempt bond administration and oversight efforts. The strategies should be developed to achieve the objectives IRS adopts to encourage voluntary compliance with tax-exempt bond requirements. The strategies should define and incorporate the roles of all IRS organizations involved with tax-exempt bonds, including specifying who will have lead responsibility. In part, such strategies should include methods for testing for, identifying, and pursuing tax-exempt bond abuses. By developing strategies to support its objectives, IRS can enhance accountability and establish a framework to provide direction for its tax-exempt bond efforts.

IRS Should Assess Resource Needs

The objectives and strategies that IRS adopts for tax-exempt bond oversight and administration will influence its staffing and information resource requirements. This staffing assessment would be broader than that required for a continuing Expanded Bond Audit Program. For example, if IRS determines that targeted litigation would be an effective strategy to encourage greater compliance, legal staff with relevant expertise may be needed. If greater use is to be made of statistical information derived from tax returns and other sources, computer programmers and data analysts may be required. Similarly, the training and the type and detail of guidance that staff will need to do their work also will depend on the objectives and strategies adopted.

IRS Should Establish Goals for Measuring Progress

As the final element in planning its tax-exempt bond efforts, IRS will need goals against which progress can be measured. IRS has recognized the need

for such goals in its overall planning efforts and has been making progress in developing and addressing IRS-wide goals. At present, IRS' progress in tax-exempt bond administration and oversight cannot be measured because clear objectives, strategies to achieve them, resource needs, and the goals against which to adequately measure this progress have not been established.

Conclusions

IRS has taken a reactive approach to tax-exempt bond oversight, and, as in other areas of tax administration, has relied on tax-exempt bond market participants for voluntary compliance. However, over the last 25 years, the tax-exempt bond industry has evolved from one that concentrates on relatively simple financing of traditional governmental projects to one that increasingly includes complex, innovative financing of projects involving private parties. At the same time, numerous intricate tax-exempt bond statutory and regulatory requirements have been established to guide this more complex industry. This new environment has made compliance more difficult and has created greater opportunities for noncompliance. Over time, IRS has become more aware that noncompliance within the tax-exempt bond industry occurs and has begun to understand the new opportunities for noncompliance. Because IRS must balance tax-exempt bond enforcement efforts against its many other responsibilities, it must use its limited tax-exempt bond oversight resources as effectively and efficiently as possible.

In recent attempts by Employee Plans and Exempt Organizations to more proactively test the market, unsuspected potential compliance problems have emerged. In contrast, the Expanded Bond Audit Program, IRS' principal effort to oversee tax-exempt bonds, has continued to focus on past abuses that were externally identified. Officials in this primary tax-exempt bond oversight program are just beginning to consider how a more active and ongoing enforcement effort may be instituted. Although the past abuses this program is addressing merit attention, we believe that IRS can have a positive impact on the level of compliance by partially redirecting its Expanded Bond Audit Program resources to oversee current market activities. An active and current presence in the market can yield useful information about the extent of compliance in market segments and better enable IRS to judge whether it is obtaining an acceptable deterrent effect from its enforcement presence. Market forces cannot take the place of an independent IRS presence; we believe, as do IRS and others, that voluntary compliance is stronger in an environment that has independent oversight and enforcement.

Additional improvements should also be made in the Expanded Bond Audit Program. IRS recently has begun to consider how to use available information more effectively for tax-exempt bond oversight. However, it has not identified the information it needs or developed systems and analytic methods to help it use such information to identify potential noncompliance. Such information also could assist IRS in determining staffing and training needs, what strategies to follow, and otherwise how to direct its enforcement efforts. IRS officials also have not provided agents assigned to the Expanded Bond Audit Program final guidance containing reliable procedures to detect noncompliance and consistently address potential abuses.

Staffing and training for the Expanded Bond Audit Program have not been reconsidered in light of the evolving program. Staff assigned to the Expanded Bond Audit Program are located in 24 districts and devote little time on average to tax-exempt bond work. Although the staff were given some training on the specific abuses IRS has been pursuing, providing such training on highly technical abuses to agents who have little opportunity to apply it may not be the most effective approach. If a more proactive oversight approach is adopted, revenue agents will need more comprehensive training so that they can detect abuses other than those that were included in their initial training. As IRS closes out the cases in its inventory, the appropriateness of the current staffing and training to a continuing Expanded Bond Audit Program should be reassessed. A more centralized staffing option may enable IRS to provide training more cost-effectively and may help agents gain greater expertise and skill in investigating these complex cases. Centralization need not entail costly relocation of agents but may incur additional travel expenses.

Although improvements can make Examination's Expanded Bond Audit Program more effective, IRS should consider how it can best use its overall resources to promote voluntary compliance with tax-exempt bond requirements. As an agency, IRS has been working to set agencywide goals, establish priorities, guide budget decisions, and measure the progress of its various organizations toward achieving well-defined objectives. Although they are beginning to consider how to improve IRS' tax-exempt bond efforts, IRS officials have not developed and executed a plan to guide these efforts or to help direct IRS' limited tax-exempt bond resources most effectively. Developing and executing an overall tax-exempt bond plan that takes into account the efforts of the Expanded Bond Audit Program as well as other existing and potential efforts would focus IRS' attention on identifying and resolving key tax-exempt bond issues and allow it to

establish a clear direction for its tax-exempt bond efforts and move toward achieving it.

Recommendations

So that IRS can better understand and more effectively deter tax-exempt bond noncompliance, we recommend that the Commissioner of Internal Revenue partially redirect existing Expanded Bond Audit Program oversight and enforcement efforts to include active testing of current market compliance.

To achieve more effective oversight using existing Expanded Bond Audit Program resources, we recommend that the Commissioner of Internal Revenue identify and make better use of information to detect noncompliance and direct enforcement efforts, provide final guidance to staff assigned to tax-exempt bond enforcement, and reassess staffing levels and locations and training needs to take into account the program's future.

To make more effective use of resources throughout the agency to promote voluntary compliance in the tax-exempt bond industry, we recommend that the Commissioner of Internal Revenue develop and implement a plan to guide the agency's tax-exempt bond oversight efforts. The Commissioner should ensure that this plan does the following:

- Establishes clear objectives. These objectives should form the base on which a comprehensive plan for IRS' tax-exempt bond work will be built.
- Includes coordinated and proactive strategies to achieve the objectives. These strategies should specify who will have lead responsibility for IRS' tax-exempt bond efforts, incorporate the roles of the many IRS components with tax-exempt bond-related duties, and be used to assign responsibilities clearly and hold responsible parties accountable. The overall strategies should include a strategy for encouraging voluntary compliance that defines a proactive role for IRS in the tax-exempt bond market.
- Assesses staff and information needs to carry out the strategies. Through this assessment, IRS should determine how many staff members will be required, where they will be located, and what skills and guidance they will need. Further, the information that can be used to encourage compliance with tax-exempt bond requirements beyond just information needed for enforcement efforts should be identified as well as methods for gathering, analyzing, and using it.
- Sets measurable goals. IRS should adopt specific goals so that progress toward achieving them can be measured.

Agency Comments and Our Evaluation

In oral comments on a draft of this report, IRS officials generally agreed with our recommendations and the information presented in this chapter. IRS officials agreed that they need a more effective means of assessing their tax-exempt bond program, which would include program staffing levels, locations, and training. In addition, they said that Examination would pursue a more specialized issue/industry examination approach for tax-exempt bonds that would include the development of specialized guidelines to be provided to field staff and updated when necessary.

Officials also agreed that IRS should determine what information would be helpful to target tax-exempt bond enforcement efforts. However, they said that a cost-benefit analysis should be done to determine whether additional data would detect noncompliance and to address the issue of the cost of additional data systems.

As we said in our draft report, IRS first needs to make better use of information it already collects on tax-exempt bond returns. IRS then needs to identify whether other information would help direct its enforcement efforts; and, having done so, IRS should certainly consider the costs and benefits of obtaining such information.

IRS officials also said that partially redirecting existing Expanded Bond Audit Program oversight and enforcement efforts to include active testing of current market compliance should be studied to determine if it would be an effective means for identifying tax-exempt bond issues for examination. We believe that IRS' moving away from its historically reactive tax-exempt bond oversight approach to a proactive oversight presence is vital to encouraging compliance. To this end, we believe that actual testing of more current bonds is essential. Such testing would provide IRS with a better understanding of current compliance issues and would provide an active enforcement presence in the tax-exempt bond market to encourage compliance.

IRS officials also said they did not agree that tax-exempt bonds should be worked on by only a few agents. They said that they believed there should be a national coordinator to oversee the activities and direction of IRS' tax-exempt bond program in conjunction with specialized agents in districts where they are needed and that this approach should accomplish the goal of establishing a more proactive approach and result in better overall communication.

We did not intend to suggest that IRS should only assign a few agents to the Expanded Bond Audit Program. In 1991, only about 2 staff years were expended by revenue agents spread throughout the districts on the Expanded Bond Audit Program. Because of several disadvantages to this staffing approach given the program's evolving direction, we recommended a reassessment of staffing levels and locations and presented as one possible option that IRS concentrate tax-exempt bond staff in fewer districts or centralize them in one location. Although we explained how IRS could do this if it decided to retain the 2-staff-year staffing level, we said that the level of staffing for IRS' tax-exempt bond enforcement efforts was a determination that IRS itself would have to make in light of its various enforcement responsibilities and judgments about the level of active enforcement that was needed both to counter existing tax-exempt bond abuse and to deter future abuse. While IRS should determine how many staff to assign, we encourage IRS to staff the program such that sufficient expertise can be developed by agents in this complex area.

In their response to our recommendation that the Commissioner of Internal Revenue develop and implement a plan to guide the agency's tax-exempt bond oversight efforts that establishes clear objectives, includes coordinated and proactive strategies, assesses staff and information needs, and sets measurable goals, IRS officials said that although they thought the Expanded Bond Audit Program should set objectives and determine staffing and information needs, they did not agree the program should be included as part of the strategic business plan objectives. In addition, they said that even if it is expanded, it is doubtful that the program would merit a specific IRS-wide strategy.

We did not intend to suggest that IRS should include a tax-exempt bond program as part of its strategic business plan objectives. Instead, in our report, we were using IRS' strategic management process, and the business plan that results from it, as an example of a process that includes good planning principles that we think IRS can apply to its tax-exempt bond efforts. We have changed the wording of our report to remove any implication that IRS' tax-exempt bond efforts should be part of its strategic business plan objectives. However, we continue to believe that all IRS functions involved with tax-exempt bonds should be included and involved in the planning effort just as they have been in the Tax-Exempt Bond Committee.

Options to Enhance Voluntary Compliance

A key part of IRS' tax-exempt bond oversight strategy, as in other areas, is enhancing voluntary compliance. Although IRS can take administrative and enforcement actions to encourage compliance, as discussed in chapters 1 and 2, Congress can enhance IRS' ability to deter tax-exempt bond abuse by providing appropriate incentives in the law to promote voluntary compliance. IRS does not know the extent of current noncompliance in the tax-exempt bond market, but it is reasonable to assume that some degree of noncompliance exists. For example, despite limited enforcement efforts in the nearly $800 billion tax-exempt bond market given IRS' limited resources across a range of priorities, IRS has found some cases of noncompliance. However, Congress has not adopted a penalty structure for tax-exempt bonds that IRS can use to encourage compliance. Consequently, if noncompliance is discovered, the basic sanction available to IRS is to tax the interest that bondholders receive on the bonds; however, this sanction does not target those found to be responsible for the noncompliance and is disproportionately severe for many types of noncompliance with tax law.

The IRC generally prohibits IRS from disclosing federal taxpayer information, including information about its enforcement activities related to tax-exempt bonds. However, tax-exempt bond market forces can encourage compliance if information is available to support judgments about tax-related compliance risks. Market participants would tend to avoid doing business with noncompliant parties or would require a higher return on investments to compensate for increased risks. Although the disclosure prohibitions are based on concerns that cannot be ignored, such as respect for citizens' privacy, some of these concerns may be less applicable to the governmental bodies that issue bonds. Moreover, although any changes in disclosure restrictions for tax-exempt bonds would have to be carefully considered, it may be possible to alleviate some concerns through the design of a disclosure provision limiting what could be disclosed.

House report language accompanying the Omnibus Reconciliation Act of 1989 clarified that IRS can use the penalty for promoting abusive tax shelters found in IRC section 6700 for tax-exempt bonds. This penalty would target those responsible for noncompliance if they were involved in providing the bond as an abusive shelter of income from taxes. However, it has not yet been tested by IRS in a tax-exempt bond case. It also does not apply to all types of noncompliance.

Simplifying the laws and regulations applying to tax-exempt bonds, perhaps by restricting complex requirements to complex transactions, may also promote compliance by making the requirements more readily understandable and less burdensome. However, these requirements are likely to remain relatively complex because of continuing congressional concerns with the ways tax-exempt bonds have been used. Therefore, IRS will need to encourage voluntary compliance through such means as education of participants in the tax-exempt bond market, clear regulations, and well-designed enforcement efforts.

Penalties to Promote Compliance

Congress promotes voluntary compliance with the tax law by providing incentives as well as sanctions and penalties in the IRC. IRS policy emphasizes penalties as an important mechanism to encourage voluntary compliance. If penalties are to encourage voluntary compliance, they must be targeted to the individual(s) responsible for the noncompliant behavior and known to them. In addition, IRS must be willing to impose the penalty, the penalty must be readily administrable, and it must be both of appropriate magnitude to the severity of the noncompliant behavior and of sufficient magnitude to deter noncompliance. However, because Congress has never adopted a penalty structure for tax-exempt bonds, the basic sanction available to IRS when a bond does not meet IRC requirements is to tax the bondholders' interest on the bond.

As in other tax areas, IRS relies on voluntary compliance in the tax-exempt bond industry. However, what makes this reliance unusual for tax-exempt bonds is that the tax liability for noncompliance does not fall to those whom IRS relies on to voluntarily comply, such as issuers (state and local governments, special authorities, and districts) and the specialists that issuers rely on to provide legal, financial, and other services (bond counsels, underwriters, and others). Instead, that liability falls to the bondholders, whose interest earned on bonds they thought were tax exempt is taxed when noncompliance is discovered. Thus, the incentive to comply is different from that in areas of tax law in which the abuser is directly liable for the abuse.

Historically, IRS has been reluctant to impose the sanction of taxing bondholders' interest because it is a severe sanction that is not directed at the parties responsible for the noncompliant behavior. In addition, this sanction is difficult to administer because IRS has to identify the individual investors, notify them that the interest is now taxable, collect the taxes due, and potentially bring individual suits against them if they do not pay

the taxes. With the growth of tax-exempt mutual funds, hundreds or thousands of investors may own small portions of a given tax-exempt bond and their proportional ownership of a particular bond may be very small and difficult to verify.

Rather than taxing the interest on a bond, IRS' practice has been to use closing agreements when it determines that bond transactions do not comply with the tax laws. Under the approximately 70 agreements since 1981, issuers almost always paid IRS an agreed-upon amount and the bondholders' interest remained tax exempt. However, in a 1991 memorandum, IRS officials concluded that closing agreements typically resulted in settlements that represented only a small fraction of the arbitrage profits earned, which in turn were often of much smaller amounts than lost tax revenues. Because they typically are much smaller than the arbitrage gained, closing agreements provided little incentive to comply. According to an IRS official, Examination no longer wants to use closing agreements to settle tax-exempt bond cases because closing agreements are not designed to promote voluntary compliance.

Apart from these concerns, the ability of closing agreements to deter abuse is limited for other reasons. Because they are not prescribed penalties and each agreement is the result of individual negotiations, their terms are not defined. In addition, because of prohibitions in the IRC, their terms cannot be disclosed by IRS. Those in the tax-exempt bond industry typically would learn of closing agreements resulting from issuers' noncompliant bonds if the issuers publicly discussed them. Thus, unlike the consequences of a prescribed penalty, industry participants cannot know in advance the consequences that will result if noncompliance is discovered by IRS. We believe that this combined with IRS' reactive use of its limited resources to oversee compliance, the relatively small amounts paid by those who reached closing agreements with IRS, and the reluctance of IRS to use the available sanction of taxing bondholders' interest, constrains the deterrent effect of IRS' oversight.

As of May 1992, IRS had decided to consider taxation for a number of bonds that it judged highly abusive. Almost all of these bonds were issued in 1985 or 1986, were identified for IRS by external sources, and were allegedly issued to avoid the requirements of the Tax Reform Act of 1986. According to a December 1992 press article, in a court motion by IRS in response to a lawsuit filed by a bondholder to prevent IRS from collecting taxes on interest earned on bonds IRS contended were not tax exempt, IRS indicated that it is examining or challenging the tax-exempt status of more

than 30 bond issues nationwide. Nevertheless, officials have recognized that taxation is administratively complex and that the investors who would be required to pay the taxes were not likely to be those responsible for the abuses. To prioritize its cases, as of May 1992, IRS had adopted thresholds for determining which bondholders should be notified that their interest was taxable. Although this effort to tax some bonds may convince issuers that IRS is willing to take further action and thus may help motivate issuers to reach closing agreements with IRS in the future, the other limitations of closing agreements in promoting compliance will not be fully overcome.

House report language accompanying the Omnibus Budget Reconciliation Act of 1989 clarified that IRC section 6700, which contains the penalty for promoting abusive tax shelters, applies to parties involved in the organization or sale of tax-exempt bonds. Section 6700 may provide IRS with a more appropriate penalty for tax-exempt bond abuses than taxing bondholders' interest or reaching closing agreements with issuers because it has attributes that may encourage voluntary compliance. That is, it (1) is set by statute and therefore industry participants can know in advance the consequences of noncompliance, (2) was adjusted by Congress in the 1989 act to more closely align the penalty with the severity of the noncompliant behavior by applying it to each sale of an interest in an abusive tax shelter, and (3) is targeted to those responsible for the noncompliance.

Language changes in the Omnibus Budget Reconciliation Act of 1989 were made to clarify that the section 6700 penalty applies not just to the overall activity of promoting abusive tax shelters but rather to each individual sale of an interest in a shelter. Because of these changes, instead of being penalized one time for creating an abusive tax shelter, a shelter promoter would be penalized for each time an individual bought into the shelter. The 1989 act also revised the amount of the penalty under section 6700. Before the 1989 act, the IRC penalty imposed for promoting abusive tax shelters was "equal to the greater of $1,000 or 20 percent of the gross income derived or to be derived by such person from such activity." As revised by the 1989 act, the penalty equals $1,000 or, if the person establishes that it is lesser, 100 percent of the gross income derived (or to be derived) by such person from each such activity. The effective date of the legislative changes to this penalty was January 1, 1990.

Although this penalty would target those responsible for the noncompliance if IRS used it for tax-exempt bond abuses, it is not clear whether the penalty can be used to effectively encourage compliance in

the tax-exempt bond industry because IRS has not applied it in a tax-exempt bond case. To use the penalty, IRS must prove that those parties considered responsible intentionally promoted a bond through which investors could improperly shelter income and avoid paying taxes. To date, IRS largely has been wrapping up cases from 1985 and 1986. Even if this penalty is appropriate for certain types of tax-exempt bond abuses that amount to promoting abusive tax shelters, IRS still lacks appropriate penalties for other forms of noncompliance such as failure to file tax-exempt bond information returns.

In an April 20, 1990, response to the Chairman, Committee on Ways and Means, House of Representatives, regarding simplification of the IRC, the staff of the Joint Committee on Taxation recommended that a statutory penalty system be developed as an alternative to, or in combination with, loss of tax exemption for selected violations of the IRC's tax-exempt bond rules. The staff's letter stated, "In general, the only sanction for violation of any of the numerous Code requirements applicable to tax-exempt bonds is loss of tax exemption. Even for many of the most serious violations, loss of tax exemption is directed toward the wrong party—the investor holding the bonds rather than the issuer of the bonds." The letter also stated that for more minor violations, loss of tax exemption was too severe a sanction and that IRS avoided imposing it in practice.

The Government Finance Officers Association—an association representing local government finance officials—and other groups also have taken the position that taxing bondholders is inappropriate because they are not the parties responsible for the noncompliance. A statement submitted on behalf of the Government Finance Officers Association and several other organizations to the House Ways and Means Committee in 1990 said that although section 6700 represents an important first step to reforming tax-exempt bond-related penalty provisions, they supported further reexamination of penalty provisions.

IRS is considering alternative penalties in a somewhat analogous area. That is, when a tax-exempt organization, such as a charity, fails to meet applicable requirements, IRS can revoke its tax-exempt status. As with the tax-exempt bond sanction, IRS has been reluctant to use this sanction because of its relative severity. According to IRS' Director of Exempt Organizations' Technical Division, Exempt Organizations will be using alternative penalties that would be more appropriate, including tax shelter penalties.

Penalties for specific kinds of noncompliance could be developed for tax-exempt bonds that would be similar to other penalties routinely employed by IRS. For example, other than by taxing the interest on bonds they have issued, IRS cannot (1) penalize issuers for failing to file tax-exempt bond returns (e.g., IRS Forms 8038, 8038-G, and 8038-T) or (2) penalize issuers for inaccurate or late returns or for the underpayment or late payment of arbitrage rebates.

Readily administrable penalties exist for other taxes, and similar types of penalties could be developed to encourage compliance by tax-exempt bond issuers. For example, employers—including units of state and local government—who withhold income and social security taxes from their employees' wages are required to deposit these employment taxes under the federal tax deposit system. If employment tax deposits are neither timely nor of sufficient amount, IRS can assess a failure-to-deposit penalty. This time-sensitive penalty ranges from 2 percent of the underpayment if employment taxes are late but deposited within 5 days of the due date to 15 percent if the taxes are not deposited before the earlier of 10 days after the date of the first delinquency notice or the day on which notice and demand for immediate payment is given.

Limited Disclosure of IRS' Tax-Exempt Bond Enforcement Efforts Could Encourage Compliance

Disclosing information about IRS' tax-exempt bond enforcement could encourage compliance. Such disclosures would notify industry participants that IRS is enforcing tax-exempt bond laws and regulations. Disclosures could also provide information that market participants need to better judge the risks of noncompliance. Because their reputations and thus their success in the market could be hurt by disclosures of their noncompliance, issuers, underwriters, bond counsels, and others would have an additional incentive to comply with tax-exempt bond requirements. However, IRS generally is prohibited by statute from disclosing federal taxpayer information, including information related to tax-exempt bonds. This prohibition applies to return information IRS receives as well as to any other information it obtains, for example, through its investigations and enforcement actions.

Generally, the federal disclosure restrictions are based on a respect for citizens' privacy and a judgment that violating that privacy would be detrimental to voluntary compliance. This judgment is based on the belief that citizens would not be inclined to provide IRS with all of the information it needs if IRS were allowed to disclose that information freely.

The federal prohibition also is based on a fear of possible inappropriate use of taxpayer information for political purposes.

Although these concerns are valid, we believe that tax-exempt bonds are sufficiently different and the benefits of limited disclosure sufficiently worthwhile that Congress should consider a limited exception to the disclosure restrictions. The goal of such disclosure would be for IRS to provide information needed to make the tax-exempt bond market more efficient at recognizing risks of noncompliance. If an exception is adopted, it can be designed to minimize potential adverse consequences.

How Disclosure Could Encourage Compliance for Tax-Exempt Bonds

The sanction for tax-exempt bond abuse—IRS' taxation of the interest bondholders earned on the bonds—does not directly penalize the issuer of those bonds or other parties that were involved in the abuse. Rather, the bondholders, who purchased the bonds under assurances that they met IRC requirements and who were not involved in perpetrating the abuse, must pay any taxes and penalties IRS determines are due. This sanction is unlike the penalties for noncompliance with most other tax laws.

Generally, penalties for noncompliance are levied on those IRS holds responsible to comply with the law. Thus, the penalties serve as an incentive to comply. For example, for personal income taxes, IRS reviews an individual's tax return and if noncompliance is detected, the individual is responsible for paying any penalties in addition to the applicable taxes. If the individual was assisted in preparing the return by an income tax return preparer, penalties can be assessed against the preparer in certain cases. Similarly, IRS reviews corporate tax returns; corporations, or the shareholders that own them, are responsible for paying any additional taxes and related penalties that are due.[1]

Taxation of bondholders' interest can indirectly penalize an issuer in a bond deal if information regarding the taxation becomes available to future bond purchasers and negatively affects the issuer's ability to sell the bonds. For example, bond purchasers could demand from the issuer a higher interest rate for the bonds to compensate for any increased risk that the bonds would be declared taxable. Similarly, other participants in a

[1]Unlike bondholders who have no say in the management of the entity issuing a tax-exempt bond, shareholders own a corporation and, through their voting rights, have a say in the corporation's management. Tax-exempt bondholders are more similar to corporate bondholders than to the shareholders of corporations. To the extent that information, including tax-related matters, could materially affect a corporation's financial results, accounting principles specify that it should be disclosed on public financial statements.

bond whose interest is found to be taxable would also be indirectly penalized. For example, if an underwriter is known to have been responsible for a tax law violation related to a particular bond, issuers may be less likely to use that underwriter for their future bonds. Thus, disclosing abuses can serve as an incentive to comply because of the potential negative effect on the issuer and other participants.

Some information about tax-exempt bond abuses has appeared in the press, having been released by participants in questioned bonds or resulting from the filing of public suits. However, such releases of information may not always occur and, when they do, may be incomplete or inaccurate. IRS cannot disclose information about tax-exempt bond cases it is pursuing or has concluded, and therefore its perspective is missing when industry participants release information.

We discussed with various tax-exempt bond experts the merits and drawbacks of publicizing information on IRS enforcement efforts. As will be discussed in greater detail, some expressed reservations about adverse consequences that might flow from disclosure. However, some industry participants thought that a periodic report providing general information about IRS' tax-exempt bond enforcement actions could serve as a deterrent to abuse. Several of the experts we spoke with agreed that disclosure, in general, could strengthen IRS' oversight position and encourage voluntary compliance.

Primary Reasons for Prohibiting Disclosure Are Less Convincing for Tax-Exempt Bonds

The legislative history for the disclosure restrictions contained in the Tax Reform Act of 1976 shows considerable concern for the reasonable expectations of privacy that citizens have for the information that they provide to IRS. The history also suggests that citizens may be less willing to report information to IRS if this expectation is not met, thus undermining the system of voluntary compliance with the tax laws. However, we believe that these concerns are less convincing for tax-exempt bond information than for some other types of taxpayer data.

Congress took citizens' expectations of privacy into account when revising the disclosure rules in 1976:

"The Congress reviewed each of the areas in which returns and return information were subject to disclosure. With respect to each of these areas, the Congress strove to balance the particular office or agency's need for the information involved with the citizen's right to

privacy and the related impact of the disclosure upon the continuation of compliance with our country's voluntary tax assessment system."[2]

IRS has concluded that the disclosure restrictions Congress adopted in 1976 apply to the information returns of tax-exempt bond issuers and any information that IRS uses in determining tax liability related to such bonds. In a September 1992 letter to us, IRS said that it supports the disclosure prohibition for tax-exempt bonds, in part because the confidentiality afforded to IRS compliance information plays an important role in fostering voluntary compliance in the tax-exempt bond enforcement program as well as elsewhere.[3]

However, it is not clear to us that the same expectation of privacy does or should apply to the bond issuances of governmental bodies. Governmental units are accountable to the citizens they represent. Indeed, one approach Congress has taken is to require that private activity tax-exempt bonds be publicly approved by the appropriate governmental unit after a public hearing or by voter referendum.

It is also unclear to us to what extent the IRC disclosure provisions help foster voluntary compliance and cooperation by tax-exempt bond issuers (1) in providing information on Forms 8038 and (2) in reaching closing agreements with IRS. Regarding information, for Forms 8038 for bonds we reviewed, a substantial portion of the information that IRS requires from issuers on the forms is available to the public in documents associated with the bond's issuance. This includes, for example, information about the type of bond and the terms of issuance such as the issue date, maturity, price, and yield.

Typically, the closing agreements that IRS has reached with issuers have been the result of issuers approaching IRS. Although it can be argued that these issuers approached IRS in part because confidentiality shielded them from public disclosure of their noncompliance, their actions may not have been entirely voluntary. Generally, issuers have approached IRS after it issued a revenue ruling or other guidance revealing IRS' knowledge of the characteristics of bonds that did not satisfy particular bond-related

[2]General Explanation of the Tax Reform Act of 1976, Joint Committee on Taxation (Dec. 29, 1976), p. 315.

[3]In its letter to us, IRS also said that as a practical matter, issuers have borne the liability for noncompliance. Because IRS generally has reached closing agreements with issuers rather than taxing bondholders' interest, this may be true. However, IRS officials have concluded that closing agreements have not been very effective and are not designed to promote voluntary compliance, and IRS now is pursuing the option of taxing bondholders' interest.

requirements. Thus, issuers may be prompted to approach IRS not because of voluntary compliance but because of the fear that IRS might be able to associate their bonds with characteristics similar to those identified in the revenue ruling.

Other Concerns Can Be Minimized in Designing Disclosure Options for Tax-Exempt Bonds

Other concerns relating to disclosing information also have been raised. The legislative history of the disclosure prohibition in the Tax Reform Act of 1976 also refers to possible inappropriate use of taxpayer information for political purposes. In addition, some tax-exempt bond experts have expressed reservations about disclosure, such as (1) that innocent parties could be unjustly incriminated and adversely affected if information were released before IRS completed an investigation or before the implicated parties had the opportunity to appeal an adverse decision and (2) that publicizing information about IRS' tax-exempt bond enforcement activities would be overly harmful to the issuers because the marketability of future bond issues would suffer even if the issuer did not create the abuse.

These concerns could be alleviated with an appropriately designed disclosure provision. Each of the disclosure options discussed in the following subsection could be structured so as to minimize the possibilities of disclosure for political reasons and of premature disclosure. In each case, IRS could be permitted to disclose information about a bond only after (1) a closing agreement is reached or (2) either an issuer has failed to appeal a case within prescribed time frames or any appeals have been settled. If incorporated into a disclosure provision, these two limitations would prohibit disclosure by IRS until a case is settled. This timing would help counteract disclosures for political reasons in that IRS' position on noncompliance would either have to be accepted by the issuer or upheld on appeal before any disclosure could be made.

The possibility that disclosure would be overly harmful to issuers because the future marketability of bond issues would suffer even if the issuer did not create the abuse can be addressed for most of the options to varying degrees. Ways to address this possibility are discussed with each option in the following subsection.

Some Disclosure Options That Could Enhance Compliance

We believe Congress should reconsider the disclosure prohibition for tax-exempt bonds. Several options for IRS disclosure of information on tax-exempt bonds could be considered. One option would disclose the names of issuers, bond counsels, underwriters, or other parties

responsible for the noncompliance. A second option would disclose the identity of any specific bonds for which IRS has taxed bondholders' interest or reached closing agreements with issuers. A third would permit IRS to issue a periodic report summarizing the enforcement actions it has taken. A fourth option would disclose descriptive information about bonds that are found noncompliant, focusing on what made them noncompliant. Any of the options would better notify industry participants of the extent of IRS' enforcement efforts and enhance the ability of the tax-exempt bond market to recognize the risks of noncompliance. Moreover, the resulting damage to the reputations of noncompliant parties, and thus to their success in the market, would serve to indirectly penalize their noncompliance. Each option would have various advantages and disadvantages.

The option of disclosing the names of parties responsible for noncompliance would enable future market participants to assess better the reliability of those connected with bond offerings. Just as a consumer might call an organization such as the Better Business Bureau before making a purchase to obtain information on problems associated with specific merchants, future market participants could obtain information on past compliance problems of specific issuers, bond counsels, and others when they investigate the soundness of bond offerings. To guard their reputations, market participants would be motivated to avoid noncompliance. This type of information might be particularly useful to issuers lacking extensive expertise by giving them a more informed basis for judging the reputation of bond counsels, underwriters, and others who may seek out their business. Because this option limits disclosure to the names of those responsible for noncompliance, the possibility would be decreased of hurting issuers' future issuances when they were not responsible for previous noncompliance.

A possible disadvantage of this approach is that IRS may have to spend more time on cases to determine who is responsible for noncompliance. Also, industry participants who were involved in an abusive bond might be less willing to voluntarily approach IRS about the abuse because their involvement could be publicly disclosed.

A more limited disclosure option could authorize IRS to publish the specific identity of any bond and its issuer for which it has taxed the interest earned by bondholders or reached a closing agreement. This disclosure option would ensure that some limited information about all noncompliant bonds is disclosed. In addition to encouraging issuers to comply, this

option would have the advantage of informing any potential investors in bonds with taxable interest that the interest they receive will not be tax exempt. This would be somewhat analogous to IRS' procedure of publicizing the names of organizations that no longer meet exempt organization requirements to inform future contributors that their contributions will not be tax deductible.

In addition, this option could indirectly encourage compliance because articles in the press would likely identify the other parties associated with bonds that were so disclosed and publicize whatever is known about why the bonds were noncompliant. Again, bond industry participants would have an incentive to avoid questionable transactions to protect their reputations. Currently, this type of information is often publicized by bondholders or issuers who can reveal that a bond's interest was taxed or that a closing agreement was reached, whereas IRS cannot now formally disclose the identity of a bond that was found noncompliant.

This option would not directly address the criticism that disclosure would harm future issuances when issuers were not responsible for past noncompliance. Indirectly, if the press determines and publicizes the details of the faulty bond, market participants may be able to judge responsibility. This "trial by press" may be imperfect and result in some penalization of innocent parties. And, as was the case with the first option, this option would have the possible disadvantage of discouraging participants from approaching IRS.

The third option—IRS periodically issuing a summary report of its enforcement actions—would encourage compliance mainly by alerting industry participants that IRS is enforcing the law. To the extent that the report further identified the types of transactions that were found noncompliant, industry members would have information to use in judging the risks associated with new bond issuances. If periodic reports were designed so that individual issuances were not likely to be identified, the problems associated with the first two options would be minimized. However, given the low level of IRS activity in the tax-exempt bond area, an informed researcher might be able to determine which specific issues were being reported on even though an IRS report was deliberately constructed to minimize this possibility. Because of this potential, this option also would require a modification to the disclosure prohibition. Moreover, this option gives a periodic report on IRS enforcement actions that attempts to avoid identifying individual issuers, thus muting the possible adverse effects on individual issuers' future bonds.

The final option—disclosing descriptions of noncompliant bonds and the characteristics that made them noncompliant—would help the market participants to more effectively identify future bonds that may not comply with requirements. These descriptions could work in a manner similar to IRS letter rulings. Letter rulings explain whether a specific set of circumstances meets requirements of the IRC. Although letter rulings are not generalizable and do not form precedents, tax professionals use them to gain a better understanding of IRS' views. Similar descriptions for all bonds that IRS judges to be noncompliant could be used by investors to better judge the potential risks associated with particular types of tax-exempt bonds. An issuer or the issuer's bond counsel similarly would be better able to identify bond transactions that may not comply with requirements and either restructure the bonds or not issue them.

This option addresses the concern that disclosure would harm future issuances when issuers were not responsible for past noncompliance by focusing attention on the characteristics that caused the noncompliance. Although in some cases knowledgeable parties might identify the issuer of the bond, the issuer's future bonds may not suffer as long as they are not structured in a way that is similar to the transaction that was found to be noncompliant.

Simplifying Tax-Exempt Bond Laws and Regulations: Desirable but Difficult

Simplifying the laws and regulations that apply to tax-exempt bonds could reduce impediments to achieving compliance. Bond issuers would be better able to understand requirements and ensure that they are in compliance, and IRS could more efficiently use its limited resources. Some regulatory simplification can be achieved within the current statutory structure, and IRS has been pursuing this approach with some success. More comprehensive simplification, however, would require reconsidering the statutory framework governing tax-exempt bonds. Congress has considered revisions to simplify statutes, especially concerning the arbitrage restrictions for tax-exempt bonds.

Origins of Complexity

The IRC contains numerous provisions on the use of tax-exempt bond proceeds and controls on bond financing. These provisions have accumulated over time, especially in the past 2 decades. The statutory restrictions were meant to encourage the use of tax-exempt bonds for public-purpose projects, reduce the growing number of tax-exempt bond issuances, and limit certain types of transactions that Congress considered abusive. In large part, Congress has been incrementally narrowing the

scope of what constitutes a public purpose suitable for tax-exempt financing. These provisions accumulated as the tax-exempt bond industry grew and changed over time. As one congressional staff member observed, the tax law cannot be simple when the transactions the law governs are complex.

In addition, as the statutory restrictions have grown, IRS has issued regulations, revenue rulings, and other guidance to further explain and interpret the legal requirements. This information is extensive and complex. For example, in November 1992, IRS issued 177 pages of proposed rules on the IRC arbitrage restrictions. Despite their considerable length and technical complexity, these proposed rules are viewed by IRS as well as tax-exempt bond market participants as a major simplification to approximately 400 pages of existing rules.

Some of the statutory provisions also contain administrative mechanisms for IRS' use in overseeing tax-exempt bonds and administrative requirements for bond issuers to follow to comply with the law. For example, operators of low-income housing projects funded with tax-exempt bonds must file certifications regarding the income level of tenants, and issuers earning arbitrage usually must rebate the earnings to the United States.

Benefits and Costs

The additional restrictions that Congress has placed on tax-exempt bond use seem to have accomplished, at least in part, what Congress intended. For instance, the percentage of long-term tax-exempt bonds issued for private activities in general, which Congress sought to curb, has decreased since the Tax Reform Act of 1986 was enacted. On the other hand, Congress' success in curbing the use of tax-exempt bonds for private activities comes with some associated costs. Like the taxpayer, IRS is adversely affected by IRC complexity. In monitoring compliance, IRS must write regulations, publish rulings interpreting those regulations and the law, answer taxpayer questions, and render judgments when conducting examinations. These tasks are made more difficult and require more resources when the IRC is complex.

Similarly, issuers face administrative burdens and must devote more resources to understanding and complying with the detailed and confusing requirements. For example, as the National Association of Bond Lawyers stated in their April 20, 1990, response regarding tax simplification to the Chairman, Committee on Ways and Means, U.S. House of Representatives:

"Because the Internal Revenue Code is so complicated in the sections addressing tax-exempt finance, state and local governments cannot comply without hiring a variety of experts, much of the cost of which could be reduced with tax simplification. The result would be that more of the benefits of tax-exempt financing would go into public facilities."

Because they are difficult to understand and comply with, complex tax provisions requiring legal interpretation also may hamper decisionmaking by municipalities in selecting the best financing alternative for their infrastructure and economic development projects. Additionally, in many cases, provisions that are directed at the actions of a few issuers can result in administrative burdens for all issuers. For example, in their April 20, 1990, response regarding tax simplification to the Chairman, Committee on Ways and Means, U.S. House of Representatives, the Joint Committee on Taxation staff criticized Treasury's May 1989 temporary regulations on arbitrage rebate for requiring "a level of detail and precision that imposes administrative burdens significantly in excess of those necessary to ensure compliance with Congressional objectives" and recommended that in its revision of these regulations, Treasury "be instructed, to the extent possible, to organize the rules applicable to 'plain vanilla' governmental bonds separately from special rules applicable only to more complex, less frequently issued transactions."

Perhaps more importantly, the burdens resulting from multiple requirements, changes, and complexity may undermine voluntary compliance with the tax law by discouraging or impeding taxpayers from voluntarily complying with what they may judge to be unreasonable requirements or with what they may not understand. In describing its commitment to reducing taxpayer burden in its fiscal year 1992 Strategic Business Plan, IRS acknowledged the role of tax law complexity in making voluntary compliance more difficult. Similarly, in the preface to the Committee on Ways and Means, U.S. House of Representatives, May 1990 compilation of written proposals on tax simplification submitted to it, the Chairman cited the responsibility of Congress and the Committee for pursuing meaningful tax simplification to ease compliance burdens facing taxpayers and to maintain the viability of the voluntary tax system. At the 1990 Invitational Conference on the Reduction of Income Tax Complexity, a former Commissioner of the IRS also addressed this issue by stating, "[I]n order to voluntarily comply, taxpayers must be both willing and able to comply. . . . The real threat of change and complexity in our tax system is that they may so undermine the willingness and ability of a sufficiently large number of our taxpayers to voluntarily comply that it could substantially and adversely affect our tax system."

Recent Simplification Efforts

Both the legislative and executive branches have been working to simplify tax-exempt bond requirements. Several bills were introduced during the 102nd Congress that included provisions intended to simplify these requirements. Treasury and IRS officials have shown a willingness to take on the major problem areas, and IRS has been working at simplifying related regulations. In its Strategic Business Plan, IRS has described an organizational goal to reduce the burden on taxpayers and enhance voluntary compliance by making it easier for taxpayers to comply with the law.

During the 102nd Congress, bills were considered that would make changes intended to simplify some of the tax-exempt bond requirements, especially those related to arbitrage rebate. For example, proposals were made to decrease the number of issuers that would be subject to arbitrage rebate requirements by increasing the applicable dollar thresholds for exceptions and to eliminate more complex arbitrage restrictions that achieve purposes similar to those achieved by less complex provisions.

Treasury and IRS have been working to simplify tax-exempt bond arbitrage regulations, including the temporary arbitrage rules issued in May 1989. In May 1992, Treasury issued the 1989 temporary rules, with interim amendments, as final regulations. At the same time, IRS and Treasury announced a commitment to simplify and clarify those regulations by revising and finalizing them by June 1993. In November 1992, Treasury issued 177 pages of proposed regulations on arbitrage restrictions to replace approximately 400 pages of existing rules on arbitrage. Generally viewed as a major simplification, the proposed regulations would provide greater coordination of the rules on yield restriction and rebate, more unified definitions, general antiabuse rules in lieu of numerous special rules, clarifications of ambiguous areas, and new guidance on many previously reserved topics. As an example, the proposed regulations would provide a one-time yield computation for a fixed yield issue, which generally would eliminate the requirement to recalculate the yield on a fixed-yield issue except in narrow circumstances. A representative of the National Association of Bond Lawyers referred to the proposed regulations as an important move toward simplification because of their smaller size as well as the guidance they provided in areas such as rebate exception.

Conclusions

Although the extent is unknown, IRS has found some noncompliance in the tax-exempt bond area. However, IRS' ability to effectively address

noncompliance and promote overall market compliance could be enhanced if the law provided further incentives to deter noncompliance.

IRS could more appropriately penalize noncompliance in the tax-exempt bond industry, and thereby promote compliance, if it had a choice of penalties beyond the basic sanction of taxing the interest earned by bondholders. Taxing the interest on bonds is administratively complex, penalizes investors rather than directly punishing the parties most likely responsible for the abusive transactions, and is a severe sanction to levy for minor infractions such as filing Forms 8038 late. Until recently, IRS avoided taxing bondholders largely for these reasons. Instead, they entered into closing agreements. Yet officials have judged this reliance on closing agreements to be inadequate in promoting compliance and have had to resort to pursuing the taxation of bondholders; effective alternative penalties are not available for the cases they have targeted.

IRS can use the penalty for promoting abusive tax shelters contained in IRC section 6700 to direct penalties to those responsible for tax-exempt bond abuses. However, IRS has not had a good opportunity to apply it because the noncompliance cases it is pursuing predate the January 1, 1990, effective date of legislative language that more clearly makes the resulting penalty worth the effort. Because this penalty would be targeted to those responsible for noncompliance, we believe IRS should test it for tax-exempt bond abuses that have occurred after the effective date of the clarifying legislative language to determine whether it can be used to effectively enhance tax-exempt bond compliance.

Even if the section 6700 penalty can be successfully used by IRS to target responsible parties in abuses that amount to promoting abusive tax shelters, the nature and seriousness of potential tax-exempt bond abuses vary widely. For many potential abuses, the taxation of bondholders' interest is not commensurate with the severity of the violation, in addition to being a sanction that is not directed at the responsible party. Additional alternative penalties, including narrower penalties for specific kinds of noncompliance, such as failure to file tax-exempt bond returns, would assist IRS in promoting compliance.

Several disclosure options could provide additional incentives to promote compliance with tax-exempt bond requirements. If information about tax-exempt bond enforcement actions could be released, the market forces created by the motivation of tax-exempt bond market participants to protect their reputations and financial interests could better assist IRS in

ensuring compliance. One important component of an efficient market that would be strengthened by disclosure is the free exchange of information with which market participants can make reasoned judgments about compliance risks.

Removal of the current prohibition on disclosure, even in a limited sense, however, must be carefully considered. The concerns related to disclosing information either do not apply as strongly for tax-exempt bonds as for other protected information or may be alleviated through a carefully designed disclosure provision. Because the disclosure prohibitions currently are contained in law and very inclusive, arguably prohibiting even a very general report on IRS enforcement activities, Treasury cannot effect this change on its own. Therefore, we believe Congress should consider options allowing some disclosure of IRS' tax-exempt bond enforcement efforts.

Simplifying tax-exempt bond requirements, as Congress and the executive branch are considering, is desirable. Simplification could enhance compliance by countering the burdens to both IRS and issuers associated with complexity. Nevertheless, because Congress is likely to retain many restrictions that are intended to preclude transactions that it considers undesirable, the rules governing tax-exempt bonds probably will remain relatively complex. Consequently, IRS will need to encourage voluntary compliance through such means as education of participants in the tax-exempt bond market, clear regulations, and well-designed enforcement programs.

Recommendation

We recommend that the Commissioner of Internal Revenue test the use of the penalty contained in IRC section 6700 for promoting abusive tax shelters in appropriate tax-exempt bond abuse cases to determine whether this penalty is an effective tool for encouraging tax-exempt bond voluntary compliance. In doing so, the Commissioner needs to determine whether in practice the penalty is reasonably administrable and is of sufficient magnitude to deter noncompliance.

Matters for Congressional Consideration

Congress may want to consider several options to enhance tax-exempt bond voluntary compliance. The penalty structure for tax-exempt bond abuses needs to be improved. Congress may want to consider adopting other penalties for specific kinds of noncompliance. Also, if after testing IRS finds that the section 6700 penalty is not effective in encouraging

compliance in the tax-exempt bond market, Congress may want to consider further revising section 6700 or adopting additional penalties. We also believe Congress should consider whether permitting the disclosure of some tax-exempt bond-related tax information, with appropriate safeguards, would improve overall compliance incentives in the tax-exempt bond industry.

Agency Comments and Our Evaluation

In oral comments on a draft of this report, IRS officials generally agreed with our recommendation. IRS agreed that the emphasis of tax-exempt bond enforcement activities should be on the promoters and not on the investors. However, they said that the application of the section 6700 penalty to tax-exempt bond abuses is difficult in that it is hard to prove and applies only to cases after 1989. We agree that this penalty could be difficult to apply in a tax-exempt bond case because intent is difficult to prove and, as we said in our report, IRS must prove that those parties considered responsible in the case intentionally promoted a bond through which investors could improperly shelter income and avoid paying taxes. It is for this reason that we believe IRS should test the use of the penalty to determine whether it is an effective tool for encouraging tax-exempt bond voluntary compliance. It is also another reason that Congress may want to consider alternatives. In that regard, IRS officials also agreed that permitting the disclosure of some tax-exempt bond information is an issue for Congress to decide.

Tax-Exempt Bond Requirements in the Internal Revenue Code

Tables I.1 through I.11 provide summary explanations of the major subsections related to the 11 sections of the Internal Revenue Code (IRC) that comprise the primary statutory provisions on tax-exempt bonds (sections 103 and 141 through 150).[1] Because some related tax-exempt bond provisions are not grouped together but interspersed throughout the tax-exempt bond sections of the IRC, we reorganized related sections and subsections as follows:

- Table I.1 covers the overall tax exemption (section 103).
- Tables I.2 and I.3 cover the sections of the IRC that apply to all governmental and private activity bonds (sections 148 and 149).
- Tables I.4 through I.7 cover the sections of the IRC that generally apply to all tax-exempt private activity bonds (sections 141, 146, 147, and 150).
- Tables I.8 through I.11 cover the sections of the IRC that apply to specific qualified private activity bonds (sections 142, 143, 144, and 145).

Table I.1: IRC Section 103—Overall Tax Exemption for Interest on State and Local Bonds

Requirement	Explanation
Overall tax exemption	Gross income does not include interest on any state or local bond.
Exceptions	**Nonqualified private activity bonds (PAB).** A PAB must be qualified to be tax-exempt. **Arbitrage bonds.** A bond cannot be issued for the purpose of earning arbitrage. **Nonregistered bonds.** Bonds must generally be issued in registered form.

[1]These tables are based on the table entitled "Summary of Tax-Exempt Bond Provisions" included in Tax Policy: Internal Revenue Code Provisions Related to Tax-Exempt Bonds (GAO/GGD-91-124FS, Sept. 27, 1991). The sections, subsections, and explanations included in these tables are updated through the enactment of the Tax Extension Act of 1991. The tables do not (1) detail all of the technical intricacies of the tax laws, (2) include references to the Department of the Treasury's authority to prescribe regulations and certain definitions, or (3) represent a legal interpretation of the various tax-exempt bond provisions. Consequently, the IRC should be consulted for details on the full legal requirements associated with the use of tax-exempt bonds. Additionally, these tables do not detail the myriad of other laws and regulations that may apply, such as applicable Treasury regulations, antifraud and securities law, and state and local laws.

Table I.2: IRC Section 148—Arbitrage Requirements Applicable to All Tax-Exempt Bonds

Requirement	Explanation
Arbitrage bond	Any bond that is issued as part of an issue of which any portion of the proceeds are reasonably expected to be used directly or indirectly to acquire higher yielding investments or to replace funds that were used directly or indirectly to acquire higher yielding investments.
Higher yielding investment	Any "investment property"[a] producing a yield over the term of issue that is materially higher than the yield on the issue. In certain cases, investment property includes tax-exempt bonds in which an alternative minimum tax must be paid on the interest as defined in section 57(a)(5)(c).
Temporary period exception	The period before the spending of bond proceeds when arbitrage can be earned without rebating. The length of the period differs for various types of bonds.
Special rules for reserve and replacement allowances	These rules permit 10 percent of bond proceeds to be invested in higher yielding investments that are part of a reasonably required reserve or replacement fund. Additional requirements and exceptions are specified for bond proceeds that are invested in investments that are not related to the purpose for which a bond is issued.
Minor portion—lesser of 5 percent or $100,000	Notwithstanding other restrictions, a de minimis amount of 5 percent or $100,000 may be used for higher yielding investments.
Arbitrage rebate[b]	The IRC requires that the issuer rebate to theU.S. excess profits when the bonds are called or once every 5 years in installments of 90 percent of the rebatable portion. In determining whether the arbitrage is rebated and if so, how much, several special rules must be followed. For determining the arbitrage amount, exceptions from the rebate requirements are specified for the following: certain temporary investments, proceeds used to finance certain construction expenditures, governmental units using $5 million or less of bonds, and certain qualified student loan bonds. Certain issuers may elect to pay a penalty instead of a rebate.
Student loan incentive payments exclusion	Except to the extent that is otherwise provided in regulations, payments that are made according to section 438 of the Higher Education Act of 1965 are not considered for purposes of acquiring higher yielding investments in determining yields on student loan notes.
Determination of yield	The yield will be determined on the basis of the issue price within the meaning of IRC sections 1273 and 1274.

[a]Investment property is defined as follows: any security that falls within the meaning of section 165(g)(2)(A) or (B); any obligation (excluding tax-exempt bonds, except any PAB that is issued after August 7, 1986, and interest of which is not includable in gross income under section 103); any annuity contract; any investment-type property; or, for non-PABs, any residential rental property that is used for family units outside of the jurisdiction of the issuer and that is not acquired to implement a court-ordered or -approved housing desegregation plan.

[b]The rebate is equal to the amount earned on all nonpurpose investments minus the amount that would have been earned if such nonpurpose investments were invested at a rate equal to the yield on the issue, plus any income attributable to the excess described above.

Table I.3: IRC Section 149—Other Requirements That Apply to Tax-Exempt Bonds in General

Requirement	Explanation
Registration requirement	A bond must generally be in registered form unless it is of a type that is not offered to the public; matures in less than 1 year; is sold or resold to a non-U.S. person, and the interest is payable only outside the U.S. (and its possessions); and includes on its face a statement that any U.S. person who holds the obligation will be subject to limitations under U.S. tax laws. Certain exceptions and special rules apply.
No federal guarantee allowed[a]	Interest and principal payments may not be backed by the federal government, with certain exceptions, such as certain insurance programs (including Federal Housing Administration, Federal Home Loan Mortgage Corporation), debt service, housing programs, and loans or guarantees to financial institutions.
Tax exemption must be derived from this title	Generally, no interest on any bond, except as provided in section 149(c)(2), shall be exempt from taxation under this title unless the interest is exempt from tax under this title without regard to other provisions of law. Certain prior exemptions are excluded.
Advance refunding bonds	An advance refunding is a bond issued more than 90 days before the redemption of the refunded bond (i.e., the original issue). However, no exemption is provided under section 103 for advance refundings of certain PABs, certain other bonds, and abusive transactions. Rules specify additional conditions for exemption, such as limits on the number of times an original issue can be refinanced through advance refunding.
Information reporting	Certain information must be reported by the issuer to IRS concerning the bond issue in a stated time period that may be extended by the Secretary of Treasury through IRS if willful neglect is not involved.
Treatment of pooled financing bonds	Pooled financing bonds are generally bonds that are issued as part of an issue when more than $5 million of the proceeds are reasonably expected to be used directly or indirectly to make or finance loans to two or more borrowers. Restrictions govern the manner and timing of the payment of issuance costs. Another restriction, the reasonable expectation requirement, requires that the issuer reasonably expects that 95 percent of the net proceeds will be loaned within 3 years of issuance.
Treatment of hedge bonds	The IRC places certain conditions on the tax-exemption for interest on bonds that are issued before they are needed to take advantage of lower interest costs. Hedge bonds must meet the reasonable expectations criteria as to when proceeds will be spent, what determines a hedge bond, and other special rules.

[a]Certain exceptions exist. See section 149(b)(3).

Table I.4: IRC Section 141—Private Activity Bonds and Private Activity Bonds That Are Qualified Bonds for Tax-Exemption

Requirement	Explanation
Private activity bond determination	A PAB is any bond that meets the private business use and private security or payment test or that meets the private loan financing test.
Qualified bonds	Once a bond is deemed a PAB it must meet the requirements for one of the seven types of qualified bonds that are specified in section 141 (e)(1)(A-G) to be tax exempt. The seven types of qualified bonds are exempt facilities, qualified mortgage bonds, qualified veterans mortgage bonds, qualified small-issue bonds, qualified student loan bonds, qualified redevelopment bonds, or qualified 501(c)(3) bonds.a
Private business tests	**Private business use test**. More than 10 percent of the proceeds of the issue are used for any private trade or business use. **Private security or payment test**. The payment of the principal or interest on more than 10 percent of the proceeds is directly or indirectly (a) secured by any interest in the property used or that is to be used for a private business use, or that is secured by any interest in payments from the property, or (b) to be derived from the payments from the property or from borrowed money that is used or that is to be used for a private business use. **Five percent test for business use not related or disproportionate to government use**. An issue meets the private business use and private security or payment tests if more than 5 percent of the proceeds, payments, property, and borrowed money from any use of proceeds are used for private business in which (1) the proceeds that are used for any private use are not related to any government use, and (2) the proceeds that are used for private business exceed the proceeds used for related government use. **Coordination with volume cap if nonqualified amount exceeds $15 million**. Any bond will be treated as a PAB if the portion of the bond that is used for private or business purposes (nonqualified amount) exceeds $15 million, even if it does not exceed the other previously discussed private business tests. Issuers can avoid PAB designation if they use a portion of the state volume cap for PABs to cover this amount.

(continued)

Requirement	Explanation
Private business tests (*continued*)	**Lower limitation for certain output facilities.** Any issue using 5 percent or more of the proceeds for any output facility, such as electric energy or gas, shall be treated as meeting the private business tests if the nonqualified amount exceeds $15 million minus the aggregate nonqualified amounts of all prior tax-exempt issues of which 5 percent or more of the proceeds were used to finance such a facility (or any other facility that is part of the same project). **Qualified 501(c)(3) exception.** The private business test and the private loan financing test will not apply to the portion of the proceeds that are elected to be treated as a qualified 501(c)(3) bond.
Private loan financing test	An issue meets the private loan financing test if the amount of the proceeds that are to be used to make or finance loans to persons other than governmental units exceeds the lesser of 5 percent or $5 million.
Issues used to acquire nongovernmental output property[b]	PABs include bonds that are used by a governmental unit to acquire nongovernmental output property if the bond proceeds exceed the lesser of 5 percent or $5 million, with certain exceptions for output to certain areas and property that is converted to nonoutput use.

[a]See IRC section 501(c)(3) for an explanation of these tax-exempt organizations.

[b]An issue in which 5 percent or more of the proceeds are to be used for any output facility will be deemed a PAB if the nonqualified amount exceeds the excess of $15 million over the aggregate nonqualified amounts of all prior issues, in which 5 percent or more of the proceeds are or will be used for the same facility.

Table I.5: IRC Section 146—Volume Cap Restrictions for Qualified PABs

Requirement	Explanation
General rule for volume cap	The amount of PABs that are issued during any calendar year cannot exceed the volume cap for the state agency and other issuing authorities, such as local governments within the state.
State ceiling	The ceiling for any state is $75 multiplied by the state population or $250 million through 1987 and $50 multiplied by the state population or $150 million after 1987. Certain other restrictions apply for constitutional home rule cities, and special rules apply for U.S. possessions.
Volume cap for state agencies	A state agency is allocated 50 percent of the state ceiling for the year. If a state has multiple agencies that are authorized to issue PABs, the agencies will be treated as a single agency.
Volume cap for other issuers within the state	The cap for issuing authorities other than state agencies is 50 percent of the state ceiling. The ceiling for each of the issuing authorities will be the ratio of the authority's population to the state's population.
State may provide for different allocation	States may provide a different volume allocation for authorities or government units. Exceptions apply to constitutional home rule cities.
3-year unused carry-forward election for specified purpose	An issuer may elect to carry forward all or any portion of its unused volume cap for up to 3 years for one or more of the following qualified carry-forward purposes: exempt facility bonds, qualified mortgage bonds, mortgage credit certificates, qualified student loan bonds, or qualified redevelopment bonds. Carry-forward is used in the order in which it arises, and carry-forward that is used for bonds that are issued does not affect the volume cap.
Exception for certain bonds	PABs that are excluded from the volume cap are qualified veterans' mortgage bonds, any qualified 501(c)(3) bonds, any exempt facility bonds of subsection 142(a)(1) (airports) or (2) (docks and wharves), and 75 percent of any bond that is issued as described in section 142(a)(11) (high-speed intercity rail facilities).
Exception for governmental solid waste disposal	For volume cap purposes, PABs do not include exempt facility bonds as described in section 142(a)(6) (solid waste disposal) that are issued as part of an issue if all of the property to be financed by the net proceeds is to be governmentally owned using a safe harbor test to determine ownership.
Treatment of refunding issues	Refunding bonds will not affect the volume cap provided that they do not exceed the amount of the refunded bond. Special rules apply to refunding bonds for student loan and qualified mortgage bonds and for determining average maturity. This exclusion does not apply to advance refunding bonds.

(continued)

Requirement	Explanation
Facility must be located within the state	No portion of the state ceiling can be used to finance a facility outside of the state. An exception is made for water furnishing, sewage, solid waste disposal, or qualified hazardous waste facilities if the issuer establishes that the state's share of use or output will equal or exceed the state's share of PABs issued for the facility. Bonds for certain output facilities and for other exempt facilities are also excepted from this rule.
Issuer of qualified scholarship funding bonds	Qualified scholarship funding bonds are to be treated as issued by a state or local issuing authority (whichever is appropriate).
Treatment of amounts allocated to private activity portion of government use bonds	The volume cap shall be reduced by the amount allocated by the issuer to an issue where the private activity portion exceeds $15 million. Any advance refundings will be taken out of the volume cap to the extent that it was or would have been allocated for this purpose.
Reduction for mortgage credit certificates	The volume cap of any issuing authority shall be reduced by the sum of the amount of qualified mortgage bonds not issued under section 25(c)(2)(A)(ii) (qualified credit certificate programs) during the year, plus the amount of any qualified mortgage bonds used for certificates that do not meet requirements in section 25(d).

Table I.6: IRC Section 147—Other Restrictions for PABs

Requirement	Explanation
Substantial user restriction	PABs must not be held by the person who is the substantial user of the facilities (or related person of such substantial user).
Maturity limits	For certain bonds, the IRC restricts the maximum allowable average maturity of bonds to 120 percent of the reasonably expected average economic life of facilities that are being financed. Certain special rules apply, such as the treatment of pooled financing of 501(c)(3) bonds and Federal Housing Administration insured loans.
Limitation on use for land acquisition	The IRC provides that 25 percent or more of the proceeds cannot be used to acquire land and that no percentage can be used to buy land for farm use. An exception is made for first-time farmers and certain land acquired for environmental purposes, such as noise abatement and wetland preservation, or for future specified transportation facilities.
Acquisition of existing property not permitted	The use of net proceeds to cover the cost of previously purchased property is not allowed, except for certain rehabilitations. A special rule applies for certain projects.
Disallowed usages of proceeds	A PAB shall not be a qualified bond if it is issued as part of an issue from which any portion of the proceeds is to be used to provide an airplane, a skybox or other luxury box, a health club facility, a facility that is used primarily for gambling, or a store that is primarily in business for the sale of off-premises alcohol consumption.
Public approval	A bond must be publicly approved by the appropriate governmental unit either by an applicable elected representative or by voter referendum. Special rules define the governmental unit that must approve PABs for (1) airports or high-speed intercity rail facilities and (2) scholarship funding bond issues and volunteer fire department bonds.
Cost of issuance (2 percent and 3.5 percent)	The IRC restricts the amount of bond proceeds that can be used for issuance costs to 2 percent (or 3.5 percent in the case of qualified mortgage bonds or qualified veterans' mortgage bonds if the proceeds of the issue do not exceed $20 million).
Certain rules not to apply to mortgage revenue bonds, qualified student loan bonds, and qualified 501(c)(3) bonds	Certain subsections (substantial user restriction, maturity limits, land acquisition, and acquisition of existing property) do not apply to mortgage revenue bonds and qualified student loan bonds; and certain subsections (substantial user restriction, land acquisition, acquisition of existing property, and the "health club facility" portion of the disallowed usages restriction) do not apply to qualified 501(c)(3) bonds.

Table I.7: IRC Section 150—Definitions and Special Rules for PABs

Requirement	Explanation
Change in use	The IRC restricts the changing of use or ownership of most PAB-acquired property and projects. **Mortgage revenue bonds**. Special rules apply that result in the nondeductibility of interest (that accrues during a continuous period of at least 1 year when the residence is not the principal residence for at least one original mortgagor) paid on mortgage or veterans' mortgage bond-financed residences. **Qualified residential rental projects**. Special rules apply for bonds that are used to finance qualified residential rental projects that result in the nondeductibility of interest, which accrues during the period beginning on the first day of the taxable year in which the project fails to meet elected set-asides for low-income tenants and ending on the date the project meets such requirements. Exceptions are provided for advance refundings. **Qualified 501(c)(3) bonds**. Special rules apply that result in the nondeductibility of interest paid during the time that a portion of a 501(c)(3) or governmentally owned unit is used in a trade or business of any person other than a 501(c)(3) organization or governmental unit but continues to be owned by the 501(c)(3) organization or governmental unit. The 501(c)(3) organization will also have to recognize unrelated trade or business income with respect to such portion in an amount not less than its fair rental value. **Certain exempt facilities and small-issue bonds**. Facilities that are financed with proceeds from exempt facility bonds or qualified small-issue bonds must be used for a purpose for which a tax-exempt bond could have been issued, or the interest is not deductible during the period that this facility is not so used. **Facilities financed by PABs required to be owned by 501(c)(3)s or governmental units**. The facilities must be so owned or the deduction of interest is not allowed during the period that the facilities are not so owned. **Certain small-issue bonds that exceed capital expenditure limitation**. In the case of financing that is provided from the proceeds of any purported small-issue bond, no deduction is allowed for interest that is accrued during the period that such a bond is not a qualified small-issue bond.

(continued)

Requirement	Explanation
Exceptions and special rules for changes in use contained in subsection 150(b)	Change in use requirements only apply to the portion of a facility that is financed by bond proceeds and that is not used for the exempt purpose. Proceeds that are not required to be used for the exempt purpose are excepted from the change in use restrictions. Special rules apply to the treatment of amounts other than interest.
Qualified scholarship funding bond	Bonds falling within the defined meaning of qualified scholarship funding bonds are treated as state or local bonds, not as PABs.
Bonds of certain volunteer fire departments	These bonds are to be treated as bonds of a political subdivision of a state if certain qualifications are met. However, these bonds are treated as PABs for the purposes of public approval (section 147(f)) and advance refundings (section 149(d)).

Table I.8: IRC Section 142—Exempt Facility PABs

Requirement	Explanation
Exempt facility bonds	Exempt facility bonds include the following: airports, docks and wharves, mass commuting facilities, facilities for the furnishing of water, sewage facilities, solid waste disposal facilities, qualified residential rental projects, facilities for the local furnishing of electric energy or gas, local district heating or cooling facilities, qualified hazardous waste facilities, or high-speed intercity rail facilities.
95 percent or more of the proceeds are used to provide for an exempt activity	The IRC restricts to no more than 5 percent the amount of bond proceeds that can be used for nonexempt activities and still qualify as an exempt facility bond.
Special exempt facility bond rules	The IRC requires that certain facilities (airports, docks and wharves, and mass commuting facilities) be governmentally owned and restricts the location and use of office space that can be treated as an exempt facility.
Airports, docks and wharves, mass commuting facilities, and high-speed intercity rail facilities	The IRC defines eligibility for exempt financing of storage and training facilities that are related to airports, docks and wharves, mass commuting facilities, and high-speed intercity rail facilities. It denies exempt financing for certain private establishments that are associated with these exempt facilities, such as lodging and certain retail establishments (in excess of the size needed to serve passengers and employees of the exempt facility).
Qualified residential rental project	The IRC requires that 95 percent or more of the bond proceeds be used for qualified residential rental projects and that certain occupancy requirements, special rules, current income eligibility determinations, and certifications be met throughout the qualified project period.
Special facility restrictions	Subsections 142(e) through 142(i) of the IRC contain restrictions and definitions that specify how certain exempt facilities are to be operated. For example, exempt financing will be available only for the local furnishing of electric energy or gas within an area consisting of (1) a city and one contiguous county or (2) two contiguous counties.

Table I.9: IRC Section 143—Mortgage Revenue Bonds: Qualified Mortgage Bonds and Qualified Veterans' Mortgage Bonds

Requirement	Explanation
Qualified mortgage bonds[a]	**Qualified mortgage bond requirements.** The IRC requires that a qualifying bond meet certain requirements and other specified good-faith tests, such as using all of the proceeds, except issuance costs and a reasonably required reserve, to finance owner-occupied residences. Proceeds must generally be used within 42 months of issuance. **3-year requirement.** 95 percent or more of the proceeds must be used to finance residences for mortgagors who had no prior ownership interests in their principal residence during the 3-year period ending on the mortgage execution date. Exceptions exist for targeted areas, qualified home improvement loans, and qualified rehabilitation loans. **Purchase price requirement.** The IRC restricts the acquisition cost to 90 percent of the average area purchase price (except for qualified home improvement loans) or 110 percent in the case of targeted areas. The average purchase price is determined separately for new versus previously occupied residences and for single- to four-family residences. **Income requirements.** Generally, the purchasers' income cannot exceed 115 percent of the applicable family median income. Special rules apply for targeted area residences and to the adjustments of income requirement based on the relationship of high housing costs to income and family size. **Portion of loans required to be placed in targeted areas.** The IRC requires that a certain amount of proceeds be set aside for targeted area residences for a prescribed period of time. **Recapture of federal subsidy.** If a taxpayer disposes of a federally subsidized property, then he or she must pay a recapture amount. A number of exceptions, limitations, and special rules apply.
Qualified veterans' mortgage bonds	**Qualified veterans' mortgage bonds requirements.** The IRC requires that a qualifying bond meet certain requirements, such as that at least 95 percent of the proceeds must be used to provide residences for veterans and good-faith tests. **Additional requirements.** Additional restrictions apply to qualified veterans' mortgage bonds including (1) that the mortgagor be a qualified veteran, (2) that the state program be effective before June 22, 1984, and (3) that the volume does not exceed the state veterans' limit. A special rule applies for short-term bonds.

(continued)

Requirement	Explanation
Requirements applying to both qualified mortgage and veterans' mortgage bonds	**Residence requirement.** The IRC requires that the mortgagor live principally in the mortgaged residence and that it is located within the jurisdiction of the issuing authority.
	Additional arbitrage restrictions. Additional arbitrage restrictions apply to qualified mortgage and veterans' mortgage bonds. The effective rate of mortgage interest cannot exceed the bond yield by more than 1.125 percentage points. Any arbitrage and investment gains from qualified veterans' mortgage bonds must be used to reduce costs of owner financing.
	Other requirements. Mortgages must generally be new mortgages. Certain requirements must be met where the mortgage is assumed for qualified mortgage bonds.

[a]The tax exemption for qualified mortgage bonds expired June 30, 1992. In a related area, the mortgage credit certificate program of IRC section 25 also expired June 30, 1992.

Table I.10: IRC Section 144—Qualified Small-Issue Bonds, Qualified Student Loan Bonds, and Qualified Redevelopment Bonds

Requirement	Explanation
Qualified small-issue bonds[a]	**Qualified small-issue bond requirements.** Small-issue bonds are bonds that are issued as part of an issue not exceeding an aggregate face amount of $1 million. At least 95 percent of the net proceeds must be used to finance manufacturing facilities or land for first time farmers. **Prior issues (aggregate).** Under certain circumstances, prior issues are aggregated with any later issue in determining the aggregate amount of that issue, such as facilities located in the same incorporated municipality or county or the principal user being two or more related persons. **$10 million special case limit.** The limit is increased to $10 million in certain cases for the aggregate face amount. **5 percent residential purpose limit.** Bonds where 5 percent or more of the proceeds are used for residential property do not qualify as small-issue bonds. **Limitations on treatment of bonds as part of the same issue.** Generally, bonds that would be treated as part of the same issue will be treated as separate issues unless the proceeds of such bonds are to be used for two or more facilities located in more than one state, or which have the same person or related persons as the principal user. Special restrictions exist for franchises. **Subsection not to apply if bonds are issued with certain other tax-exempt bonds.** The small-issue bond subsection does not apply to bonds that are issued as part of other tax-exempt issues (other than those applicable under the $10 million limit). **Restrictions on certain facilities.** The IRC restricts the amount of proceeds that can be used for facilities having certain retail or recreational facilities as their primary purposes. **Aggregation of issues with respect to single project.** Two or more issues will be treated as one issue if part or all of the net proceeds are to be used for a single building; enclosed mall; or strip of offices, stores, or warehouses using common facilities. **$40 million taxpayer limit.** The IRC limits the amount that a facility owner or principal user can be allocated to $40 million during an initial 3-year period.

(continued)

Requirement	Explanation
	$250,000 limit on depreciable farm property. The IRC limits to $250,000 the amount of proceeds that can be used to provide depreciable farm property whether the principal user will be the same person or two or more related persons.
Qualified student loan bonds	**Qualified student loan bond requirements.** The proceeds of qualified student loan bonds are to be used directly or indirectly for student loans. **Higher Education Act of 1965 applies.** A qualified student loan bond must be issued under a student loan program that (1) meets the requirements of the Higher Education Act of 1965 or (2) is approved by the state if certain limitations are imposed. **Applicable percentages for qualifying status.** 90 percent or more of the proceeds must be used to finance student loans under the Higher Education Act programs and 95 percent or more for state-approved programs. **Residence and nonbias requirement.** The student must be a resident or student in the issuing state and the program may not discriminate on the basis of the location of the school.
Qualified redevelopment bonds	**Qualified redevelopment bond requirements.** 95 percent or more of the proceeds must be used for one or more redevelopment purposes in areas that are designated by the local governing body as blighted. **Additional restrictions.** The IRC requires that state laws authorize redevelopment bonds that are secured by the general taxing authority of the governmental unit; that local redevelopment plans must be adopted before issuance; that sales of property acquired by the local government must be at fair-market value; and that no additional charges are required of owners or users of property located in the financed area. **Redevelopment purposes.** The IRC defines what represents redevelopment purposes, including the acquisition of real property in blighted areas, the clearing and preparation of property, the rehabilitation of property, and the relocation of occupants. New construction is not included. **Designated blighted areas.** Generally, the IRC restricts the amount of real property that can be designated as blighted to 20 percent of the total assessed real property in the jurisdiction and quantifies what constitutes a minimum designated blighted area.

(continued)

Requirement	Explanation
Qualified *redevelopment bonds* (continued)	**No additional charge requirements.** The IRC requires that *users or owners of property that is located in a financed area* not be charged fees or be assessed differently (with respect to the property) than owners or users of property of the same type that lies within the jurisdiction of the governmental unit but outside of the area that is financed with bond proceeds. **Use of proceeds requirements.** The IRC restricts the amount of proceeds that can be used for certain types of activities, such as retail food establishments and recreational facilities. **Restriction on acquisition of land not to apply.** The 25-percent land limit restriction of section 147(c) does not apply to redevelopment bond proceeds.

[a]The tax exemption for qualified small-issue bonds expired on June 30, 1992.

Table I.11: IRC Section 145—Qualified 501(c)(3) Bonds

Requirement	Explanation
Qualified 501(c)(3) bond requirements	A qualified 501(c)(3) bond is any PAB that is issued where (1) all of the property is to be owned by the 501(c)(3) or a governmental unit and (2) 5 percent or less of the proceeds are used for private business and private security or payment and the 501(c)(3) organization is treated as a governmental unit with respect to its tax-exempt activities.
Qualified hospital bond	When 95 percent or more of the proceeds are to be used for hospital purposes, a bond is a qualified hospital bond.
$150 million limit on nonhospital bonds	The IRC restricts the amount of nonhospital bonds that can be outstanding at one time to $150 million for each exempt organization. Other restrictions include a requirement that two or more organizations under common management or control be treated as one organization.
Restrictions on residential rental housing for family units	The IRC restricts the amount of proceeds that can be used for housing,[a] except for qualified residential rental housing bonds that are to be used for family units or property that is scheduled for rehabilitation. This section also defines when certain property is to be treated as new or substantially rehabilitated, with certain exceptions.
Election out	Qualified 501(c)(3) bond restrictions do not apply to bonds if the issuer elects not to have this section apply and if such issue is an exempt facility bond or qualified redevelopment bond to which the volume cap applies.

[a]Section 145 (d)(2) addresses restrictions to this section of the IRC.

Example of a Tax-Exempt Bond Abuse

IRS' recent tax-exempt bond enforcement efforts have focused on bonds issued mostly in 1985 or 1986 that allegedly attempted to disguise the use of bond proceeds to earn arbitrage through a variety of complex and difficult-to-trace series of transactions. Many of these bonds were industrial development bonds issued for residential rental projects. When this type of tax-exempt bond is issued to build a project, the bond proceeds are usually lent to a developer and the developer is responsible for paying back the proceeds plus interest so that the issuer can pay interest to the bondholders and at some point redeem the bonds. However, the developer must be able to provide assurance to the issuer and the bondholders that it can pay back the borrowed proceeds plus interest. If the developer does not have a sufficient credit rating of its own, or if the issuer wants backup assurance, the developer must obtain alternative assurance (an alternate security) that the issuer, and thus the bondholders, will be repaid.

For example, a bank can provide the developer with a letter of credit and, in exchange, the developer may give the bank a mortgage note secured by the project. The letter of credit basically provides that if the developer cannot, for any reason, repay the issuer, the letter-of-credit bank will do so. To better protect bondholders from the possibility of the developer going bankrupt, the letter-of-credit bank may directly repay the issuer, possibly through a trustee, which is a bank designated by the issuer as the custodian of the bond's funds and the official representative of the bondholders. The developer then repays the letter-of-credit bank for the payments it has made to the issuer.

Tax-exempt bond financing structures used in some of the abuses IRS has been focusing on exploited the situation of a developer obtaining such an alternate security. For example, the use of one such structure to obscure the use of bond proceeds to earn arbitrage is referred to as a "black box" abuse because of the difficulty in identifying all of the structure's components and tracing the bond proceeds within that structure.

In a simplified description of one black box abuse, the proposed project's soundness is questionable so a legitimate letter-of-credit bank does not want to back it. The abusive participants use this opportunity to create a shell corporation, which has no substantial assets, to provide the letter of credit. Thus the shell must sell the developer's mortgage note to a mortgage note purchaser so that it has the funds to make payments to the trustee bank for the developer. Through a disguised series of transactions, the mortgage note purchaser, who is a party to the abuse, obtains bond

proceeds from the trustee bank to purchase the mortgage note. The mortgage note purchaser pays less than face value for the mortgage note, but the shell corporation invests the bond proceeds from the sale in a higher yielding investment (typically a guaranteed investment contract). Thus, the shell corporation earns enough to pay the interest on the bonds. The remaining bond proceeds not used to purchase the discounted mortgage note (other than proceeds spent on costs of issuance or the reasonable administrative costs of the issuer) are viewed by IRS as impermissible arbitrage. The financial structures of these bonds and their complexity varied, but common elements underlying most of the structures were that at issuance (1) reasonable expectations that the bond proceeds would be used for their stated purpose did not exist and (2) reasonable expectations to invest the bond proceeds in materially higher yielding obligations resulting in arbitrage did exist. Because the parties to the abuse never expected to build the project and the bond proceeds are used to earn arbitrage, no bond proceeds are available to lend to the developer. The excess bond proceeds and any excess earnings are split among the parties in the deal, which may include participants in all or only some of the financial transactions involved.

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