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*TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION*



*Available Data Are Not Being Used  
to Proactively Identify Potentially Erroneous  
Rehabilitation Credit Claims*

**April 29, 2016**

**Reference Number: 2016-40-024**

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

**Redaction Legend:**

1 = Tax Return/Return Information

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## HIGHLIGHTS

### AVAILABLE DATA ARE NOT BEING USED TO PROACTIVELY IDENTIFY POTENTIALLY ERRONEOUS REHABILITATION CREDIT CLAIMS

## Highlights

**Final Report issued on April 29, 2016**

Highlights of Reference Number: 2016-40-024 to the Internal Revenue Service Deputy Commissioner for Services and Enforcement.

### IMPACT ON TAXPAYERS

The Rehabilitation Credit is jointly administered by both the IRS and the National Park Service (NPS). The Rehabilitation Credit uses tax incentives to encourage the private sector to restore and maintain historic structures. Qualified applicants may claim as much as 20 percent of their expenditures as a credit to reduce their overall tax liability. For Tax Year (TY) 2013, approximately \$732 million in Rehabilitation Credits was claimed on 2,168 tax returns.

### WHY TIGTA DID THE AUDIT

Similar to other general business credits, the IRS does not determine the primary qualifications of the project for which the Rehabilitation Credit is based. Rather, the IRS relies on the certification provided by the NPS, i.e., the NPS assigns a project number to each rehabilitation project when the certification application is submitted. The overall objective of this review was to assess the effectiveness of the IRS's controls to ensure that business taxpayer claims for the Rehabilitation Credit were valid.

### WHAT TIGTA FOUND

Third-party data received from the NPS are not being proactively used to identify potentially erroneous Rehabilitation Credit claims. The cornerstone of the IRS's ability to ensure compliance with many tax provisions is the ability to obtain reliable third-party data. Although the IRS receives a complete electronic copy of the NPS database twice a year, it has

not established effective processes to use the data to identify potentially erroneous claims, both during tax return processing and in post-processing compliance efforts.

Also, processes are needed to ensure that required information to claim the Rehabilitation Credit is provided and is accurate on all tax forms. A review of 2,720 TY 2013 Forms 3468, *Investment Credit*, identified 39 taxpayers claiming almost \$47 million in Rehabilitation Credits that did not provide either the required NPS project number or Employer Identification Number (EIN) of a pass-through entity.

Finally, the IRS does not have a process to identify invalid NPS project numbers or pass-through entity EINs during processing of tax returns. TIGTA's review of the 2,720 TY 2013 Forms 3468 identified 12 taxpayers claiming \$154,639 in Rehabilitation Credits that provided an invalid NPS project number or pass-through entity EIN.

### WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS develop processes and procedures to use NPS data to identify potentially erroneous claims and revise programming to identify and reject electronically filed business tax returns claiming the Rehabilitation Credit in which the required information is not provided on Form 3468 and when the information provided is invalid. TIGTA also recommended that the IRS work with the Department of the Treasury's Office of Tax Policy and propose existing regulations to provide clear reporting requirements for claiming the Rehabilitation Credit.

The IRS agreed with four recommendations, partially agreed with one recommendation, and disagreed with three recommendations.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

April 29, 2016

**MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND  
ENFORCEMENT**

**FROM:** Michael E. McKenney  
Deputy Inspector General for Audit

**SUBJECT:** Final Audit Report – Available Data Are Not Being Used to  
Proactively Identify Potentially Erroneous Rehabilitation Credit Claims  
(Audit # 201540005)

This report presents the results of our review to assess the effectiveness of the Internal Revenue Service's controls to ensure that business taxpayer claims for the Rehabilitation Credit are valid. This audit is included in our Fiscal Year 2016 Annual Audit Plan and addresses the major management challenge of Fraudulent Claims and Improper Payments.

Management's complete response to the draft report is included as Appendix VII.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. If you have any questions, please contact me or Russell P. Martin, Assistant Inspector General for Audit (Returns Processing and Account Services).



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*Abbreviations*

EIN	Employer Identification Number
IRS	Internal Revenue Service
NPS	National Park Service
TY	Tax Year



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## *Background*

The Rehabilitation Credit is a Federal tax credit that is an incentive to encourage the private sector to rehabilitate and reuse historic structures. Owners of buildings certified by the National Park Service (NPS) on behalf of the U.S. Department of the Interior may be eligible to claim a credit for expenses incurred in a certified rehabilitation project. The NPS assigns a number to each rehabilitation project when the certification application is submitted to the NPS. The NPS project number is available to the public and provided to the Internal Revenue Service (IRS). In addition, the NPS project number is required to be included on the Form 3468, *Investment Credit*,<sup>1</sup> used for all credits claimed for a certified historic structure.

The Internal Revenue Code<sup>2</sup> allows a 20 percent nonrefundable general business tax credit<sup>3</sup> for the qualified rehabilitation expenditures<sup>4</sup> of structures certified by the NPS as historic either individually or as contributing to the significance of a registered historic district.<sup>5</sup> These nonrefundable general business tax credits are subject to certain limitations, *e.g.*, passive activity loss limitations.<sup>6</sup> Additionally, the NPS must certify that the rehabilitation project is consistent with the historic character of the property and, where applicable, the district in which it is located. The building must be rehabilitated for commercial, industrial, agricultural, or rental residential purposes and not be used exclusively as the owner's private residence. The credit is calculated as a percentage of qualified expenditures. The expenditures are generally taken into account for the tax year<sup>7</sup> in which the rehabilitated building is placed in service.<sup>8</sup>

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<sup>1</sup> See Appendix V for an example of portions of Form 3468.

<sup>2</sup> Internal Revenue Code § 47.

<sup>3</sup> Nonrefundable credits are designed to allow taxpayers to reduce their tax liability. If a taxpayer has enough credits to reduce the liability to zero, any remainder may not be used in the current year. However, the taxpayer may carry any amount of unused credits forward 20 years after carrying it back one year.

<sup>4</sup> Qualified rehabilitation expenditures generally include costs that are directly related to the repair or improvement of structural and architectural features of the historic building.

<sup>5</sup> If the structure does not qualify as a certified historic structure for the 20 percent credit, it may qualify for a 10 percent credit if it is for a building that was placed in service before 1936. Our review focused only on the 20 percent credit.

<sup>6</sup> Generally, losses from passive activities that exceed the income from passive activities are disallowed for the current year. Disallowed losses can be carried forward to the next taxable year.

<sup>7</sup> A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

<sup>8</sup> Taxpayers may elect to take the expenditures into account for the tax year in which they were paid if the normal rehabilitation period for the building is at least two years and it is reasonable to expect that the building will be a qualified rehabilitated building when placed in service. The election is made by checking the box on Line 11a of Form 3468.



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In addition to the NPS's criteria for certifying the historic building and the rehabilitation project, the Internal Revenue Code sets forth the criteria that need to be met for a "qualified rehabilitated building" and "qualified rehabilitation expenditure." Figure 1 provides an overview of these criteria.

**Figure 1: Qualified Rehabilitated Building and Expenditure Requirements**

Qualified Rehabilitated Building	Qualified Rehabilitation Expenditures
The building must be certified as a historic structure by the NPS.	The expenditures must be for nonresidential rental property, residential rental property, or real property that has a class life of more than 12 years.
The building must be substantially rehabilitated. <sup>9</sup>	The expenditures must be incurred in connection with the rehabilitation of a qualified rehabilitated building.
Depreciation must be allowable with respect to the building.	The expenditures must be capitalized and depreciated using the straight-line method.
The building must have been placed in service before the beginning of rehabilitation.	The expenditures cannot include the costs of acquiring or enlarging any building.
	If the expenditures are in connection with the rehabilitation of a certified historic structure, the rehabilitation must be certified by the NPS as being consistent with the historic character of the property or district in which the property is located.
	With certain exceptions, the expenditures cannot include any costs allocable to the part of the property that is (or may reasonably expect to be) tax-exempt use property.

Source: IRS Form 3468 instructions for Tax Year (TY) 2014.

### **Process of applying for certification from the NPS**

Similar to other general business credits, the IRS does not determine the primary qualifications of the project for which the Rehabilitation Credit is based. Rather, the IRS relies on the certification provided by the NPS. For property owners to obtain certification from the NPS,

<sup>9</sup> A building is considered substantially rehabilitated if the qualified rehabilitation expenditures during a 24-month period are more than the greater of \$5,000 or the adjusted basis in the building. If the building is rehabilitated in phases under a written architectural plan and specifications that were completed before the rehabilitation began, a 60-month period is used.





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they must first submit the application to their State Historic Preservation Office.<sup>10</sup> The State Historic Preservation Office reviews the application and forwards it to the NPS with its recommendation for approving or denying the request. Once received, the NPS uses the following criteria when making its certification determination:

1. The historic building must be listed in the National Register of Historic Places or be certified as contributing to the significance of a “registered historic district.”
2. The rehabilitation work must be done according to the Secretary of the Interior’s Standards for Rehabilitation.<sup>11</sup>

The NPS requires property owners to use a three-part application, Form 10-168, *Historic Preservation Certification Application*, to apply for the certification required for the 20 percent credit.

- Part 1 is used by a building owner for requests that include certification that a building contributes to the significance of a registered historic district or a National Register of Historic Places property. Part 1 is also used by an owner to request a preliminary determination of whether an individual building not yet listed in the National Register of Historic Places might meet the criteria. Buildings listed in the National Register of Historic Places are already certified historic structures and owners of the buildings do not need to complete Part 1.
- Part 2 requires the applicant to describe the rehabilitation work to be undertaken on the building. Part 2 will not be reviewed by the NPS until Part 1 has been filed and acted upon.
- Part 3 is used by the applicant to request approval of a completed rehabilitation project.

Only after the application is submitted to the NPS will the NPS determine if a project has met the Standards for Rehabilitation and is a “certified rehabilitation.” Part of the certification process may include a physical inspection of the building and rehabilitation work. Although the NPS does not regularly conduct such inspections, many of the State Historic Preservation Offices make site visits on a pre-application basis and conduct inspections upon completion of the rehabilitation work. In addition, the NPS may request that the State Historic Preservation Office conduct an inspection of a specific project in instances for which it feels an inspection might be warranted. The NPS also visits several dozen projects each year that are selected in consultation with the State Historic Preservation Offices.

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<sup>10</sup> A State Historic Preservation Office is the first point of contact for property owners wishing to submit an application for approval. It maintains complete records of the State’s buildings and districts listed in the National Register of Historic Places and makes certification recommendations to the NPS.

<sup>11</sup> Appendix VI provides the Secretary of the Interior’s Standards for Rehabilitation.



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**Process of claiming the Rehabilitation Credit**

Once the steps for applying for NPS certification are completed, the taxpayer may begin determining if they are eligible for the tax credit by completing Form 3468. The following information is required to be provided on Form 3468:

- **The NPS project number assigned to the application.** If the taxpayer is a partner, shareholder, or beneficiary claiming the credit from an S corporation, partnership, estate, or trust, it must enter the pass-through entity's<sup>12</sup> Employer Identification Number (EIN) in place of the project number. In these situations, the pass-through entity is required to provide the NPS project number on Form 3468 if it is the property owner.
- **The date of the final certification of completed work received from the Secretary of the Interior.**<sup>13</sup> If the final certification has not been received by the time the tax return is filed, the taxpayer must attach the first page of Part 2, *Description of Rehabilitation*, of the NPS Form 10-168. In this case, after the final certification of completed work has been received, the taxpayer must file Form 3468 with the next tax return and enter the assigned NPS project number and the date of the final certification of completed work. The taxpayer must also attach an explanation and indicate the amount claimed in prior years. Taxpayers that do not receive the certification within 30 months of the claim for the credit must submit a written statement to the IRS stating that fact and consent to extending the assessment period.
- **The amount of qualified rehabilitation expenditures.** For taxable entities,<sup>14</sup> the amount of the credit is 20 percent of the qualified rehabilitation expenditures entered on Form 3468. In comparison, pass-through entities do not claim the Rehabilitation Credit. These entities report the amount of qualified rehabilitation expenditures. This amount is then distributed to its owners, *i.e.*, partners, shareholders, or beneficiaries, for use in computing the credit. All qualified rehabilitation expenditure amounts from pass-through entities are ultimately transferred to taxable entities. Taxable entities (hereafter referred to as taxpayers) enter their amount of qualified rehabilitation expenditures on Form 3468 and compute the 20 percent credit.

For TY 2013, we identified 2,720 electronically filed<sup>15</sup> Forms 3468 associated with a certified historic structure. These included 2,168 Forms 3468 filed by taxpayers that claimed

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<sup>12</sup> Pass-through entities include partnerships, S corporations, estates, and trusts. Pass-through entities do not claim the Rehabilitation Credit but are required to report the amount of qualified rehabilitation expenditures on Form 3468. Rehabilitation expenditures pass through to taxable entities that claim the credit.

<sup>13</sup> If the credit is from an S corporation, partnership, estate, or trust, the entity may not have information related to the final certification because final certification is provided to the owner of the property.

<sup>14</sup> Taxable entities include corporations and individuals that are subject to income tax.

<sup>15</sup> We did not include information for Rehabilitation Credits claimed on paper tax returns because we only identified 45 paper tax returns that claimed \$5.4 million in Rehabilitation Credits.



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Rehabilitation Credits totaling more than \$732 million and 552 Forms 3468 filed by pass-through entities reporting about \$3.5 billion in qualified rehabilitation expenditures.

This review was performed at the Planning and Special Programs office in St. Louis, Missouri, and with information obtained from the Large Business and International Division in Washington, D.C.; the Small Business/Self-Employed Division in Bloomington, Minnesota; and the Wage and Investment Division in Atlanta, Georgia. We also obtained information from the NPS's Technical Preservation Services office in Washington, D.C. This audit was conducted during the period January through November 2015. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



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*Results of Review*

***Third-Party Data Received From the National Park Service Are Not  
Being Used to Proactively Identify Potentially Erroneous  
Rehabilitation Credit Claims***

The IRS has not established processes to use NPS data to ensure that taxpayers claiming the Rehabilitation Credit meet eligibility requirements at the time returns are filed. In addition, the IRS is not maximizing its use of the NPS data during post-processing to identify potentially erroneous claims. The NPS maintains a cumulative database with information on every application submitted from the mid-1990s to the present. This information includes the NPS project number, property owner's name, address, project expenditures, and status of the application, *e.g.*, approved, denied, pending, *etc.*

The cornerstone of the IRS's ability to ensure compliance with many tax provisions is the ability to obtain reliable third-party data. Although the IRS receives a complete electronic copy of the NPS database twice a year, it has not established processes to use the data to identify potentially erroneous claims, both during tax return processing as well as in its post-processing compliance efforts. Specifically, the IRS is not using NPS data to match against electronically filed tax returns that claimed the credit to evaluate the risk that the credit claimed is potentially erroneous or not in compliance with regulations. For example, this information could have been used by the IRS to identify taxpayers claiming the Rehabilitation Credit for projects without a final certification of completed work that do not attach a copy of the first page of Part 2 of the NPS application as required.

Our review identified four taxpayers that claimed \$741,728 in Rehabilitation Credits and \*\*1\*\*  
\*\*\*\*\*1\*\*\*\*\*

but did not attach a copy of the first page of Part 2 of the NPS application to the Forms 3468 as required. Therefore, they did not qualify for the Rehabilitation Credit at the time the tax return was filed. Further, the NPS data showed that the projects associated with the NPS project numbers listed on these returns had not received Part 2 approval from the NPS at the time the tax return was filed.

Treasury Regulations<sup>16</sup> state that taxpayers may claim the Rehabilitation Credit even though final certification has not been granted. In these situations, the taxpayer is required to submit a copy of the first page of Part 2 of the NPS application along with Form 3468. However, the taxpayer

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<sup>16</sup> Treas. Reg. §1.48-12 (d)(7)(ii).



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does not enter the date of final certification of completed work because it has yet to be provided by the NPS. Once final certification is received, the taxpayer is required to provide the NPS project number and date of the final certification on Form 3468 with the first tax return filed after receipt of final certification.

When we raised concerns about taxpayers not receiving Part 2 approval, including not providing the required copy of Part 2 of the NPS application with Form 3468, IRS management advised us that in order to facilitate electronic filing, the regulations were modified to permit the taxpayer to provide the date of certification in lieu of attaching the actual final certification documentation, *i.e.*, Part 3. IRS management stated that they observed that taxpayers incorrectly provided the date of Part 2 in lieu of a copy of Part 2. According to IRS management, taxpayers appeared to mistakenly believe that the modification allowing the date of Part 3, rather than an actual copy, also applied to Part 2.

IRS management indicated that NPS data are used to identify indicators that a project may not meet the criteria to qualify for the Rehabilitation Credit, such as a discrepancy in the square footage completed, and to evaluate the potential risk that the taxpayer is not in compliance with claiming the credit. IRS management also stated that the NPS data are used after tax returns have been selected for examination.<sup>17</sup>

### ***Recommendations***

The Commissioners, Large Business and International and Small Business/Self-Employed Divisions, should:

**Recommendation 1:** Verify whether the four taxpayers and \*\*\*\*\*1\*\*\*\*\* we identified that claimed the Rehabilitation Credit without final certification of completed work or Part 2 approval from the NPS are entitled to claim the credit.

**Management's Response:** The IRS disagreed with this recommendation. The IRS disagreed with the premise that the lack of the Part 2 approval warrants examination. The failure to attach the Part 2 does not provide a basis to disallow the credit. The IRS confirmed that each of the \*\*1\*\* forms provided a valid NPS number and a valid Part 2 application date. Although the NPS database does not reflect Part 2 approval, it also does not reflect that these applications have been denied, indicating that they are likely pending. \*\*\*1\*\*\*\*\* cases have zero or minimal potential tax adjustments. Because compliance risk for these \*\*1\*\* Small Business/Self-Employed Division taxpayers is minimal, the IRS has concluded that further action is not warranted.

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<sup>17</sup> The IRS provided results for five examinations related specifically to the Rehabilitation Credit for Fiscal Years 2012 through 2014 from the Small Business/Self-Employed Division. The Large Business and International Division informed us that it did not have any similar examination results related to the Rehabilitation Credit.



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The IRS also disagreed with our outcome measure. The IRS stated that missing or incorrect information on a Form 3468 or on an associated partnership return does not mean that claim is erroneous. In addition, the IRS stated that our outcome measure does not account for the opportunity costs associated with redeploying resources away from cases with higher compliance risks and larger potential for adjustments to those cases with a lower compliance risk and minimal potential adjustments. Moreover, the IRS stated that the four identified taxpayers showed no affirmative indication of noncompliance and only claimed a total of \$257,000 in credits.

**Office of Audit Comment:** The IRS's response noted that for the \*\*1\*\* claims we identified, the taxpayer provided a valid NPS number and the Part 2 application date. Based on this, the IRS concluded that the compliance risk for these taxpayers is minimal. We disagree with this assertion. Providing a Part 2 application date does not qualify a taxpayer to claim this credit. For \*\*1\*\* these claims, NPS data reflected no final certification of completed work or Part 2 approval from the NPS. This indicates that these projects may not have met the criteria to qualify for the credit. We used the NPS data to identify these \*\*1\*\* claims. During the course of our review, IRS management stated that they use this data to identify indicators that a project may not meet the criteria to qualify for the Rehabilitation Credit.

In addition, we disagree with IRS management's assertion that \*\*\*1\*\*\*\*\* cases have zero or minimal potential tax adjustments because they only claimed \$257,000 in credits. These individuals actually claimed a total of \$741,728 on Form 3468 (\$257,000 was used to offset their TY 2013 tax liability, the rest can be carried forward to offset subsequent years' tax liabilities). In our opinion, either amount, if erroneously claimed, represents a significant loss to the government.

**Recommendation 2:** Develop processes and procedures to use NPS data to identify potentially erroneous claims both during tax return processing and during post-processing compliance efforts.

**Management's Response:** The IRS partially agreed with this recommendation. The IRS agreed to add clarification to the Internal Revenue Manual to explain in detail how the NPS data should be used to identify, classify, and examine returns claiming the Rehabilitation Credit. The IRS also agreed to update information on Rehabilitation Credits on "IRS.gov" to include a reminder about properly completing Form 3468. The IRS will also issue a reminder to its auditors about available audit tools and resources relating to the Rehabilitation Credit, including information on the use of NPS data during examinations.

However, the IRS disagreed that NPS data can be used effectively during returns processing. During returns processing, the IRS can reject forms that contain blank or improperly formatted EINs or NPS numbers, but the IRS cannot ensure that properly formatted EINs or NPS numbers are actually correct, *i.e.*, associated with an approved





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project for which the taxpayer is entitled to claim a Rehabilitation Credit. Implementing electronic filing business rules will yield minimal compliance benefits while imposing unnecessary burdens on taxpayers with valid rehabilitation tax credit claims. These taxpayers may be unable to provide the required information or may commit good faith errors due to complicated business arrangements. In addition, NPS data are already used to identify potential erroneous claims during post-processing compliance efforts. The IRS will continue to work with the audit teams examining the taxpayers that claim the majority of the Rehabilitation Credits.

**Office of Audit Comment:** The IRS's disagreement is contrary to the fact that it has established and uses a process to ensure that a properly formatted EIN is correct. For example, during the processing of Forms 1040, *U.S. Individual Income Tax Return*, the IRS ensures that the EIN reported on Form W-2, *Wage and Tax Statement*, is an approved EIN and was issued before the tax year of the filed tax return. Furthermore, establishing processes to ensure that valid EINs and/or NPS numbers are provided serves as a deterrent against those that try to make erroneous claims of the Rehabilitation Credit.

## ***Processes Are Needed to Ensure That Required Information to Claim the Rehabilitation Credit Is Provided and Is Accurate on All Tax Forms***

Our review of 2,720 TY 2013 Forms 3468 identified 105 that did not provide either the required NPS project number or EIN of a pass-through entity. These Forms 3468 were filed by 43 taxpayers that claimed almost \$47.5 million in Rehabilitation Credits and 62 pass-through entities that reported qualified rehabilitation expenditures totaling more than \$289 million. We provided the claims that we identified to the IRS for review and concurrence. The IRS confirmed that it was unable to identify the NPS project or information associated with Forms 3468 filed by 39 of the 43 taxpayers we identified. These 39 taxpayers claimed almost \$47 million in Rehabilitation Credits. The IRS also agreed that 10 of the 62 pass-through entities we identified did not provide either the required NPS project number or EIN of a pass-through entity. These 10 pass-through entities reported expenditures totaling almost \$23 million. The remaining 56 Forms 3468 involved mistakes made by the taxpayers because they did not include the required information on the Form 3468. However, the IRS was able to identify either the NPS project number associated with the credit or the pass-through entity from which the credit was claimed by manually researching documents associated with each return.

Treasury Regulations<sup>18</sup> require that a taxpayer claiming the Rehabilitation Credit for a certified historic structure<sup>19</sup> provide the project number assigned by the NPS on the tax return. If the taxpayer claims the credit for qualified rehabilitation expenditures from a pass-through entity,

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<sup>18</sup> Treas. Reg. §1.48-12 (d)(7)(iv).

<sup>19</sup> The portion of the credit is filed on Lines 11h, 11i, or 11j of Form 3468.



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then the taxpayer must provide the EIN of the pass-through entity instead of the NPS project number. The EIN of the pass-through entity is necessary to enable the IRS to identify the specific Form 1065, *U.S. Return of Partnership Income*, or Form 1120S, *U.S. Income Tax Return for an S Corporation*, where the NPS number is required to be provided. This information is to be included on Line 11k of Form 3468.

The IRS rejects electronically filed Forms 1040 and Forms 1041, *U.S. Income Tax Return for Estates and Trusts*, when the required NPS project number or EIN of the pass-through entity is missing from Form 3468. However, the IRS has not developed similar business rules to reject business returns, *e.g.*, Form 1065, Form 1120, or Form 1120S, when the required information is not provided.

When we brought our concern to IRS management's attention, they explained that the costs of rejecting electronically filed returns outweigh the potential benefits due to the limited compliance value that the information on Line 11k of Form 3468 provides. The IRS provided no cost-benefit analysis to support this position, and we do not believe that this position is justified. We identified and reported the 39 taxpayers that claimed Rehabilitation Credits totaling almost \$47 million and 10 pass-through entities that reported expenditures totaling almost \$23 million that the IRS could have rejected the tax return back to the filer to request the required information. This would help avoid the need for compliance actions later on.

**The IRS does not have a process to identify invalid NPS project numbers or pass-through entity EINs**

Our review of the 2,720 TY 2013 Forms 3468 identified 43<sup>20</sup> that contained an invalid NPS project number or pass-through entity EIN. These Forms 3468 were filed by 33 taxpayers that claimed Rehabilitation Credits totaling approximately \$1.2 million and 10 pass-through entities that reported approximately \$17.1 million in qualified rehabilitation expenditures. We provided the claims we identified to the IRS for review and concurrence. The IRS confirmed that it was unable to identify information associated with Forms 3468 filed by 12 taxpayers of the 33 taxpayers we identified. These 12 taxpayers claimed \$154,639 in Rehabilitation Credits. The IRS also was unable to identify information associated with three of the 10 pass-through entities. These three pass-through entities reported qualifying expenditures totaling \$41,800. The remaining 28 Forms 3468 filed by 21 taxpayers and seven pass-through entities involved mistakes on the part of the filer.<sup>21</sup> However, the IRS was able to identify valid numbers after

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<sup>20</sup> This includes only Forms 3468 that have a credit or expenditure amount of \$1,000 or more. These 43 forms are different from the 43 forms that did not provide either the required NPS project number or EIN of a pass-through entity previously reported.

<sup>21</sup> \*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*.





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spending a significant amount of time manually researching documents associated with each return.

When we brought our concern about the invalid NPS project numbers or pass-through entity EINs to IRS management's attention, they stated that there is no way to determine whether NPS project number or the pass-through entity EIN is valid at the time the return is processed. Management indicated that the only way to determine whether either of these numbers is valid is through manual research, which, as previously noted, takes a significant amount of time. Further, the IRS would not know during processing whether the taxpayer intended to provide a NPS project number or pass-through entity EIN.

As previously mentioned, the IRS receives data from the NPS twice a year and can use this information to verify the validity of NPS numbers provided on Forms 3468. Additionally, the IRS has its own internal data it could use to perform a match to determine if an EIN of a pass-through entity is a valid number issued by the IRS. Returns identified with an invalid NPS project number or EIN of a pass-through entity could be rejected back to the taxpayer to provide accurate information. This would help avoid the need for compliance actions later on.

### **Our analysis indicates that the NPS project number or pass-through entity EIN can help identify noncompliance**

Using a program developed by the IRS, we were able to review a statistically valid stratified sample<sup>22</sup> of 110 of the 488 Forms 3468 filed by taxpayers that provided a valid pass-through entity EIN and identified 11 Forms 3468 (10 percent) with potentially erroneous Rehabilitation Credit claims totaling more than \$7.9 million. The program we used (the yK1 tool) is a web-based tool that displays the investment relationships of corporations, partnerships, trusts, and individuals. The yK1 tool assists examiners who audit pass-through entities in the identification of investment interest of complicated business structures. We were able to use the tool to identify relationships between taxpayers claiming the credit and the entities from which those taxpayers directly received the qualified rehabilitation expenditures supporting the claimed credit. The 11 potentially erroneous claims include:

- Five claims with Rehabilitation Credits totaling almost \$3.4 million \*\*\*\*\*1\*\*\*  
\*\*\*\*\*1\*\*\*\*\* did not even report the qualified rehabilitation expenditures. According to the Form 3468 instructions, pass-through entities that own the historic property are required to report qualified rehabilitation expenditures for a certified historic structure on Form 3468.
- Three claims with Rehabilitation Credits totaling more than \$4.5 million \*\*\*\*1\*\*\*  
\*\*\*\*\*1\*\*\*\*\* passed through Low-Income

<sup>22</sup> To select our statistically valid sample, we used an expected error rate of 10 percent, a precision rate of 5 percent, and a confidence interval of 95 percent.



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Housing Credits and not qualified rehabilitation expenditures. As a result, the taxpayers claimed Rehabilitation Credits to which they were not entitled.

- \*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*1\*\*. According to IRS internal guidance, a pass-through entity is an entity that passes its income, loss, deductions, or credits to its owners. As such, a taxpayer who is not a partner, shareholder, or beneficiary (owner) in a pass-through entity cannot receive or claim expenditures or credits, like the Rehabilitation Credit, from a pass-through entity.  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*.
- \*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*<sup>23</sup>\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*1\*\*.

When we brought the previously mentioned examples to IRS management's attention to demonstrate the importance and usefulness of ensuring that required pass-through entity EINs are provided, management indicated that even if every entity complied with current reporting requirements, they would be unable to reliably connect NPS project numbers with the ultimate credit claimant.

Management further noted that the intricacies involved with multiple-tiered structures, in combination with unclear regulations and the complexity of the law, results in some taxpayers failing to understand their obligation to file Forms 3468, while others lack information to properly file Forms 3468. For example, the regulations do not clearly state the Form 3468 filing requirements for middle-tier pass-through entities that simply act as an intermediary for the passing through of the credit. However, subsequent to our discussion with IRS management, they issued an opinion that all pass-through entities involved in the credit are required to file Form 3468.

In addition, IRS management noted that regulations also are not clear regarding Form 3468 filing requirements for taxpayers involved in a master tenant lease structure. In the case of a master

<sup>23</sup> \*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*.



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## *Available Data Are Not Being Used to Proactively Identify Potentially Erroneous Rehabilitation Credit Claims*

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tenant lease structure,<sup>24</sup> the regulations<sup>25</sup> allow a lessor of the property to elect to treat the property as having been acquired by the lessee. The lessee then claims the credit and submits Form 3468. Although Form 3468 requires the taxpayer that is claiming the property to provide the NPS project number and date of final certification, the lessor is not required to provide the lessee with this information. Furthermore, the regulations do not require middle-tier pass-through entities to file Form 3468. Although the IRS has no plans to change how it processes Form 3468, IRS management stated that they plan to clarify the Form 3468 reporting requirements by revising the regulations.

### ***Recommendations***

The Commissioners, Large Business and International and Small Business/Self-Employed Divisions, should:

**Recommendation 3:** Revise electronic filing programming to identify and reject electronically filed Forms 1065, Forms 1120, or Forms 1120S tax returns with a Rehabilitation Credit claim in which the required NPS project number or EIN of a pass-through entity was not provided on Form 3468.

**Management's Response:** The IRS disagreed with this recommendation. The IRS believes that implementing this business rule would be premature. An EIN or NPS number on a Form 3468, in and of itself, does not verify compliance and, conversely, the lack of a valid number does not demonstrate that a claim is erroneous. Further, implementing these business rules will increase taxpayer burden while yielding minimal compliance benefits.

**Office of Audit Comment:** The IRS's statement that implementing our recommendation would be premature is contrary to the fact that it has established processes to reject electronically filed Forms 1040 and Forms 1041 when the required NPS project number or EIN of the pass-through entity is missing from Form 3468. Furthermore, the IRS's process of only rejecting certain returns meeting this condition results in disparate treatment of taxpayers.

**Recommendation 4:** Revise electronic filing programming to identify and reject any electronically filed tax return with a Rehabilitation Credit claim that includes an invalid NPS project number or pass-through entity EIN on the Form 3468.

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<sup>24</sup> A master tenant lease structure uses two entities. The lessor entity is the owner of the historic property and incurs the qualified rehabilitation expenditures. The other entity is the lessee or "master tenant." The master tenant leases the property from the owner and will either sublease the property to other tenants or pass the credit to other lower tiered entities.

<sup>25</sup> Treas. Reg. §1.48-4 (a).



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**Management's Response:** The IRS disagreed with this recommendation. During returns processing, the IRS cannot ensure that the number provided on a Form 3468 actually is associated with the taxpayer claiming the credit; rather, the IRS only can verify that an EIN or NPS number reported on the Form 3468 has the correct characters and number of digits to appear to be a valid number. The IRS stated that ensuring the "proper format" of EINs and NPS numbers on Forms 3468 will not materially enhance its compliance efforts.

**Office of Audit Comment:** The IRS's statement that it cannot verify required identification numbers reported on Forms 3468 is not accurate. In fact, the IRS already uses a process to ensure that a properly formatted EIN is correct. For example, during the processing of Forms 1040, the IRS ensures that the EIN reported on Form W-2 is an approved EIN and was issued before the tax year of the filed tax return. Furthermore, establishing processes to ensure that valid EINs and/or NPS numbers are provided serves as a deterrent to those who would otherwise submit erroneous claims for the Rehabilitation Credit.

**Recommendation 5:** Verify whether the 39 taxpayers and 10 pass-through entities that claimed rehabilitation expenditures or credits without providing the required NPS project number or pass-through entity EIN are entitled to claim the expenditures or credits. This should include incorporating this issue into the open examinations for the 32 taxable entities.

**Management's Response:** The IRS agreed with this recommendation. At least 32 of these cases are being evaluated for compliance risk independent of the Treasury Inspector General for Tax Administration's audit, and the IRS will continue to work these cases in accordance with its existing examination procedures. The IRS has concluded that the compliance risk of the remaining taxable entities does not warrant further action. In addition, the IRS has identified the NPS projects or entities associated with these claims, or has confirmed that minimal credit amounts were claimed by the taxpayers associated with these forms. Therefore, the IRS has concluded these cases do not warrant further action.

The IRS disagreed with our outcome measure. The IRS stated that any revenue protected with respect to the 32 taxpayers would not be attributable to the above recommendation.

**Office of Audit Comment:** We confirmed the IRS's statement that 32 of the 39 taxpayers we identified all had indications of examination involvement prior to the start of our audit. \*\*1\*\* of the remaining seven taxpayers \*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*. Review of the other \*\*\*1\*\*\* taxpayers found that they were not examined, *i.e.*, their returns were selected for examination but subsequently surveyed without being assigned to an examiner. As such, we have revised our outcome accordingly.



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However, although these 32 cases are being examined, IRS management was unable to provide documentation showing that the Rehabilitation Credit was being considered as part of the examination risk assessment process. IRS management stated that they would be unable to determine if the Rehabilitation Credit was in fact reviewed until the examination was completed.

**Recommendation 6:** Verify whether the 12 taxpayers and three pass-through entities that included an invalid entry on Form 3468 Line 11k are entitled to claim the expenditures or credits.

**Management's Response:** The IRS agreed with this recommendation. For these entities (taxable and pass-through), the IRS has identified the NPS project or sources of the qualified rehabilitation expenditures associated with the claim, or has determined that minimal credit amounts were actually claimed by the taxpayers associated with the forms. The IRS, therefore, concludes these cases do not warrant further action.

The IRS disagreed with our outcome measure. The IRS stated that it disagreed with the premise that missing or incorrect information on a Form 3468 or on an associated partnership return does not mean that claim is erroneous. In addition, the IRS stated that our outcome measure does not account for the opportunity costs associated with redeploying resources away from cases with higher compliance risks and larger potential for adjustments to those cases with a lower compliance risk and minimal adjustments. Moreover, the IRS stated that of the 12 identified taxpayers, only three taxpayers reporting a total of \$96,425 in credits show any potential compliance risk.

**Office of Audit Comment:** IRS management concluded that the cases we identified warrant no further action, yet contradicts this position by stating in their response that three taxpayers show a potential compliance risk.

**Recommendation 7:** Verify whether the 11 taxpayers who claimed potentially erroneous Rehabilitation Credits from a pass-through entity were entitled to claim the credits. This should include incorporating this issue into the open examinations for the four entities with an open examination indicator.

**Management's Response:** The IRS agreed with this recommendation. For these entities (taxable and pass-through), the IRS has identified the NPS project or qualified rehabilitation expenditures associated with the claims or otherwise reconciled the return information, or has determined that credit amounts claimed by the taxpayers associated with the forms do not warrant further action at this time.

The IRS disagreed with our outcome measure, stating that we extrapolated the \$8.6 million based on 54 taxpayers that potentially made \$7.9 million of erroneous claims from pass-through entities, but only three, reporting approximately \$535,000 in potential errors, show any compliance risk.



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**Office of Audit Comment:** In discussions with management on the results of our analysis, they informed us that four of the 11 taxpayers we identified were selected for examination prior to the start of our audit. We confirmed these four taxpayers were in fact being examined and that the claims made by these taxpayers accounted for the majority of the potentially erroneous Rehabilitation Credits we identified. As such, we revised our outcome accordingly.

Although these four cases are being examined, IRS management was unable to provide documentation showing that the Rehabilitation Credit was being considered as part of the examination risk assessment process. IRS management stated that it would be unable to determine if the Rehabilitation Credit was in fact reviewed until the examination was completed.

The Deputy Commissioner for Services and Enforcement should:

**Recommendation 8:** Work with the Department of the Treasury's Office of Tax Policy to propose changes to existing regulations and provide clear reporting requirements for claiming the Rehabilitation Credit.

**Management's Response:** The IRS agreed with this recommendation. The IRS agreed to work with the Department of the Treasury on guidance that would provide clearer reporting requirements for claiming the rehabilitation tax credit. The IRS will submit a guidance proposal to the Office of Chief Counsel for prioritization vis-à-vis other regulatory projects under consideration by the Department of the Treasury.





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## **Appendix I**

### *Detailed Objective, Scope, and Methodology*

Our overall objective was to assess the effectiveness of the IRS's controls to ensure that business taxpayer claims for the Rehabilitation Credit are valid. To accomplish this objective, we:

- I. Evaluated the IRS's processes to ensure that a valid NPS project number or pass-through entity EIN was included on Form 3468, *Investment Credit*.
  - A. Assessed the IRS's effectiveness to ensure that the NPS project number or pass-through entity EIN was provided on Form 3468 when required.
    1. Reviewed the Internal Revenue Manual, electronic filing business rules, and other processing procedures to identify controls in place to ensure that the NPS project number or pass-through entity EIN was provided.
    2. Interviewed IRS management to determine the controls in place to ensure that the NPS project number or pass-through entity EIN was provided.
    3. Evaluated the IRS's controls used to ensure that the NPS project number or pass-through entity's EIN was provided on Form 3468.
    4. Obtained a Modernized Tax Return Database<sup>1</sup> extract of 12,471 Forms 3468 from the Individual Master File<sup>2</sup> and 3,877 from the Business Master File<sup>3</sup> for Processing Year<sup>4</sup> 2014 and TY 2013.
    5. Identified 2,720 Forms 3468 that included an expenditure or credit amount for a certified historic structure. Of those, we identified 2,564 that included an entry on Line 11k and 156 Forms 3468 that did not.
    6. Researched the 156 Forms 3468 to remove cases that we deemed were not questionable and determined that 105 Forms 3468 filed by 43 taxpayers and 62 pass-through entities should have included an NPS project number or pass-through entity EIN but did not. We sent these cases to the IRS for review.

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<sup>1</sup> The legal repository for original electronically filed returns received by the IRS through the Modernized e-File system.

<sup>2</sup> The IRS database that maintains transactions or records of individual tax accounts.

<sup>3</sup> The IRS database that consists of Federal tax-related transactions and accounts for businesses. These include employment taxes, income taxes on businesses, and excise taxes.

<sup>4</sup> The calendar year in which the tax return or document is processed by the IRS.



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7. Identified 488 Forms 3468 that provided a valid pass-through entity EIN on Line 11k and worked with the Treasury Inspector General for Tax Administration's contract statistician to select a statistically valid stratified sample based on an expected error rate of 10 percent, a precision rate of 5 percent, and a confidence interval of 95 percent. We reviewed the sample to determine if the Rehabilitation Credit was potentially erroneously claimed by the taxable entities reporting the credit from a pass-through entity. We worked with the contract statistician to project the error rate identified to the population of 488 Forms 3468.
- B. Determined if the NPS project number or pass-through entity EIN on Form 3468 was valid.
  1. Obtained the list of certified structures and expenditures created and maintained by the NPS as of July 9, 2015.
  2. Identified 2,564 Forms 3468 that included an entry on Line 11k. Of those, 677 included an NPS project number on Line 11k that was related to a project on the NPS database; 1,778 included a valid pass-through entity EIN on line 11k; 24 included an entry such as "see attached" on Line 11k; and 85 included an invalid number.
  3. Researched the 85 Forms 3468 that included an invalid number to remove cases that we deemed were not questionable and determined that 43 Forms 3468 filed by 33 taxpayers and 10 pass-through entities included an invalid number on Line 11k. We sent these cases to the IRS for review.
- II. Evaluated the processes used to verify that expenses claimed on Form 3468 were accurate.
  - A. Used data from the NPS to determine the total expenditures certified for each project and computed the amount of Rehabilitation Credit that should have been allowed for each project based on the expenditures.
  - B. For those Forms 3468 with an NPS project number that matched the NPS list, matched the expenditure amount from Lines 11h through 11j with the expenditure amount from the NPS to determine whether the expenditure amount was accurate. We identified credits claimed more than one year after the NPS certification date, quantified the amount, and identified those for which the expenditure amount claimed was incorrect. We computed the difference between the expenditure amount from the NPS and the expenditure amount claimed on Form 3468 and used this to compute the credit amount. We quantified the credit amount that was claimed using expenditures that were not properly supported by information from the NPS.
- III. Evaluated the processes to ensure that the projects used to claim the credit have received final certification of completed work.





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- A. Reviewed the Internal Revenue Manual and other applicable IRS material for information on the processes in place to ensure that final certification from the NPS had been completed and interviewed IRS personnel to determine the controls in place to ensure that final certification from the NPS had been completed.
- B. Using the 677 records that had a matching NPS number, identified 89 cases that did not have final certification at the time the credit was claimed. For those that had not received final certification at the time the credit was claimed, we determined whether a copy of the first page of Part 2 of the NPS application was attached.

**Data validation methodology**

During this review, we relied on data from the IRS's Business Master File and Individual Master File databases for Processing Year 2014 that was provided by the Treasury Inspector General for Tax Administration's Office of Investigations' Strategic Data Services. We performed additional extracts from the Business Master File and Individual Master File located on the Treasury Inspector General for Tax Administration's Data Center Warehouse.<sup>5</sup> Before relying on our data, we ensured that each file contained the specific data elements we requested. In addition, we selected random samples of each extract and verified that the data in the extracts were the same as the data captured in the IRS's Integrated Data Retrieval System<sup>6</sup> and the IRS's Return Request and Display application.<sup>7</sup> We also received data from the NPS pertaining to applications to the National Register of Historic Places and worked with NPS representatives to understand the contents of the data and determine its relevance to our audit objective. We also used the NPS's public website and application lookup tool to verify the accuracy of the data and discussed with NPS representatives their methods for validating the data. Based on the results of our testing, we believe that the data used in our review were reliable.

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<sup>5</sup> A collection of IRS databases containing various types of taxpayer account information that is maintained by the Treasury Inspector General for Tax Administration for the purpose of analyzing data for ongoing audits.

<sup>6</sup> IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.

<sup>7</sup> The Return Request and Display application displays specific tax return and status information for tax returns processed by the Modernized e-File application.



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### **Internal controls methodology**

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: processes and procedures to assess the effectiveness of the IRS's controls to ensure that business taxpayer claims for the Rehabilitation Credit are valid. We evaluated the controls by reviewing the IRS's Internal Revenue Manual, interviewing IRS management, and reviewing past Treasury Inspector General for Tax Administration audit work on related subjects.



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## **Appendix II**

### *Major Contributors to This Report*

Russell P. Martin, Assistant Inspector General for Audit (Returns Processing and Account Services)  
Diana M. Tengesdal, Director  
Kathleen A. Hughes, Audit Manager  
Levi J. Dickson, Lead Auditor  
Quinn A. Major, Auditor  
J. Edmund Carr III, Audit Evaluator



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**Appendix III**

*Report Distribution List*

Commissioner  
Office of the Commissioner – Attn: Chief of Staff  
Commissioner, Large Business and International Division  
Commissioner, Small Business/Self-Employed Division  
Commissioner, Wage and Investment Division  
Deputy Commissioner (Domestic), Large Business and International Division  
Deputy Commissioner, Small Business/Self-Employed Division  
Deputy Commissioner, Operations, Wage and Investment Division  
Director, Customer Account Services, Wage and Investment Division  
Director, Submission Processing, Wage and Investment Division  
Director, Office of Audit Coordination



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## **Appendix IV**

### *Outcome Measures*

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to Congress.

#### **Type and Value of Outcome Measure:**

- Increased Revenue – Potential; \$741,728 from four taxpayers that had not received Part 2 approval from the NPS (see page 6).

#### **Methodology Used to Measure the Reported Benefit:**

We identified 89 Forms 3468, *Investment Credit*, that claimed the Rehabilitation Credit and did not have a final certification from the NPS. Of those, we identified \*\*1\*\* taxpayers that claimed \$758,673 in Rehabilitation Credits but did not attach a copy of the first page of Part 2 of the NPS application as required and had not received Part 2 approval from the NPS at the time the tax return was filed. The IRS reviewed all \*\*1\*\* claims for the credit and agreed that four claims totaling \$741,728 had not attached Part 2 of the NPS application to the tax return and had not received Part 2 approval from the NPS. Because the Rehabilitation Credit is a nonrefundable credit, the taxpayer is only allowed to claim the credit amount up to the amount of tax liability on the tax return. Any unused portion of the credit can be used to reduce tax liabilities by carrying it back one year and forward 20 years. Thus, our outcome measure is based on the full amount of the Rehabilitation Credit reported on the Form 3468 and that is at risk of being used to reduce a tax liability.

#### **Type and Value of Outcome Measure:**

- Revenue Protection – Potential; \$154,639 from 12 taxpayers that provided an invalid NPS project number or pass-through entity EIN on Line 11k of Form 3468 (see page 9).

#### **Methodology Used to Measure the Reported Benefit:**

We identified 2,720 TY 2013 Forms 3468. Of those, we identified 33 taxpayers that entered an invalid NPS project number or pass-through entity EIN. The IRS reviewed the Forms 3468 submitted by the 33 taxpayers to determine whether the claims for the Rehabilitation Credit were questionable. The IRS confirmed that Forms 3468 filed by 12 taxpayers and that claimed \$154,639 in Rehabilitation Credits were questionable. Because the Rehabilitation Credit is a nonrefundable credit, the taxpayer is only allowed to claim the credit amount up to the amount of tax liability on the tax return. Any unused portion of the credit can be used to reduce tax



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liabilities by carrying it back one year and forward 20 years. Thus, our outcome measure is based on the full amount of the Rehabilitation Credit reported on the Form 3468 and that is at risk of being used to reduce a tax liability.



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Appendix V

Form 3468, Investment Credit

(Top of page 1)

Form <b>3468</b>	<b>Investment Credit</b>	OMB No. 1545-0155
Department of the Treasury Internal Revenue Service (99)	► Attach to your tax return. ► Information about Form 3468 and its separate instructions is at <a href="http://www.irs.gov/form3468">www.irs.gov/form3468</a> .	<b>2014</b> Attachment Sequence No. 174
Name(s) shown on return		Identifying number
<b>Part I Information Regarding the Election To Treat the Lessee as the Purchaser of Investment Credit Property</b>		
If you are claiming the investment credit as a lessee based on a section 48(d) (as in effect on November 4, 1990) election, provide the following information. If you acquired more than one property as a lessee, attach a statement showing the information below.		
1	Name of lessor	
2	Address of lessor	
3	Description of property	
4	Amount for which you were treated as having acquired the property	► \$

(Top of page 2)

Form 3468 (2014)		Page <b>2</b>
<b>Part III Rehabilitation Credit and Energy Credit</b>		
<b>11</b> Rehabilitation credit (see instructions for requirements that must be met):		
a Check this box if you are electing under section 47(d)(5) to take your qualified rehabilitation expenditures into account for the tax year in which paid (or, for self-rehabilitated property, when capitalized). See instructions. <b>Note.</b> This election applies to the current tax year and to all later tax years. You may not revoke this election without IRS consent. <input type="checkbox"/>		
b Enter the dates on which the 24- or 60-month measuring period begins _____ and ends _____		
c Enter the adjusted basis of the building as of the beginning date above (or the first day of your holding period, if later) \$ _____		
d Enter the amount of the qualified rehabilitation expenditures incurred, or treated as incurred, during the period on line 11b above \$ _____		
Enter the amount of qualified rehabilitation expenditures and multiply by the percentage shown:		
e	Pre-1936 buildings located in the Gulf Opportunity Zone (only enter amounts paid or incurred before 2012) \$ _____	× 13% (.13) <b>11e</b>
f	Pre-1936 buildings affected by a Midwestern disaster (only enter amounts paid or incurred before 2012) \$ _____	× 13% (.13) <b>11f</b>
g	Other pre-1936 buildings \$ _____	× 10% (.10) <b>11g</b>
h	Certified historic structures located in the Gulf Opportunity Zone (only enter amounts paid or incurred before 2012) \$ _____	× 26% (.26) <b>11h</b>
i	Certified historic structures affected by a Midwestern disaster (only enter amounts paid or incurred before 2012) \$ _____	× 26% (.26) <b>11i</b>
j	Other certified historic structures \$ _____	× 20% (.20) <b>11j</b>
For properties identified on lines 11h, 11i, or 11j, complete lines 11k and 11l.		
k	Enter the assigned NPS project number or the pass-through entity's employer identification number (see instructions) _____	
l	Enter the date that the NPS approved the Request for Certification of Completed Work (see instructions) _____	
m	Rehabilitation credit from an electing large partnership (Schedule K-1 (Form 1065-B), box 9) _____	<b>11m</b>

Source: IRS Form 3468 for TY 2014.



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### **Appendix VI**

## *Secretary of the Interior's Standards for Rehabilitation*

### **The Secretary of the Interior's Standards for Rehabilitation**

Rehabilitation projects must meet the following Standards, as interpreted by the National Park Service, to qualify as "certified rehabilitations" eligible for the 20% rehabilitation tax credit. The Standards are applied to projects in a reasonable manner, taking into consideration economic and technical feasibility.

The Standards, codified in 36 CFR 67.7, apply to historic buildings of all periods, styles, types, materials, and sizes. They apply to both the exterior and the interior of historic buildings. The Standards also encompass related landscape features and the building's site and environment as well as attached, adjacent, or related new construction.

1. A property shall be used for its historic purpose or be placed in a new use that requires minimal change to the defining characteristics of the building and its site and environment.
2. The historic character of a property shall be retained and preserved. The removal of historic materials or alteration of features and spaces that characterize a property shall be avoided.
3. Each property shall be recognized as a physical record of its time, place, and use. Changes that create a false sense of historical development, such as adding conjectural features or architectural elements from other buildings, shall not be undertaken.
4. Most properties change over time; those changes that have acquired historic significance in their own right shall be retained and preserved.
5. Distinctive features, finishes, and construction techniques or examples of craftsmanship that characterize a historic property shall be preserved.
6. Deteriorated historic features shall be repaired rather than replaced. Where the severity of deterioration requires replacement of a distinctive feature, the new feature shall match the old in design, color, texture, and other visual qualities and, where possible, materials. Replacement of missing features shall be substantiated by documentary, physical, or pictorial evidence.
7. Chemical or physical treatments, such as sandblasting, that cause damage to historic materials shall not be used. The surface cleaning of structures, if appropriate, shall be undertaken using the gentlest means possible.
8. Significant archeological resources affected by a project shall be protected and preserved. If such resources must be disturbed, mitigation measures shall be undertaken.
9. New additions, exterior alterations, or related new construction shall not destroy historic materials that characterize the property. The new work shall be differentiated from the old and shall be compatible with the massing, size, scale, and architectural features to protect the historic integrity of the property and its environment.
10. New additions and adjacent or related new construction shall be undertaken in such a manner that if removed in the future, the essential form and integrity of the historic property and its environment would be unimpaired.

*Source: Form 10-168, Historic Preservation Certification Application, instructions revised as of March 2014.*





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**Appendix VII**

*Management's Response to the Draft Report*

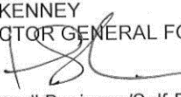


COMMISSIONER  
SMALL BUSINESS/SELF-EMPLOYED DIVISION

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

MAR 17 2016

MEMORANDUM FOR MICHAEL E. McKENNEY  
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Karen Schiller   
Commissioner Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Available Data Are Not Being Used  
to Proactively Identify Potentially Erroneous Rehabilitation Credit  
Claims (Audit # 201540005)

Thank you for the opportunity to review your draft report titled: "Available Data Are Not Being Used to Proactively Identify Potentially Erroneous Rehabilitation Credit Claims." The Rehabilitation Credit is a Federal tax credit used to induce investments from the private sector to rehabilitate and reuse historic structures. It is a non-refundable general business tax credit computed using the qualified rehabilitation expenditures (QREs) of structures certified by the National Park Service (NPS) as historic either individually or as contributing to the significance of a registered historic district. To claim the credit, a taxpayer submits a Form 3468, Investment Credit, reporting either the NPS number of the rehabilitation project (if the taxpayer is the owner of the certified historic structure); or the Employer Identification Number (EIN) of the pass-through entity from which the taxpayer is claiming the QREs (if the taxpayer is receiving the QREs through one or more pass-through entities).

The vast majority of rehabilitation tax credit dollars are claimed by a small number of very large taxpayers. The likelihood of audit for these taxpayers is very high under our normal audit selection processes. For example, in Tax Year (TY) 2013, we are evaluating the compliance risk of 35 returns (including evaluating the rehabilitation tax credit noncompliance risk) which accounted for 68 percent of the total rehabilitation tax credits claimed by taxpayers in that year. Likewise, in TY 2012, a similarly high percentage (approximately 70%) of the rehabilitation tax credit dollars were claimed by a limited number of very large taxpayers that had been selected for examination. We also pro-actively use NPS data during post-filing compliance activities to supplement the selection, classification and examination of returns.

We agree to work with the Treasury Department on changes to existing regulations that would provide clearer reporting requirements for claiming the Rehabilitation credit. We disagree with your recommendations to use the NPS data during returns processing



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## *Available Data Are Not Being Used to Proactively Identify Potentially Erroneous Rehabilitation Credit Claims*

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and to reject all e-filed returns that have Forms 3468 with missing or invalid EIN or NPS information. An EIN or NPS number on a Form 3468, in and of itself, does not verify compliance and, conversely, the lack of a valid number does not demonstrate that a claim is erroneous. This information is used to assist in identifying NPS projects associated with rehabilitation tax credit claims. TIGTA found that taxpayers provided proper EIN and NPS numbers in almost 95 percent of all Form 3468 filings and that, despite missing or invalid Form 3468, we were able to identify the NPS project or source of the QREs associated with more than half of the remaining Forms 3468. At this time, implementing TIGTA's recommendations would yield minimal compliance benefits while imposing unnecessary burdens on taxpayers with valid rehabilitation tax credit claims.

With respect to your recommendation that we verify whether the discrete population of taxpayers that you identified are entitled to claim the rehabilitation tax credit or have properly reported the QREs, we would need to audit those returns to accomplish the verification that you envision. We have reviewed the forms and available information related to the taxpayers identified by TIGTA and do not believe the filing mistakes identified by TIGTA correlate to any material compliance risk; therefore, we do not believe examinations are warranted.

We disagree with the stated outcome measures. As noted above, missing or incorrect information on a Form 3468 or on an associated partnership return does not mean that the claim is erroneous and by itself is not sufficient to warrant the examination of a rehabilitation tax credit claim. And since that is the premise that underlies your computations, we disagree with the bases of your computations. In addition, the outcome measures do not account for the opportunity costs associated with redeploying resources away from cases with higher compliance risks and larger potential adjustments to the cases with lower compliance risk and minimal potential adjustments. The identified taxpayers also claimed significantly fewer rehabilitation tax credits than are reported on the Forms 3468. Specifically:

- Increased Revenue, \$741,728 potential: The 4 identified taxpayers showed no affirmative indication of noncompliance and only claimed a total of \$257,000 in credits.
- Revenue Protection, \$47 million potential: The 39 identified taxpayers only claimed a total of \$17 million in credits. Moreover, 32 of these taxpayers already had been selected for compliance risk evaluation independent of the TIGTA audit and any revenue protected with respect to these taxpayers would not be attributable to TIGTA's recommendation.
- Revenue Protection, \$154,639 Potential: Of the 12 identified taxpayers, only 3 reporting a total of \$96,425 in credits, show any potential compliance risk.



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*Available Data Are Not Being Used to Proactively Identify  
Potentially Erroneous Rehabilitation Credit Claims*

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- Increased Revenue, \$8.6 million Potential: TIGTA extrapolates \$8.6 million in increased revenue based on 54 taxpayers that potentially made about \$7.9 million of erroneous claims from pass-through entities, but only 3, reporting approximately \$535,000 in potential errors, show any potential compliance risk.

Attached is a detailed response outlining our corrective actions to address your recommendations.

If you have any questions, please contact me, or a member of your staff may contact Shenita Hicks, Director Examination at (240) 613-2849

Attachment



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Attachment

The Commissioners, Large Business and International and Small Business/Self- Employed Divisions should:

**RECOMMENDATION 1:**

Verify whether the four taxpayers and \*\*\*\*1\*\*\*\* we identified that claimed the Rehabilitation Credit without final certification of completed work or Part 2 approval from the NPS are entitled to claim the credit.

**CORRECTIVE ACTION:**

We disagree with the premise that the lack of the Part 2 approval warrants examination. The failure to attach the Part 2 does not provide a basis to disallow the credit. We have confirmed that each of the \*\*\*1\*\* forms provided a valid NPS number and a valid Part 2 application date. Although the NPS database does not reflect Part 2 approval, it also does not reflect that these applications have been denied, indicating that they are likely pending. \*\*\*\*\*1\*\*\*\* cases have zero or minimal potential tax adjustments. Because compliance risk for these \*\*\*1\*\*\* SB/SE taxpayers is minimal, we have concluded that further action is not warranted.

**IMPLEMENTATION DATE:**

N/A

**RESPONSIBLE OFFICIAL:**

N/A

**CORRECTIVE ACTION MONITORING PLAN:**

N/A

**RECOMMENDATION 2:**

Develop processes and procedures to use NPS data to identify potentially erroneous claims both during tax return processing and during post-processing compliance efforts.

**CORRECTIVE ACTION:**

We disagree that NPS data can be used effectively during returns processing. During returns processing, we can reject forms that contain blank or improperly formatted EIN or NPS numbers, but we cannot ensure that properly formatted EIN or NPS numbers are actually correct, i.e., associated with an approved project for which the taxpayer is entitled to claim a rehabilitation credit. Implementing e-file business rules will yield minimal compliance benefits while imposing unnecessary burdens on taxpayers with valid rehabilitation tax credit claims. These taxpayers may be unable to provide the required information or may commit good faith errors due to complicated business arrangements. In addition, NPS data is already used to identify potential



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erroneous claims during post-processing compliance efforts. We will continue to work with the audit teams examining the taxpayers that claim the majority of the rehabilitation credits. In addition, we agree to:

1. Clarify our Planning and Special Program (PSP) Internal Revenue Manual. This clarification will explain in detail how NPS data should be used to identify, classify and examine returns claiming the rehabilitation tax credit. We will also update information on rehabilitation tax credits on "IRS.gov" to include a reminder about properly completing the Form 3468.
2. Issue a reminder to our auditors about available audit tools and resources relating to the rehabilitation credit, including information on the use of NPS data during examinations.

**IMPLEMENTATION DATE:**

March 15, 2017

**RESPONSIBLE OFFICIAL(S):**

Director, Exam Quality and Technical Support, SB/SE Examination  
Director, Enterprise Activities Practice Area LB&I

**CORRECTIVE ACTION MONITORING PLAN:**

IRS will monitor this corrective action as part of our internal management system of controls.

**RECOMMENDATION 3:**

Revise electronic filing programming to identify and reject electronically filed Forms 1065, Forms 1120, or Forms 1120S tax returns with a Rehabilitation Credit claim where the required NPS project number or EIN of a pass-through entity was not provided on Form 3468.

**CORRECTIVE ACTION:**

We believe implementing this business rule would be premature. An EIN or NPS number on a Form 3468, in and of itself, does not verify compliance and, conversely, the lack of a valid number does not demonstrate that a claim is erroneous. Further, implementing these e-file business rules will increase taxpayer burden while yielding minimal compliance benefits.

**RESPONSIBLE OFFICIAL:**

N/A





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**CORRECTIVE ACTION MONITORING PLAN:**

N/A

**RECOMMENDATION 4:**

Revise electronic filing programming to identify and reject any electronically filed tax return with a Rehabilitation Credit claim that includes an invalid NPS project number or pass-through entity EIN on the Form 3468.

**CORRECTIVE ACTION:**

During returns processing, we cannot ensure that the number provided on a Form 3468 actually is associated with the taxpayer claiming the credit; rather, we only can verify that an EIN or NPS number reported on the Form 3468 has the correct characters and number of digits to appear to be a valid number. Ensuring the "proper format" of EIN and NPS numbers on Forms 3468 will not materially enhance our compliance efforts.

**IMPLEMENTATION DATE:**

N/A

**RESPONSIBLE OFFICIAL:**

N/A

**CORRECTIVE ACTION MONITORING PLAN:**

N/A

**RECOMMENDATION 5:**

Verify whether the 39 taxpayers and 10 pass-through entities that claimed rehabilitation expenditures or credits without providing the required NPS project number or pass-through entity EIN are entitled to claim the expenditures or credits. This should include incorporating this issue into the open examinations for the 32 taxable entities.

**CORRECTIVE ACTION:**

At least 32 of these cases are being evaluated for compliance risk independent of the TIGTA audit, and we will continue to work these cases in accordance with our existing examination procedures. We have concluded that the compliance risk of the remaining taxable entities does not warrant further action. In addition, we have identified the NPS projects or entities associated with these claims; or have confirmed that minimal credit amounts were claimed by the taxpayers associated with these forms. Therefore, we have concluded these cases do not warrant further action.

**IMPLEMENTATION DATE:**

N/A



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**RESPONSIBLE OFFICIAL:**

N/A

**CORRECTIVE ACTION MONITORING PLAN:**

N/A

**RECOMMENDATION 6:**

Verify whether the 12 taxpayers and 3 pass-through entities that included an invalid entry on Form 3468 Line 11k are entitled to claim the expenditures or credits.

**CORRECTIVE ACTION:**

For these entities (taxable and pass-through), we have identified the NPS project or sources of the QREs associated with the claim, or have determined that minimal credit amounts were actually claimed by the taxpayers associated with the forms. We, therefore, conclude these cases do not warrant further action.

**IMPLEMENTATION DATE:**

N/A

**RESPONSIBLE OFFICIAL(S):**

N/A

**CORRECTIVE ACTION MONITORING PLAN:**

N/A

**RECOMMENDATION 7:**

Verify whether the 11 taxpayers who claimed potentially erroneous Rehabilitation Credits from a pass-through entity were entitled to claim the credits. This should include incorporating this issue into the open examinations for the four entities with an open examination indicator.

**CORRECTIVE ACTION:**

For these entities (taxable and pass-through), we have identified the NPS project or QREs associated with the claims or otherwise reconciled the return information; or have determined that credit amounts claimed by the taxpayers associated with the forms do not warrant further action at this time.

**IMPLEMENTATION DATE:**

N/A

**RESPONSIBLE OFFICIAL:**

N/A



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**CORRECTIVE ACTION MONITORING PLAN:**

N/A

The Deputy Commissioner for Services and Enforcement should:

**RECOMMENDATION 8:**

Work with the Department of the Treasury's Office of Tax Policy to propose changes to existing regulations and provide clear reporting requirements for claiming the Rehabilitation Credit.

**CORRECTIVE ACTION:**

We agree to work with the Treasury Department on guidance that would provide clearer reporting requirements for claiming the rehabilitation tax credit. We will submit a guidance proposal to the Office of Chief Counsel for prioritization vis-à-vis other regulatory projects under consideration by the Department of Treasury.

**IMPLEMENTATION DATE:**

September 15, 2016

**RESPONSIBLE OFFICIAL(S):**

Director, HQ Exam, SB/SE Examination

**CORRECTIVE ACTION MONITORING PLAN:**

IRS will monitor this corrective action as part of our internal management system of controls.