
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



*Bond Promoter Misconduct
Procedures Should Be Improved*

March 6, 2020

Reference Number: 2020-10-016

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HIGHLIGHTS

BOND PROMOTER MISCONDUCT PROCEDURES SHOULD BE IMPROVED

Highlights

**Final Report issued on
March 6, 2020**

Highlights of Reference Number: 2020-10-016
to the Commissioner of Internal Revenue.

IMPACT ON TAXPAYERS

U.S. State and local governments finance two-thirds of all infrastructure projects through the issuance of municipal bonds. The IRS's Tax Exempt Bonds (TEB) office administers Federal tax laws related to municipal financing and conducts examinations to ensure compliance, including responsibility for considering promoter misconduct under Internal Revenue Code Section 6700. The promoter penalty may be imposed on persons who organize or participate in a bond transaction and make false or fraudulent statements regarding the tax benefit to potential investors.

WHY TIGTA DID THE AUDIT

This audit was initiated to determine whether IRS management has controls in place that provide reasonable assurance that examiners consider whether Internal Revenue Code Section 6700 abusive tax shelter promoter penalties are warranted, or not, when performing tax-advantaged bond examinations.

WHAT TIGTA FOUND

TIGTA reviewed 127 closed examinations conducted in Fiscal Year 2017 and determined that examiners did not always document whether the promoter penalty was warranted or not. In addition, workpapers were incorrectly completed and quality reviewers did not identify incomplete case documentation.

When the IRS closes an examination with a penalty assessment, it uses penalty reference numbers to indicate the results in its systems; however, the TEB office used only the generic Tax Exempt and Government Entities Division reference number for all assessed penalties and

in cases for which they did not assess any penalties. This practice embeds compliance issues into one data attribute and may compromise the reliability of IRS compliance information.

According to IRS data, between Fiscal Years 2009 and 2018, examinations based on referrals have resulted in larger adjustments than examinations from other sources. The average tax adjustment from referrals was \$455,533 compared to \$159,952 from all other sources. However, the TEB office rarely opened cases from potentially productive sources such as media reports or other Federal agencies, including those sources with oversight responsibilities such as the Securities and Exchange Commission.

WHAT TIGTA RECOMMENDED

TIGTA made five recommendations including that the Commissioner, Tax Exempt and Government Entities Division, update guidance to require examiners to document their consideration of whether promoter penalties are warranted, or not, in every examination. TIGTA also recommended that the IRS ensure that quality reviewers determine examiners' consideration of promoter penalties; develop a comprehensive training program; and develop a data-driven method to track and quantify specific noncompliance issues. Furthermore, TIGTA recommended that the IRS improve identification of TEB office examination inventory by considering the merits of cases pursued by the Securities and Exchange Commission or those reported by media outlets.

In their response, IRS management agreed with three recommendations and partially agreed with the other two. Management plans to take corrective actions.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

March 6, 2020

MEMORANDUM FOR COMMISSIONER OF INTERNAL REVENUE

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Bond Promoter Misconduct Procedures Should Be Improved (Audit # 201810023)

This report presents the results of our review to determine whether Internal Revenue Service management has controls in place that provide reasonable assurance that examiners consider Internal Revenue Code Section 6700 Abusive Tax Shelter Promoter penalties when performing tax-advantaged bond examinations. This audit was included in our Fiscal Year 2019 Annual Audit Plan and addresses the major management and performance challenge of Improving Tax Compliance.

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

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 Heather M. Hill, Acting Assistant Inspector General for Audit (Management Services and Exempt Organizations).



Bond Promoter Misconduct Procedures Should Be Improved

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Abbreviations

BIMF	Base Inventory Master File
CCR	Case Chronology Record
FY	Fiscal Year
I.R.C.	Internal Revenue Code
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
LDC	Lead Development Center
SEC	U.S. Securities and Exchange Commission
TEB	Tax Exempt Bond
TE/GE	Tax Exempt and Government Entities
TIGTA	Treasury Inspector General for Tax Administration



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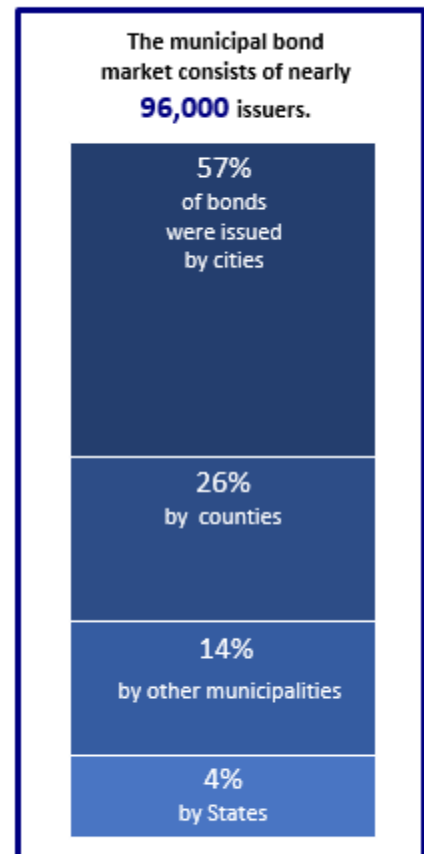
Background

U.S. State and local governments finance two-thirds of all infrastructure projects through the issuance of municipal bonds. Infrastructure projects include roads, bridges, airports, schools, hospitals, water treatment facilities, power plants, and other public buildings. In Calendar Year 2018, the municipal bond market was a \$3.8 trillion capital market with \$11.6 billion in par trades per day.¹ As of August 2019, the municipal bond market consisted of nearly 96,000 unique issuers. Figure 1 shows the various types of issuers by percentage of the market as of August 2019.

The Federal Government subsidizes infrastructure projects through tax-advantaged bonds by allowing bondholders to earn tax-exempt interest income, by providing a tax credit, or by providing State or local governments with a refundable credit payment. This tax preference means bond issuers can borrow money at a lower cost and investors benefit from mostly tax-free income. According to the Office of Management and Budget, in Fiscal Year (FY) 2018, this tax exemption provided an estimated \$28 billion in tax benefits.²

The Internal Revenue Service's (IRS) Tax Exempt and Government Entities (TE/GE) Division's Tax Exempt Bonds (TEB) office administers Federal tax laws related to municipal financing. The TEB office conducts examinations to ensure compliance with the provisions of the Internal Revenue Code (I.R.C.) applicable to tax-advantaged bonds, including tax-exempt bonds and tax credit bonds. To confirm compliance, TEB office examiners review records of the bond issuer and other parties to bond transactions.

Figure 1: U.S. Municipal Bond Issuers



Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of electronic municipal market access consolidated issuer information, as of August 2019.

¹ Municipal Securities Rulemaking Board Calendar Year 2018 Muni Facts. A par trade is a bond that sells at 100 percent of its face value.

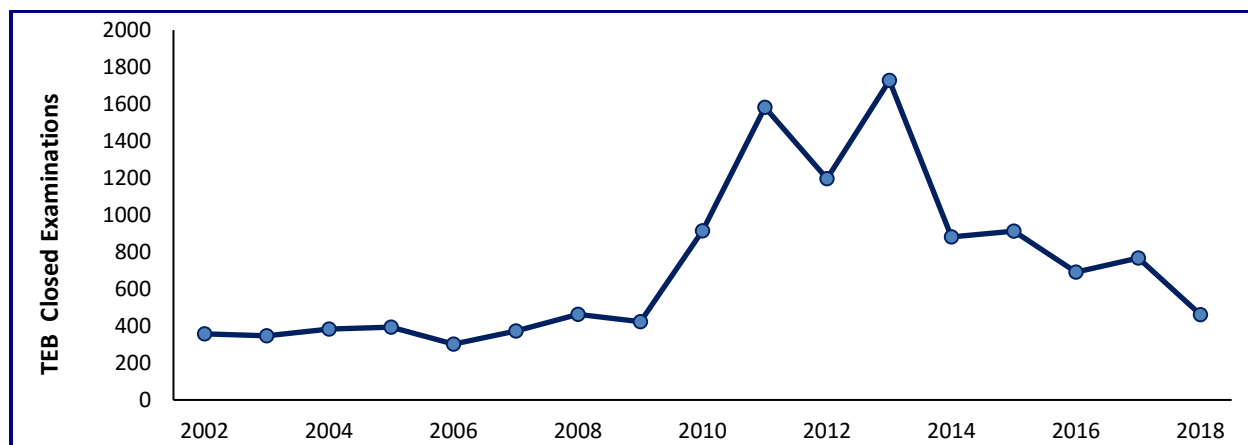
² A fiscal year is any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.



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Generally, the number of examinations the TEB office closes in a given fiscal year has remained constant over time. However, the TE/GE Base Inventory Master File (BIMF)³ showed that the TEB office experienced a notable increase in examinations from FY 2010 to FY 2013 (see Figure 2) due largely in part to focused examination projects for new types of bonds issued as part of the American Recovery and Reinvestment Act.⁴ Since that point, the TEB office examination closure rates are more in line with prior levels.

Figure 2: TEB Office Examination Closures – FY 2002 to FY 2018



Source: TIGTA analysis of prior reports and the TE/GE BIMF.

In FY 2017, the TEB office closed more than 55 percent of its examinations without changes, and the remaining examinations resulted in written advisories, agreements to taxes or penalties, closing agreements, and other examination closures that totaled nearly \$36 million in adjustments. While examinations conducted by the TEB office result in various outcomes, sometimes the IRS discovers problems with a bond, *e.g.*, not a valid debt, unqualified issuer, or misuse of bond proceeds, that might disqualify the bond from maintaining its tax-exempt status. The IRS may declare the bond taxable or the bond could lose its financial tax benefits. For example, in Calendar Year 2015, the *Malone Telegram* reported that the IRS determined that a school district's bonds did not qualify as tax-exempt. The school district paid \$1.3 million to the IRS and was financially liable for the improperly granted tax benefits. The school district sued its attorneys for more than \$4 million due to erroneous legal guidance that the bonds were qualified, and they settled in Calendar Year 2018 for an undisclosed amount.⁵

Because of the complexities associated with tax-advantaged bond issuances, issuers usually rely on bond professionals who specialize in tax-advantaged bonds to assist in structuring

³ The BIMF is a 10-year case history of examination data related to TE/GE Division activities.

⁴ Pub. L. No. 115-5 (2009).

⁵ E.J. Conzola, II, *Malone School District Settles Suit Against Law Firm Filed Over Problems With Construction Bonds*, *Malone Telegram*, May 11, 2018.



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transactions in accordance with applicable Federal tax laws and regulations. Bond transaction organizers and participants, *e.g.*, underwriters, bond counsel, or advisors, assist with bond sales and can earn substantial fees from bond proceeds.⁶ Individual agreements and bond fees are unique to each bond issuance and market conditions; therefore, fees vary.

Congress created the I.R.C. Section (§) 6700 provision in 1982 due to concerns that the widespread marketing and use of tax shelters at the time undermined the public's confidence in the fairness of the tax system. I.R.C. § 6700 provides that the IRS can impose a promoter misconduct penalty on organizers or participants to a bond transaction who made or furnished, or caused to be made or furnished, a false or fraudulent statement regarding the tax benefit in any bond transaction. An I.R.C. § 6700 promoter penalty (hereafter referred to as promoter penalty) would generally be equal to 50 percent of the gross income derived (or to be derived) by the promoter. This assessment would be against the individual or corporation promoting the abusive tax shelter or transaction.⁷

While the promoter penalty acts as a deterrent against misbehavior by organizers and participants to a bond transaction, it does not address the loss of the tax-advantaged status of the bonds or negative financial implications to involved parties such as municipalities and investors. Congress believed that abusive tax shelters should be attacked at the source—the organizer and salesman—because these types of parties were generally more responsible than the purchaser who may have relied on their representatives as to the tax consequences of the investment. Therefore, IRS oversight of compliance with I.R.C. § 6700 is essential as bond transaction organizers or participants who advise bond issuers may substantially affect the tax-advantaged bond market.

The opportunities for bond promoters to misrepresent any number of elements in a bond issuance also vary. For example, in Calendar Year 2006, the IRS found evidence of bid rigging (structuring the process so that only one firm submits an acceptable bid) in 20 bond deals that totaled nearly \$3 billion in issuances. The IRS assessed \$200 million in promoter penalties, and the promoter agreed to a separate settlement with the IRS.

TE/GE management determines examination priorities based on issues and trends identified from past work, internal sources, and external sources. Based on input from TEB office management, the TE/GE Division Compliance Planning and Classification function selects and controls the examination inventory for TEB office examiners. Once an examination begins, one of the examiner's responsibilities is to consider whether misconduct by an organizer or participant warrants application of the promoter penalty.⁸

⁶ In Calendar Year 2014, the IRS reported tax-exempt bond proceeds as \$429.2 billion, which is the most recent figure reported in the *IRS Statistics of Income*.

⁷ For activities occurring after October 22, 2004.

⁸ I.R.C. § 6700 (2004).



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In September 2017, the TEB office modified the promoter penalty referral process. If TEB office examiners become aware that the promoter penalty may apply, they consult with their managers to determine if the promoter penalty referral should be made to the Lead Development Coordinator. These referrals are now supposed to be sent to the Small Business/Self-Employed Division Lead Development Center (LDC).⁹ The LDC is responsible for reviewing and making a determination as to whether to approve or deny TEB office referrals for promoter penalty issues. When the LDC receives a referral from the TEB office, a revenue agent should review it and perform research to determine if there is sufficient evidence of abusive behavior to recommend authorization for an investigation. However, there is no documentation to indicate that the TEB office made any referrals to the LDC since that process began. This review did not assess the LDC program.

The TEB office relies on quality review to measure performance of bond examinations by using seven standards.¹⁰ For example, one of the quality standards assesses whether the examiner considered promoter penalties and made referrals as warranted. Examinations receive a pass or fail for this standard; the rating is included as an element of the Exam Quality Score and reported quarterly in the Business Performance Reviews. The TEB office may use quality review results to identify areas for case improvement, offer training, and improve consistency in examinations where needed.

While examiners consider many penalties during examinations, this audit focused on whether IRS management has controls in place that provide reasonable assurance that examiners consider the promoter penalty when performing tax-advantaged bond examinations. The examiner's consideration occurs when he or she evaluates the potential applicability of the promoter penalty during the exam and before making a decision as to whether it is warranted.

This review was performed at the TE/GE Division offices in San Francisco, California; Lafayette, Louisiana; and Brooklyn, New York, and with information obtained from TE/GE Division Headquarters in Washington, D.C., during the period August 2018 through June 2019. 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.

⁹ The Small Business/Self-Employed Division LDC acts as the clearinghouse to receive, identify, and develop leads on individuals and entities that promote or aid in the promotion of abusive tax schemes.

¹⁰ The standards include: Examination Planning, Examination Scope, Examination Techniques, Workpapers/Reports, Application of Law/Tax Determination, Timeliness, and Customer Relations/Professionalism.



Results of Review

Examiners Did Not Always Document Consideration of the Promoter Penalty

TEB office management and guidance require examiners to document consideration of tax laws (*i.e.*, promoter penalties) in every tax-advantaged bond examination; however, examiners do not have specific guidance on how or where they should include this information in the case file. Furthermore, we determined that current documentation practices do not always provide conclusive evidence that examiners considered the promoter penalty.

The IRS can assess promoter penalties at any time, as there is no statute of limitations. Moreover, the IRS does not need to declare bonds taxable to assert I.R.C. § 6700 penalties. For example, the IRS may choose to enter into a closing agreement with the bond issuer to insulate bondholders from the effects associated with bonds losing their tax-advantaged status. This would not prevent the IRS from initiating a separate promoter penalty investigation. In addition, if the IRS fails to enter into a closing agreement or declare taxability of the bonds, and the IRS determines the elements of the promoter penalty are met, the IRS may still take action under I.R.C. § 6700. IRS guidance clearly states that the determination of whether I.R.C. § 6700 is applicable is a separate penalty investigation, apart from TEB's normal bond examination activities. This speaks to the importance placed on I.R.C. § 6700 and why an examiner's documentation of his or her consideration requires clarity, consistency, and reliability.

Although examiners are required to document consideration of promoter penalties in the workpapers,¹¹ TEB office guidance does not specify how or where examiners should document their consideration of promoter penalties in the examination file. We found that in most cases examiners used the optional *TEB Penalties and Fraud Workpaper Summary*, where they can document their required consideration of all applicable penalties (*i.e.*, promoter penalty) and the potential for fraud. By correctly completing the first section of the workpaper, examiners document their consideration of the promoter penalty with a general penalty consideration statement. However, we identified instances in which examiners failed to meet minimum documentation requirements. Moreover, we found that workpapers were incorrectly completed and quality reviewers did not identify incomplete case documentation.

¹¹ IRM 4.81.5.16.1(1)-(2) (Jan. 28, 2016).



Examination case file promoter penalty documentation issues

We reviewed a random sample of 127 closed tax-advantaged bond examinations from a population of 714 examinations conducted in FY 2017.¹² In 30 (24 percent) of 127 sampled cases, the examiners did not document whether promoter penalties were warranted, or not, anywhere in the case files. Based on these results, we estimate that examiner consideration of promoter penalties is indeterminable in 169 cases.¹³

For the remaining 97 cases for which consideration was determinable, we found:

- 77 cases for which the examiner relied on a general penalty consideration statement for documentation of the promoter penalty.
- 20 cases for which the examiner relied on more clear and specific language (or added their own) to document specific consideration of the promoter penalty.

Notwithstanding, based on the documentation we reviewed for the 127 examinations, we did not identify any cases for which it appeared that the assertion of the promoter penalty was warranted.

During the course of this review, the IRS updated Internal Revenue Manual (IRM) guidance, explicitly requiring that examiners consider whether the imposition of the promoter penalty is warranted in every examination.¹⁴ Therefore, the documentation examiners use to support this requirement should reflect this updated guidance and include specific documentation related to consideration of the promoter penalty.

According to the IRM, the only workpaper specifically required to be in the case file documentation is the Case Chronology Record (CCR).¹⁵ However, case review results showed that examiners did not document whether promoter penalties were warranted, or not, on the CCR in 124 (98 percent) of the 127 sampled cases. Based on these results, we estimate that 699 CCRs do not contain the notation of the examiners' consideration of the penalty.¹⁶

Because TEB management does not specifically require or guide examiners in how they should document their consideration of promoter penalties, we found inconsistencies in the documentation examiners used when they considered promoter penalties. For example, examiners used nine different workpapers to document the consideration.

¹² See Appendix I for our sampling methodology.

¹³ We selected our sample using a 95 percent confidence interval, a 10 percent error rate, and a 5 percent precision factor. When projecting the results of our statistical sample, we are 95 percent confident that the actual total amount is between 124 and 214 cases, respectively.

¹⁴ IRM 4.81.5.18(1) (Dec. 4, 2018).

¹⁵ IRM 4.81.5.16.6(1)-(7) (Jan. 28, 2016).

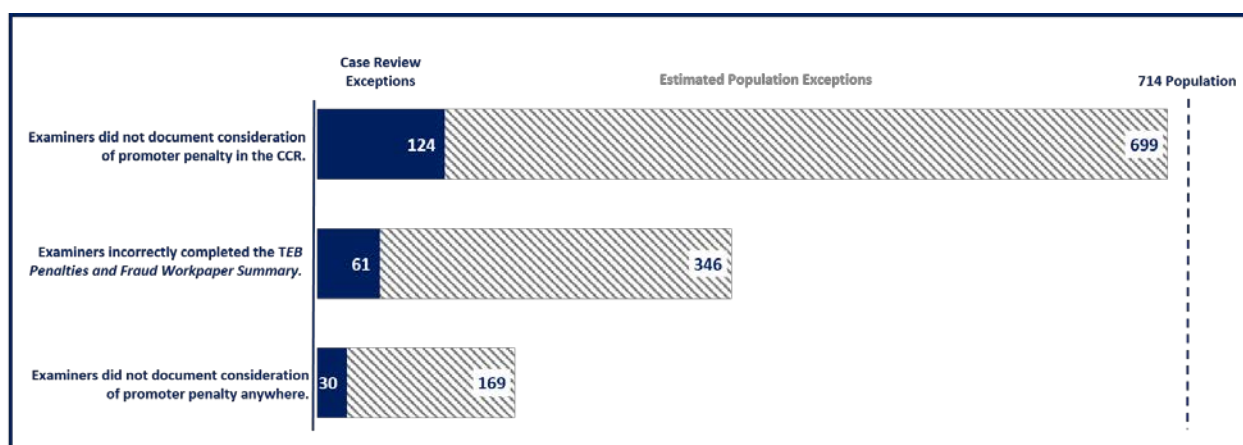
¹⁶ We selected our sample using a 95 percent confidence interval, a 10 percent error rate, and a 5 percent precision factor. When projecting the results of our statistical sample, we are 95 percent confident that the actual total amount is between 684 and 715 cases, respectively.



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In addition, for 61 (48 percent) of 127 sampled cases, examiners incorrectly completed the most commonly used workpaper, *TEB Penalties and Fraud Workpaper Summary*. For example, examiners sometimes failed to complete all required fields, incorrectly identified the names of the entities, or included unnecessary information. Based on these results, we estimate examiners improperly documented 346 cases.¹⁷ Figure 3 summarizes the results of our sampled case review and our projections to the population of cases.

Figure 3: TIGTA Analysis of TEB Examiners' Case Documentation of Promoter Penalties



Source: TIGTA analysis of TEB office examiners' case documentation.

Furthermore, quality reviews were not effective in identifying the lack of documentation. We reviewed all 89 examinations that the TEB office reviewed for quality in FY 2017 and determined that 15 (17 percent) examinations did not include any documentation of the examiners' consideration of promoter penalties. However, quality reviewers did not identify this problem and gave the examiners full credit for complying with the promoter penalty attribute. Quality reviews ceased in FY 2018 and the TE/GE Division migrated to a new Tax Exempt Quality Measurement System for all functions in FY 2019.

Additional documentation issues

In addition to the case file and quality review issues specific to the promoter penalty, we determined that examiners sometimes left the CCRs blank or they were missing from case files. TEB office guidance requires examiners to use the CCR as historical documentation of case actions.¹⁸ However, in five (4 percent) of 127 sampled cases, the CCR was blank or missing

¹⁷ We selected our sample using a 95 percent confidence interval, a 10 percent error rate, and a 5 percent precision factor. When projecting the results of our statistical sample, we are 95 percent confident that the actual total amount is between 292 and 400 cases respectively.

¹⁸ IRM 4.81.5.16.6(1)-(7) (Jan. 28, 2016).



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from the documentation file.¹⁹ Based on these results, we estimate that 29 examinations did not contain a completed CCR.²⁰

The TEB office relies on its examiners to identify potential misconduct by organizers or participants (and all noncompliance issues) during examinations, thoroughly document examination details, and develop referrals for the LDC when warranted. Therefore, it is imperative that examiners receive regular training, as this is an important component to ensure application of the penalty and proper documentation of consideration in the case file. In addition to their own IRM requirements, all Federal agencies must evaluate their training programs annually to determine if they meet organizational performance goals.²¹ However, we were unable to determine the effectiveness of the TEB office's training program because TEB office management was unable to provide documentation of attendance.

Recommendations

The Commissioner, TE/GE Division, should:

Recommendation 1: Update guidance to require examiners to document their consideration of whether promoter penalties are warranted, or not, in every examination and in the same file location (*e.g.*, the CCR). Provide examiners training on guidance updates.

Management's Response: IRS management agreed in part with this recommendation. The IRS stated that it has policies and procedures in place to consider and document penalties, when warranted by the facts. TEB will follow the Service-wide policy concerning documentation of penalties in IRM 20.1.6.1. The IRS will remind employees of this guidance and provide refresher training on documentation of cases. However, the IRS will not require examiners to document the consideration of promoter penalties in a specific worksheet or case file document.

Office of Audit Comment: IRM 4.81.5.18(1) requires TEB examiners to consider the promoter penalty in every examination to determine whether it is warranted or not. However, Service-wide policy (IRM 20.1.6.1) requires documentation of the penalty consideration only when the penalty is warranted by the facts. Therefore, for examinations in which the examiner decides the promoter penalty is not warranted by the facts, there is no requirement for the examiner to provide accompanying documentation supporting their decision.

¹⁹ The five sampled cases are included in the previous results (examiners did not document their consideration of promoter penalties anywhere in the case files nor did they document their consideration in the CCR).

²⁰ We selected our sample using a 95 percent confidence interval, a 10 percent error rate, and a 5 percent precision factor. When projecting the results of our statistical sample, we are 95 percent confident that the actual total amount is between six and 53 cases, respectively.

²¹ Code of Federal Regulations Title 5, Volume 1, § 410.202 (revised as of December 10, 2009).



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Furthermore, our analysis showed that in 30 (24 percent) of 127 sampled cases, TEB examiners did not document whether promoter penalties were warranted or not, anywhere in the case files. TEB quality reviewers incorrectly concluded examiners had documented consideration of the promoter penalty in 17 percent of the cases they quality reviewed. Using a standard and consistent location to document the promoter penalty consideration would improve the TEB's quality review process and help managers ensure that examiners are considering the penalty.

Recommendation 2: Ensure that quality reviewers determine whether examiners consider promoter penalties and provide corrective actions when appropriate.

Management's Response: IRS management agreed with this recommendation and plans to ensure that procedures instruct TEB quality reviewers to determine whether examiners consider and document penalties and to provide for corrective actions when appropriate. The quality review standard will align with Service-wide documentation requirements on penalties.

Recommendation 3: Develop a comprehensive training program for TEB office examiners that:

- Prepares examiners to consider whether promoter penalties are warranted, or not.
- Prepares examiners to accurately document their consideration of promoter penalties and all other required case actions in every tax-advantaged bond examination.
- Trains examiners to develop promoter penalty referrals for the LDC.
- Trains examiners to properly complete and document their workpapers, including the CCR and the *TEB Penalties and Fraud Workpaper Summary*.
- Uses Tax Exempt Quality Measurement System reports to evaluate the training program and make changes as necessary and offers periodic refresher courses as needed.
- Tracks and documents attendance and subject matter.

Management's Response: IRS management agreed with this recommendation. Consistent with Service-wide policies and procedures, the IRS plans to provide continuing professional education for TEB examiners on penalties, penalty documentation, and referrals to the LDC. The IRS will use training evaluations to make necessary changes to training sessions and will track and document attendance and subject matter of the training sessions.

Better Tracking of Examination Issues and Use of Referrals Could Improve Identification of Promoter Misconduct

The TEB office used a single miscellaneous penalty transaction code and reference number combination to indicate closing agreement assessments, and used the same reference number for



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all penalty cases that the TEB office closed, regardless of the type of penalty assessed. This practice limits the usefulness of closed examination results when establishing future workload priorities.

In addition, the TEB office did not pursue potential organizer or participant noncompliance reported by external sources and other Government agencies, such as the Securities and Exchange Commission (SEC). Such sources could help the TEB office identify organizers or participants engaged in potentially prohibited activities and align with the goal of using focused examinations to provide the greatest impact on potential noncompliance.

Use of a single reference number limits the identification of specific noncompliance issues

TEB office employees have the ability to choose from several reference numbers that specifically identify penalty closure information. For example, there are reference numbers for the promoter penalty, substantial understatements, and accuracy-related penalties. However, the TEB office used only the generic TE/GE Division reference number for all assessed penalties. We identified cases for which examiners used this miscellaneous penalty transaction code even when they did not assess any penalties.

The TE/GE Division's FY 2018 Work Plan states that data collection tools and data analytics are central to improving case selection for the TEB office. From a data-driven perspective, the TEB office's use of one reference number for all penalty transactions embeds compliance issues into one data attribute. The TEB office stated that it uses a singular reference number because Master File codes are for tracking taxes, and the TEB office does not technically assess taxes. However, according to the IRM, reference numbers enable the IRS to track penalties and accurate reporting of them is vital. They provide the basis for determining compliance history and the foundation for analyzing trends.²² Conversely, the reference number the TEB office uses on the Master File is generic, which could produce misleading data results, may compromise the reliability of compliance information, and makes it difficult to determine trends or emerging concerns in the bond industry.

Greater emphasis on potential organizer and participant noncompliance identified by external sources and other Government agencies could improve examination results

The IRS could improve its documentation, tracking, and case selection methodology regarding information from external sources and other Government agencies to develop examination leads, which could result in the assessment of the promoter penalty. The SEC has the primary responsibility for regulating the bond market. In March 2010, the SEC and the IRS entered into a *Memorandum of Understanding* whereby they agreed to work cooperatively to aid both

²² IRM 20.1.1.5.1(1) (Nov. 25, 2011).



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agencies in their oversight, compliance, and enforcement efforts in the tax-advantaged bonds and municipal securities industries. While the SEC uses Federal securities law to penalize bond organizers and participants for misconduct, the TEB office may work to develop and administer Federal tax law, *i.e.*, the promoter penalty, but only when applicable.

Between December 2015 and September 2018, the SEC issued at least \$87.9 million in fines against bond organizers and participants for misconduct and barred at least four from working in the municipal bond industry (see Appendix V for details regarding some of the SEC's cases).²³ The SEC published all of this information on its public website. In addition, representatives from the SEC and the TEB office meet regularly to offer cross training for employees and discuss enforcement issues. However, research of the TE/GE BIMF and discussions with TEB officials indicates no TEB office examination activity related to the SEC's recent litigation and judgments.

The circumstances in the cases litigated by the SEC included issues for which the IRS may consider investigating a potential application of the promoter penalty. For example, in one case, the bond organizer or participant intentionally diverted funds from the debt service reserve and did not replenish it as required by the bond's trust indentures. These types of issues may signify misconduct that could affect a bond's tax-exempt status. We also identified extensive media coverage of other bond organizers and participants engaging in misconduct penalized by the SEC.

IRS management stated that they do not always examine cases such as these because the SEC's bond organizer and participant misconduct cases do not always deal directly with tax issues regarding bonds. TEB office management also cited disclosure limitations as a barrier to communication. Therefore, the TEB office waits until the SEC makes its actions public to identify potential referrals. However, TEB office management could not recall the last time the TEB office initiated a case based on the SEC's work.

The TEB office/SEC *Memorandum of Understanding* encourages cooperative holistic efforts to provide coverage of both Federal tax laws (IRS) and Federal securities laws (SEC). Specifically, the IRS and the SEC should work together to identify issues and industry trends within the tax-advantaged bonds/municipal securities industry and to develop strategies to enhance performance of their respective responsibilities. To support this effort, both parties should share information in a manner consistent with the laws that govern them. This enables the IRS and the SEC to develop information that would be of value to either agency in carrying out their duties. Proactively engaging the SEC about the possibility that their cases may connect to tax law issues would better achieve these common goals.

The TEB office's IRM instructed management to determine their examination priorities and inventory needs based on issues and trends identified from examinations. This guidance also

²³ The SEC has oversight responsibilities for the bond market via the Exchange Act and other securities law.



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requires the Compliance Planning and Classification function to coordinate the selection and classification of returns to ensure adequate levels of examinations for TEB office examiners.²⁴ The TEB office selects returns for examination based on information obtained from a variety of sources, such as:

- Information gathering projects.
- Internal risk assessments of returns filed by issuers.
- Referrals from Federal agencies, informants, news articles, or internal IRS sources.
- Issues identified during open TEB office examinations.

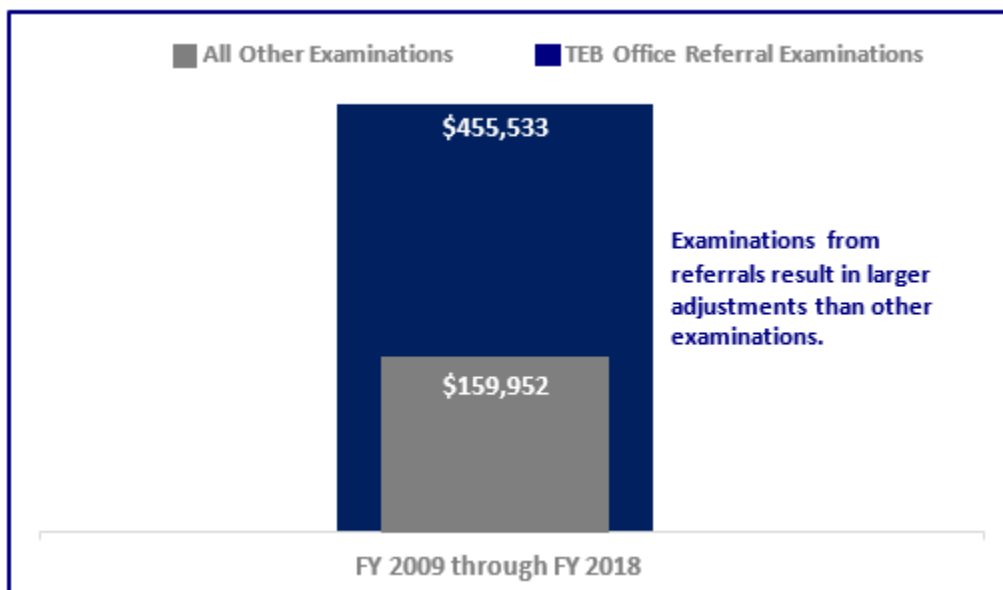
To determine the TEB office's examination sources, we reviewed the 9,782 TEB examinations initiated on the TE/GE BIMF between FY 2009 and FY 2018. The TEB office selected 9,489 (97 percent) of its examination inventory primarily based on its own risk assessments (Returns Inventory Classification System), claim filings, related returns, and taxpayer requests.²⁵ Only 292 (3 percent) cases originated from referrals, *e.g.*, internal, external, and information reports. Although the TEB office did not formally track the total number of referrals it received, at TIGTA's request, IRS management reviewed the limited information it had available and identified an average of fewer than 20 referrals each year over the 10-year period. Not all referrals will result in an examination, but cases that originate from referrals and news articles relate closely to the TEB office's goal of using focused examinations to provide the greatest impact on potential noncompliance. Figure 4 shows that since FY 2009, referral examination results have compared favorably with examination results from other sources.

²⁴ IRM 4.81.2.3(1) (Apr. 12, 2016).

²⁵ The Returns Inventory Classification System provides access to return filing and processing information for the TE/GE Division to determine compliance risk levels.



Figure 4: TEB Office Referral Examinations' Average Adjustments (FY 2009 Through FY 2018)



Source: Treasury Inspector General for Tax Administration analysis of the TE/GE BIMF.

According to the TE/GE BIMF, between FY 2009 and FY 2018, the average tax adjustment for referred cases was \$455,533, which was nearly three times more than the average tax adjustment for all other examinations (\$159,952).²⁶ The higher average adjustments suggest that referred cases are productive cases to work. However, the Compliance Planning and Classification function rarely opened TEB office cases from other potentially productive sources such as the media or other Federal agencies. Between FYs 2009 and 2018, none of the 9,782 examinations the TEB office opened came from a media lead or other Federal agencies. Proactive engagement with external sources and other Government agencies could help identify and reduce the number of bond organizers or participants potentially engaged in prohibited activities.

Recommendations

The Commissioner, TE/GE Division, should:

Recommendation 4: Develop a data-driven method to track and quantify specific noncompliance issues, *i.e.*, the promoter penalty, that are otherwise embedded in generic reference numbers, and update related guidance and train employees as needed.

Management's Response: IRS management agreed with this recommendation and will develop a data-driven method to track and quantify bond noncompliance, including

²⁶ The average tax adjustment recommended at closing.



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penalties. When the data-driven methodology is implemented, the IRS will update related guidance and train TEB employees as needed.

Recommendation 5: Improve identification of TEB office examination inventory by considering the merits of cases pursued by the SEC or reported by media outlets.

Management's Response: IRS management agreed with this recommendation in part. The IRS stated that it would consider the value of improved identification of TEB office examination inventory by continuing to consider the merits of cases pursued by the SEC or reported by media outlets. If warranted, the IRS will take steps to improve inventory identification.

In its response, IRS management also asserted that because TIGTA did not review the referral process, we did not have a basis for our conclusion that in the past the IRS has not considered SEC or media outlets in case selection.

Office of Audit Comment: We believe management can improve the identification of potential leads from cases reported by the SEC or media outlets by routinely researching publicly available information, and not relying solely on referrals.

TIGTA did not conclude that the IRS had not considered the SEC or media outlets in case selection. TIGTA concluded, based on our analysis of the 9,782 examinations opened by TEB between FY 2009 and FY 2018, that no cases actually opened came from a media lead or other Federal agency.



Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether IRS management has controls in place that provide reasonable assurance that examiners consider I.R.C. § 6700 Abusive Tax Shelter Promoter penalties when performing tax-advantaged bond examinations. To accomplish our objective, we:

- I. Determined the IRS's procedures to consider abusive tax shelter promoter penalties when performing tax-advantaged bond examinations.
 - A. Reviewed the IRM, internal resource guidance, memoranda, and other information to identify controls for TEB office examiners to consider promoter penalties when performing tax-advantaged bond examinations.
 - B. Identified and obtained any materials (required, optional, and informational) IRS management provides for examiner training, *i.e.*, classroom, digital, *etc.*, and knowledge updates pertaining to promoter penalty consideration and documentation.
 - C. Interviewed TEB office examiners and performed walkthroughs of their consideration of the promoter penalty to identify the steps they take.
 - D. Identified any issues (referrals, submissions, *etc.*) contained in other IRS systems for tax-advantaged bond specific examinations or emerging issues pertaining to the promoter penalty.
 - E. Reviewed guidance and identified TEB office examination selection criteria used to help identify noncompliance such as promoter misconduct. We obtained TEB office examination records from the TE/GE BIMF. We analyzed TE/GE BIMF data, completed reasonableness testing, and determined average tax assessment values based on examination origins (referrals, news articles, and all others) and closure types (changes versus no changes).
 - F. Performed Internet research for public information regarding bond promoter misconduct. We identified relevant SEC cases against bond organizers and participants for misconduct in the municipal bond industry and the *Memorandum of Understanding* agreement between the TEB office and the Commission. We analyzed the SEC's cases for potential pertinence to Federal tax law, *i.e.*, promoter misconduct, and the *Memorandum of Understanding's* connectivity to shared oversight of the industry.
 - G. Obtained all records on the Business Master File for reference numbers used by the TEB office to indicate assessment of miscellaneous penalties, *i.e.*, the promoter



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- penalty. We analyzed records to determine frequency, trends, or patterns in the data regarding TEB office examination closures and noncompliance activity.
- II. Determined whether IRS management controls are functioning to provide reasonable assurance that TEB office examiners are considering abusive tax shelter promoter penalties during tax-advantaged bond examinations.
- A. Reviewed the prior process and case documentation from the most recently closed promoter penalty case that was identified in a tax-advantaged bond examination.
 - B. Analyzed the 89 quality reviewed examinations from FY 2017 to determine if quality reviewers properly evaluated examiner documentation for consideration of the promoter penalty.
 - C. Consulted with TIGTA's contract statistician to select a sampling methodology. Because TEB uses specific disposal codes to characterize the type of case closure, we stratified the population of 714 FY 2017 closed TEB office examinations into six stratum by disposal code, and randomly selected a statistically valid sample of 127 cases from appropriate disposal code types.¹
 - D. Reviewed a statistically valid random sample of 127 cases from the 714 FY 2017 closed TEB office examinations and determined if the examiners documented their consideration of the promoter penalty in each examination.

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: the IRS's policies, procedures, and practices related to the consideration of promoter penalties when performing tax-advantaged bond examinations. We evaluated these controls by contacting management, reviewing IRM guidance and training provided to managers and employees, conducting site visits with TEB office examiners to walk through their processes, and analyzing closed examination data and documentation.

¹ We selected our sample using a 95 percent confidence interval, a 10 percent error rate, and a 5 percent precision factor.



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Appendix II

Major Contributors to This Report

Heather Hill, Acting Assistant Inspector General for Audit (Management Services and Exempt Organizations)

Carl L. Aley, Director

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Catherine R. Sykes, Lead Auditor

Yolanda Brown-Alexander, Auditor



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Appendix III

Report Distribution List

Deputy Commissioner for Services and Enforcement
Director, Government Entities/Shared Services, Tax Exempt and Government Entities Division
Director, Exempt Organizations, Tax Exempt and Government Entities Division
Director, Enterprise Audit Management



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:

- Reliability of Information – Potential; 169 tax-advantaged bond examinations do not document consideration of whether the promoter penalty was warranted or not in the case file (see page 6).

Methodology Used to Measure the Reported Benefit:

We selected and reviewed a statistically valid sample of 127 closed tax-advantaged bond examinations from a population of 714 examinations conducted in FY 2017.¹ We determined that 30 (24 percent) of the 127 bond examinations did not document the consideration of the promoter penalty in the case file. Based on these results, we estimate that 169 of the 714 closed examinations did not contain documentation of the examiners' consideration of the promoter penalty in the case file.

Type and Value of Outcome Measure:

- Reliability of Information – Potential; 15 quality reviewed tax-advantaged bond examination files did not identify missing documentation of the examiners' consideration of the promoter penalty (see page 6).

Methodology Used to Measure the Reported Benefit:

We selected and reviewed all 89 examinations that the TEB office selected for quality review in FY 2017. TEB office quality reviews did not identify any cases with missing documentation; however, we identified 15 examination case files that did not contain documentation of the examiners' consideration of the promoter penalty.

¹ We selected our sample using a 95 percent confidence interval, a 10 percent error rate, and a 5 percent precision factor.



Appendix V

Securities and Exchange Commission *Case Examples*

- In the Matter of BOKF, NA (Admin. Proceeding: 3-17533): On September 9, 2016, a subsidiary of Oklahoma-based BOK Financial Corporation (BOKF) agreed to pay more than \$1.6 million to settle charges by the Commission that it concealed numerous problems and overlooked red flags from investors in municipal bond offerings used to purchase and renovate senior living facilities.¹
 - Securities and Exchange Commission v. Marrien Neilson (Civil Action 16-cv-5475): On September 9, 2016, the Commission also filed a separate complaint in Federal court against BOKF's senior vice president, Marrien Neilson (BOKF terminated Neilson), who was allegedly responsible for ignoring an investment scheme by Christopher F. Brogdon (bond organizer and participant) in fraudulent bond offerings. Specifically, the BOKF did not act on behalf of bondholders and notify them about material problems with the bonds, and continued to collect fees from the deals.²
 - Securities and Exchange Commission v. Christopher Freeman Brogdon (and various Relief Defendants)-Civil Case 2: 15-cv-08173-KM-JBC: On November 20, 2015, the Commission filed a complaint seeking emergency relief against bond organizer and participant Brogdon, charged him with fraud, and the court ordered him to repay \$85 million to investors. Brogdon raised more than \$190 million through 40 conduit municipal bond offerings. The Commission asserts that Brogdon diverted bond investor proceeds (he routinely drew down on the debt service reserve funds held at the BOKF to make payments without replenishing the funds as required by the offerings' trust indentures) to pay for his and his wife's lavish lifestyles and further his business enterprise.³
 - In the Matter of John T. Lynch, Jr. (Admin. Proceeding: 3-17902): On February 6, 2018, the Commission barred John T. Lynch (bond counsel to the BOKF bond transactions) from the municipal bond market because he violated antifraud

¹ U.S. Securities and Exchange Commission, *BOK Financial, Senior Executive Charged With Turning Blind Eye to Investment Scheme*, Press Release (September 2016).

² U.S. Securities and Exchange Commission, *BOK Financial, Senior Executive Charged With Turning Blind Eye to Investment Scheme*, Litigation Release No. 23640 (September 2016).

³ U.S. Securities and Exchange Commission v. Christopher Freeman Brogdon, 2:15-cv-08173-KM-JBC (U.S. D.C.D.N.J. 2015).



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provisions of the Federal securities laws by failing to conduct reasonable due diligence during his underwriting of the BOKF bond offerings for the renovation of senior living facilities.⁴

- Securities and Exchange Commission v. Malachi Financial Products, Inc. and Porter B. Bingham (Civil Action 3: 18-cv-1-HSO-LRA): On January 2, 2018, the Commission filed a complaint against municipal advisor Malachi Financial Products, Inc. and its principal Porter B. Bingham for defrauding the city of Rolling Fork, Mississippi, during the promotion of a \$1.1 million bond offering. On June 29, 2018, a Federal district court entered judgments against them and ordered payment of disgorgement for \$33,000 plus prejudgment interest of \$2,858; Malachi will pay a civil penalty of \$50,000, and Bingham will pay a civil penalty of \$25,000.⁵
- In the Matter of Barcelona Strategies, LLC and Mario Hinojosa (Admin. Proceeding: 3-18476): On May 9, 2018, the Commission barred bond organizer and participant Barcelona Strategies, LLC (Barcelona) and its sole member Mario Hinojosa from practice in the municipal bond industry for drafting a brochure that was false and misleading in multiple respects, breaching their fiduciary duty to La Joya Independent School District, and failing to deal fairly with them.⁶
 - Barcelona and Hinojosa failed to disclose a conflict of interest to the school district when Hinojosa worked for the attorneys serving as bond counsel for the bond offerings to the school district. The Commission fined them \$382,121 and imposed a separate civil money penalty of \$160,000 for bond organizer and participant misconduct.

⁴ U.S. Securities and Exchange Commission Administrative Proceeding 3-17902, In the Matter of John T. Lynch, Jr. (April 2017).

⁵ U.S. Securities and Exchange Commission v. Malachi Financial Products, Inc. and Porter B. Bingham, 3:18-cv-1-HSO-LRA (U.S. S.D.M.N.D. 2018).

⁶ U.S. Securities and Exchange Commission Administrative Proceeding 3-18476, In the Matter of Barcelona Strategies, LLC and Mario Hinojosa (May 2018).



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Appendix VI


Management's Response to the Draft Report



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

February 7, 2020

MEMORANDUM FOR MICHAEL E. McKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Tamera L. Ripperda 
Commissioner
Tax-Exempt and Government Entities Division (TE/GE)

RE: Draft Audit Report – *Bond Promoter Misconduct Procedures Should Be Improved* (Audit # 201810023)

Thank you for the opportunity to review the referenced report. We share an interest in preserving the integrity of the tax-advantaged bond sector by ensuring compliance with the Internal Revenue Code (I.R.C.), identifying promoter misconduct, and pursuing penalties when warranted, as evidenced by the IRS' Office of Tax Exempt Bonds' (TEB) past work in assessing I.R.C. § 6700 penalties.¹

We also note that in TIGTA's report, TIGTA confirmed that in the 127 tax-advantaged bond examination cases it reviewed as part of this audit, it "did not identify any cases where it appeared that the assertion of the promoter penalty was warranted" but was not identified by the examiner.

TEB is charged with reviewing tax-advantaged bond issuances for compliance with the sections of the I.R.C. providing for such tax advantages. As TIGTA notes in its report, there are "complexities associated with tax-advantaged bond issuances." and a finding by the IRS of noncompliance with tax-advantaged bond requirements does not "de facto" mean that transaction participants should be subjected to a § 6700 investigation. If potential noncompliance with these requirements is identified and there are indicators of promoter misconduct, then the examiner is to make a referral to the Lead Development Center (LDC) to authorize an investigation of the promoter. Only if the LDC authorizes an investigation may § 6700 penalties be pursued.

These strict procedures for pursuing § 6700 penalties are consistent with the fact that in enacting the § 6700 statute, Congress limited it by a high threshold because it "believed that such a limited penalty will prevent any unintended application." JCS-38-82 (1982) at 211, accord S. Rept. 97-494, I, 267 (1982).

Given this high threshold, the promoter penalty is unlikely to be relevant in most tax-advantaged bond cases. Nevertheless, we are committed to having appropriate

¹ See TIGTA report which states "in CY 2006, the IRS found evidence of bid rigging.... [And] assessed \$200 million in promoter penalties...."



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procedures in place. Our procedures explicitly provide that we will consider in every examination in which there is noncompliance whether imposition of this penalty is warranted and require examiners to document their examination conclusions. To provide reasonable assurance that examiners undertake such consideration, TEB will follow the Servicewide policy concerning documentation of penalties in IRM 20.1.6.1. We will remind employees of this guidance and provide refresher training on case documentation. However, it is not necessary that examiners document such consideration in the same location within a case file.

TEB has for many years used information available from the U.S. Securities and Exchange Commission (SEC) and media in decisions whether to open examinations. However, the presence of media reports or noncompliance with other Federal laws or agency rules does not necessarily indicate noncompliance with the I.R.C. generally or promoter misconduct described in § 6700 specifically. TE/GE's compliance planning and case selection processes are now centralized in a single function, Compliance Planning and Classification (CP&C). TEB personnel will continue to proactively review media and other federal agency information and make referrals to CP&C for consideration as appropriate. CP&C will continue to review the referrals and select cases for examination based on consideration of potential I.R.C. noncompliance. We disagree with TIGTA's statement that in the past the IRS has not considered SEC or media outlets in case selection as this has been done through the referral process. TIGTA did not review the referral process for the timeframe in question (prior to 2017); thus, TIGTA has no basis for its conclusion. However, we will take steps to consider the value of improved identification of TEB office examination inventory as we continue to consider the merits of cases pursued by the SEC or reported by media outlets.

We appreciate the opportunity to review and comment on the draft report. Attached is a detailed response to the recommendations. If you have any questions, you or your staff may contact me at (267) 466-3016, or Margaret A. Von Lienen, Director, Exempt Organizations and Government Entities, at (513) 975-6562.

Attachment



Bond Promoter Misconduct Procedures Should Be Improved

Attachment

Corrective Actions for TIGTA Draft Audit Report – Bond Promoter Misconduct Procedures Should Be Improved (Audit #201810023)

The Commissioner, TE/GE Division, should:

RECOMMENDATION 1:

Update guidance to require examiners to document their consideration of whether promoter penalties are warranted, or not, in every examination and in the same location (e.g., the CCR). Provide examiners training on guidance updates.

CORRECTIVE ACTION:

We agree with this recommendation in part. The IRS has policies and procedures in place to consider and document penalties, when warranted by the facts. TEB will follow the Servicewide policy concerning documentation of penalties in IRM 20.1.6.1. We will remind employees of this guidance and provide refresher training on documentation of cases. However, we will not require examiners to document the consideration of promoter penalties in a specific workpaper or case file document.

IMPLEMENTATION DATE:

November 15, 2020

RESPONSIBLE OFFICIAL(S):

Director, Exempt Organizations and Government Entities, TE/GE

CORRECTIVE ACTION MONITORING PLAN:

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

RECOMMENDATION 2:

Ensure that quality reviewers determine whether examiners consider promoter penalties and provide corrective actions when appropriate.

CORRECTIVE ACTION:

We agree with this recommendation. We will ensure our procedures instruct TEB quality reviewers to determine whether examiners consider and document penalties and to provide for corrective actions when appropriate. The quality review standard will align with Servicewide documentation requirements on penalties.

IMPLEMENTATION DATE:

November 15, 2020

RESPONSIBLE OFFICIAL(S):

Director, Exempt Organizations and Government Entities, TE/GE



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CORRECTIVE ACTION MONITORING PLAN:

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

RECOMMENDATION 3:

Develop a comprehensive training program for TEB office examiners that:

- Prepares examiners to consider whether promoter penalties are warranted, or not.
- Prepares examiners to accurately document their consideration of promoter penalties and all other required case actions in every tax-advantaged bond examination.
- Trains examiners to develop promoter penalty referrals for the LDC.
- Trains examiners to properly complete and document their workpapers, including the CCR and the *TEB Penalties and Fraud Workpaper Summary*.
- Uses Tax Exempt Quality Measurement System reports to evaluate the training program and make changes as necessary and offers periodic refresher courses as needed.
- Tracks and documents attendance and subject matter.

CORRECTIVE ACTION:

We agree with this recommendation. Consistent with Servicewide policies and procedures, we will provide continuing professional education for TEB examiners on penalties, penalty documentation, and referrals to the LDC. We will use training evaluations to make necessary changes to training sessions and will track and document attendance and subject matter of the training sessions.

IMPLEMENTATION DATE:

November 15, 2020

RESPONSIBLE OFFICIAL(S):

Director, Exempt Organizations and Government Entities, TE/GE

CORRECTIVE ACTION MONITORING PLAN:

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

RECOMMENDATION 4:

Develop a data-driven method to track and quantify specific noncompliance issues, i.e., the promoter penalty, that are otherwise embedded in generic reference numbers, and update related guidance and train employees as needed.

CORRECTIVE ACTION:

We agree with this recommendation. As a result of and consistent with the results of the TE/GE Exam Lean Six Sigma (LSS) Pilot, the IRS will develop a data-driven method to



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track and quantify bond noncompliance, including penalties. When we implement the data-driven methodology, we will update related guidance and train TEB employees, as needed.

IMPLEMENTATION DATE:

July 15, 2021

RESPONSIBLE OFFICIAL(S):

Director, Exempt Organizations and Government Entities, TE/GE

CORRECTIVE ACTION MONITORING PLAN:

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

RECOMMENDATION 5:

Improve identification of TEB office examination inventory by considering the merits of cases pursued by the SEC and/or reported by media outlets.

CORRECTIVE ACTION:

We agree with this recommendation in part. We will consider the value of improved identification of TEB office examination inventory by continuing to consider the merits of cases pursued by the SEC and/or reported by media outlets. If warranted, the IRS will take steps to improve inventory identification.

IMPLEMENTATION DATE:

November 15, 2020

RESPONSIBLE OFFICIAL(S):

Director, Exempt Organizations and Government Entities, TE/GE

CORRECTIVE ACTION MONITORING PLAN:

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