



RECOVERY ACT

*Processes for Ensuring Compliance With
Qualifying Advanced Energy Project Credit
Requirements Can Be Strengthened*

February 6, 2014

Reference Number: 2014-40-011

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



HIGHLIGHTS



PROCESSES FOR ENSURING COMPLIANCE WITH QUALIFYING ADVANCED ENERGY PROJECT CREDIT REQUIREMENTS CAN BE STRENGTHENED

Highlights

Final Report issued on February 6, 2014

Highlights of Reference Number: 2014-40-011 to the Internal Revenue Service Commissioners for the Large Business and International Division and the Small Business/Self-Employed Division.

IMPACT ON TAXPAYERS

The American Recovery and Reinvestment Act of 2009 (the Recovery Act) established the Qualifying Advanced Energy Project Credit (Advanced Energy Credit) to encourage development of a manufacturing base to support renewable energy industries. The Recovery Act provided for \$2.3 billion in Advanced Energy Credits to be allocated to manufacturers for qualified projects. Manufacturers awarded the credit must meet specific requirements to claim the credit on their income tax returns. While the IRS established processes to ensure manufacturer compliance with requirements for receiving the Advanced Energy Credit, these processes can be strengthened to ensure that only eligible manufacturers receive the credit.

WHY TIGTA DID THE AUDIT

Internal Revenue Code Section 48C and IRS Notice 2009-72, *Qualifying Advanced Energy Project Credit*, contain requirements that manufacturers must meet to be eligible to claim the credit for income tax purposes. The objective of this review was to assess the effectiveness of IRS efforts to ensure manufacturer compliance with Advanced Energy Credit requirements.

WHAT TIGTA FOUND

The IRS ensured that manufacturers complied with agreement and certification requirements. In addition, for those projects that did not meet the agreement and/or certification requirements,

the IRS appropriately considered the credits allocated to the projects as forfeited, issued the manufacturers forfeit letters, and accounted for the \$150 million in Advanced Energy Credits allocated to these projects.

However, TIGTA found that the IRS did not consistently evaluate project location changes to determine if the change should result in credit forfeiture. Further, although the IRS has processes to ensure manufacturer compliance with agreement, certification, and placed-in-service requirements, similar processes were not in place to verify compliance with the provision to notify the IRS of significant changes in project plans.

Finally, while the IRS developed a Compliance Initiative Project that identifies business taxpayers erroneously claiming the credit, it does not have a similar process to identify individual taxpayers erroneously claiming the credit. Our review identified 1,149 individual taxpayers who electronically filed Forms 1040, *U.S. Individual Income Tax Return*, reporting more than \$3 million in Advanced Energy Credits for Tax Year 2011 and who do not appear to have a business relationship with a manufacturer that was awarded the credit.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS develop processes to ensure that changes in projects are fully evaluated and that all projects are placed into service at the locations specified in the manufacturer's agreement. In addition, the IRS should develop a process to verify that individual tax returns claiming the Advanced Energy Credit are valid and entitled to the credit.

IRS management agreed with the recommendations. The IRS agreed to ensure that changes in projects are fully evaluated and that all projects are placed into service at the locations specified in the manufacturer's agreement. The IRS also agreed to evaluate and assess individual taxpayer compliance risks, and determine if a compliance strategy is warranted based on its assessment of individual taxpayer compliance risks.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

February 6, 2014

MEMORANDUM FOR COMMISSIONER, LARGE BUSINESS AND INTERNATIONAL
DIVISION
COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

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

SUBJECT: Final Audit Report – Processes for Ensuring Compliance With
Qualifying Advanced Energy Project Credit Requirements Can Be
Strengthened (Audit # 201340127)

This report presents the results of our review to assess the effectiveness of Internal Revenue Service (IRS) efforts to ensure manufacturer compliance with Qualifying Advanced Energy Project Credit requirements. This audit was added to our Fiscal Year 2014 Annual Audit Plan and addresses the major management challenge of Fraudulent Claims and Improper Payments.

The American Recovery and Reinvestment Act of 2009 (Recovery Act)¹ provided separate funding to the Treasury Inspector General for Tax Administration through September 30, 2013, to be used in oversight activities of IRS programs. This audit was conducted using Recovery Act funds.

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

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me if you have questions or Russell P. Martin, Acting Assistant Inspector General for Audit (Returns Processing and Account Services).

¹ Pub. L. No. 111-5, 123 Stat. 115 (2009).



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Abbreviations

e-file(d)	Electronically file(d)
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
TIGTA	Treasury Inspector General for Tax Administration



Processes for Ensuring Compliance With Qualifying Advanced Energy Project Credit Requirements Can Be Strengthened



Background

Section 1302 of the American Recovery and Reinvestment Act of 2009 (the Recovery Act)¹ established the Qualifying Advanced Energy Project Credit (hereafter referred to as the Advanced Energy Credit) under Internal Revenue Code (I.R.C.) Section (§) 48C. The credit was intended to encourage development of a manufacturing base to support renewable energy industries. Manufacturers selected are eligible to receive a credit equal to 30 percent of the cost, limited to the amount awarded, for a project that establishes, expands, or re-equips a manufacturing facility for the production of certain types of property, including those designed to produce energy from renewable sources such as the sun and wind. For those manufacturers awarded the credit, I.R.C. § 48C and Internal Revenue Service (IRS) Notice 2009-72, *Qualifying Advanced Energy Project Credit*, contain specific requirements that the manufacturers must meet to be eligible to claim the credit for income tax purposes. Figure 1 summarizes these requirements.

On January 8, 2010, the President announced the award of the Advanced Energy Credits for 183 projects for a total of \$2.3 billion.

Figure 1: Manufacturer Requirements for the Advanced Energy Credit

Table with 2 columns: Requirement, Description. Rows include Agreement, Certification, and Placed in Service.

Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of I.R.C. § 48C and IRS Notice 2009-72.

1 Pub. L. No. 111-5, 123 Stat. 115 (2009).

2 The latest IRS certification date for some of the projects was August 31, 2011. Therefore, these manufacturers have until August 31, 2014, to place their project into service.



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The IRS is responsible for ensuring that manufacturers comply with the requirements detailed in Figure 1. For those manufacturers not in compliance with the requirements, IRS Notice 2009-72 provides that the credit awarded to the project is fully forfeited. Figure 2 shows the Phase I³ allocation of projects awarded the credit, credits forfeited, and certified projects as of March 11, 2013.

Figure 2: Advanced Energy Credit Phase I Allocation

Phase I Project Status	Projects	Manufacturers ⁴	Credit Amount Awarded
Credits Originally Awarded	183	133	\$2.30 billion
Credits Forfeited	32	24	\$150 million
Projects Certified	151	116	\$2.15 billion

Source: TIGTA analysis of IRS project files as of March 11, 2013.

Manufacturers are allowed to claim the credit for the tax year⁵ the property is placed in service or during the tax years that qualified progress expenditures are made.⁶ Under the qualified progress expenditures election, a manufacturer must meet the placed-in-service requirement, *i.e.*, three years from the date of certification. When this election is made and the three-year requirement is not met, the manufacturer forfeits the credit and must recapture, *i.e.*, add back to income tax, the amount of any previously claimed Advanced Energy Credit.⁷

The Advanced Energy Credit is claimed on a tax return as a General Business Credit.⁸ A General Business Credit reduces a taxpayer’s tax liability amount, *i.e.*, the credit is subtracted directly from taxes the taxpayer owes. The Advanced Energy Credit is nonrefundable and is subject to Alternative Minimum Tax limitations.⁹ Any unused credit amount from the current

³ The Phase I allocation occurred between September 16, 2009, (manufacturers to submit a preliminary project application) and January 7, 2010 (the IRS notifies selected manufacturers that they have been awarded the credit).

⁴ In the case of C corporations, we consider the parent corporations to be the manufacturer when consolidated returns are filed. Our review also determined that seven manufacturers had more than one project awarded. These manufacturers forfeited a project credit but have other projects that remain ongoing. Therefore, the total of “Projects Certified” is larger (116) than the difference between “Credits Originally Awarded” and “Credits Forfeited.”

⁵ 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.

⁶ Qualified progress expenditures are those expenditures made before the property is placed in service and for which the taxpayer has made an election to treat the expenditures as progress expenditures.

⁷ 26 U.S.C. § 50(a)(2) and 26 C.F.R. § 1.47-1.

⁸ For Tax Year 2011, there were a total of 32 source credit forms that made up the credits claimed as a General Business Credit.

⁹ The Alternative Minimum Tax attempts to ensure that individuals and corporations that benefit from certain exclusions, deductions, or credits pay at least a minimum amount of tax. The limitation for General Business Credits is calculated based on the taxpayer’s net income tax minus the greater of the tentative minimum tax or 25 percent of the net regular tax liability that is more than \$25,000.



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year can be carried back one year by filing an amended tax return or carried forward for up to 20 years on subsequently filed tax returns. The credit is reported on Form 3468, *Investment Credit*, Part II, line 7, and carried forward to Form 3800, *General Business Credit*, Part III, line 1a. Figure 3 shows where the Advanced Energy Credit is reported on Form 3468.

Figure 3: Selected Sections of Form 3468 for Tax Year 2012

Form 3468 Department of the Treasury Internal Revenue Service (99)	Investment Credit Attach to your tax return. Information about Form 3468 and its separate instructions is at www.irs.gov/form3468 .	OMB No. 1545-0155 2012 Attachment Sequence No. 174	
Name(s) shown on return		Identifying number	
Part II Qualifying Advanced Coal Project Credit, Qualifying Gasification Project Credit, and Qualifying Advanced Energy Project Credit			
c	Total. Add lines 6a and 6b	6c	
7	Qualifying advanced energy project credit (see instructions): Qualified investment in advanced energy project property placed in service during the tax year \$ _____ × 30% (.30)	7	

Source: Form 3468 for Tax Year 2012.

In general, the allowable portion of the credit (including carryback or carryforward) from Form 3800 is then used to offset taxes on the manufacturers’ income tax returns. However, for manufacturers that are pass-through entities,¹⁰ the income, loss, deductions, and credits are reported on the income tax returns of the owners of the entities. Manufacturers awarded the credit include corporate taxpayers, S corporations, partnerships, and sole proprietorships. The shareholders and partners of the pass-through entities include corporations, trusts, and individual taxpayers. As of July 2013, a total of 72 manufacturers reported Advanced Energy Credits totaling approximately \$926 million for Tax Years 2009 through 2011.

A prior TIGTA review identified inconsistencies between issued guidance and the law

A prior TIGTA review¹¹ identified inconsistencies exist between IRS Notice 2009-72 and I.R.C. § 48C criteria. For example, IRS Notice 2009-72 issued September 2009 included

¹⁰ Pass-through entities include partnerships, S corporations, estates, and trusts in which the income, loss, deductions, and credits are passed on to the underlying owners. Owners of these entities may be partners, shareholders, beneficiaries, or investors.

¹¹ TIGTA, Ref. No. 2013-40-029, *Assessment of the Internal Revenue Service’s Interpretation of Section 1302 of the Recovery Act: Qualifying Advanced Energy Project Credit* (Mar. 2013).



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Program Policy Factors that would be considered when selecting manufacturers for the credit. These factors were in addition to the selection criteria included in I.R.C. § 48C. Figure 4 provides a description of each of the four Program Policy Factors.

Figure 4: Program Policy Factors Applied to Select Manufacturers

Program Policy Factor	Description
Geographic Diversity	Applied in an effort to ensure that the Advanced Energy Credit was awarded to manufacturers that were geographically dispersed throughout the United States.
Technology Diversity	Applied in an effort to ensure that the Advanced Energy Credit was awarded to projects that represented a diverse technology base.
Project Size Diversity	Applied in an effort to ensure that Advanced Energy Credits awarded were dispersed among large, medium, and small projects.
Regional Economic Development	Applied in an effort to ensure that the Advanced Energy Credit was awarded to those projects that would have a positive impact on the economic development within the region where the manufacturing would occur.

Source: Department of Energy, Office of Energy Efficiency and Renewable Energy.

The inconsistencies between IRS Notice 2009-72 and I.R.C. § 48C criteria resulted from the IRS’s efforts to: 1) simplify program guidance so it would be more easily understood by manufacturers; and 2) ensure that the credits were disbursed equitably among qualified applicants. However, the inconsistencies did not affect the IRS’s compliance with the Code requirements when awarding the Advanced Energy Credit.

The U.S. Department of Energy noted that the Program Policy Factors were used to ensure that the \$2.3 billion in allocated credits was disbursed across a range of project types, sizes, and locations among qualified applicants. The use of the Program Policy Factors affected which qualified projects the Department of Energy recommended to the IRS. All Advanced Energy Credit awards made by the IRS were consistent with U.S. Department of Energy rankings and recommendations. The IRS’s involvement in the ranking and review process was limited to verifying that manufacturers timely filed a complete application for certification with the IRS for each recommended energy project.

This review was performed at the IRS’s Large Business and International Division, Natural Resources and Construction Industry function, in Houston, Texas, and the Wage and Investment Division office in Atlanta, Georgia, during the period January through August 2013. 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



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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

Processes Ensure Manufacturer Compliance With Agreement and Certification Requirements

The IRS ensured that the manufacturers complied with agreement and certification requirements. For example, for each of the 151 projects certified, the manufacturers submitted their agreements to the IRS by the March 15, 2010, deadline and provided necessary documentation, such as environmental or occupancy permits, purchase invoices, and/or other evidence to show the project was progressing by the January 7, 2011, deadline for certification.

The manufacturers for the remaining 32 of 183 projects did not meet the agreement and/or certification requirements. The manufacturers either decided not to pursue the projects due to market conditions, did not provide documentation required by the deadline, or moved the project outside of the United States. The IRS appropriately considered the credits allocated to the projects as forfeited, issued the manufacturers forfeit letters, and accounted for the \$150 million in Advanced Energy Credits allocated to these projects.

The amount of credit forfeited for these projects agreed with the amount the IRS determined to be available for a Phase II allocation. On February 7, 2013, the IRS issued Notice 2013-12 reporting the results of the Phase I allocation and established a second allocation phase (Phase II allocation) of the Advanced Energy Credit to distribute the \$150 million of credits available as a result of credits forfeited by manufacturers in Phase I. The IRS plans to use a process similar to what was used to select qualifying projects in Phase I to award the forfeited credits as part of the Phase II allocation.

Finally, the IRS established a process to monitor manufacturer compliance with the placed-in-service requirement. Manufacturers are instructed to notify the IRS when they have placed a project into service. The IRS records and tracks this information for all projects. The IRS informed us that, after the three-year deadline¹² for placing a project into service has passed, it will contact those manufacturers that have not notified the IRS to learn whether the manufacturers have placed the projects into service.

¹² The latest date for a manufacturer to place a project into service from the initial allocation is August 31, 2014.



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The IRS did not consistently evaluate project location changes to determine if the change should result in credit forfeiture

The IRS did not document its evaluation of the location change *****1*****
*****1*****. Our review of IRS project file information identified a total of eight projects in which the manufacturer changed the project’s location from the location included in the original application. For all eight projects, the manufacturer notified the IRS of the location change. However, *****1*****
*****1*****
*****1*****, the IRS evaluated the location change by using a multifactor evaluation process that included obtaining guidance from the Department of Energy. This process evaluated the location change in terms of factors used by the Department of Energy such as the time required to complete the project, regional economic development, and geographical diversity. For example, *****1*****
*****1*****
*****1*****
*****1*****

When ranking projects for the Phase I allocation, the Department of Energy considered the number of projects that would be awarded to an individual State and whether the location was more depressed economically and could thereby benefit more from the jobs the project would create. The location of the project is especially important as it affected two of the four Program Policy Factors used in ranking and awarding credits – Geographic Diversity and Regional Economic Development. IRS Notice 2009-72 requires taxpayers to inform the IRS of any potentially significant change in the projects’ plans. This is defined as a change that may have affected the rankings and recommendations by the Department of Energy or the IRS in accepting the applications. If the change is deemed significant, the credit is forfeited.

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Processes were not established to ensure manufacturer compliance with the provision to notify the IRS of significant changes in project plans

We found that although the IRS has processes to ensure manufacturer compliance with agreement, certification, and placed-in-service requirements, similar processes were not in place to verify compliance with the provision to notify the IRS of significant changes in project plans. Processes had not been established to verify manufacturer compliance with project specifications



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such as the physical location of the project. For example, as of March 11, 2013, 96 projects were either placed in service (64 projects) or a credit was claimed by the manufacturer (32 projects). For 87 of the 96 projects, we were able to verify the location of the project via review of IRS project files, news articles, manufacturer press releases, *etc.* However, for nine of these 96 projects, we were unable to verify that the manufacturers placed the projects at the locations indicated in their application for certification.

On July 8, 2013, we notified the IRS of our inability to confirm the location for nine projects we reviewed, but it was unable to provide any additional information to confirm the location of the projects. The IRS indicated that it would verify manufacturer compliance with provisions included in the manufacturers' project plans as part of an audit examination.

Recommendations

The Commissioner, Large Business and International Division, should:

Recommendation 1: Develop a process to ensure that changes in projects are fully evaluated for significance and a determination is made as to whether forfeiture of the credit is required.

Management's Response: IRS management agreed with this recommendation. The IRS will instruct Compliance Initiative Project examiners to look for changes in projects, and will provide the examiners guidance on determination of significance and whether credit forfeiture is warranted.

Recommendation 2: Develop a process to ensure manufacturer compliance with project specifications including that projects are placed into service at the locations specified in the manufacturer's agreement.

Management's Response: IRS management agreed with this recommendation and will develop a process to ensure that projects are placed into service at the locations specified in the manufacturer's agreement.

The Process to Identify Taxpayers Erroneously Claiming Advanced Energy Credits Can Be Improved

The IRS developed a Compliance Initiative Project that focuses on the compliance of business taxpayers claiming the credit. This initiative involves identifying business taxpayers reporting an Advanced Energy Credit basis and/or credit amount on an electronically filed (e-filed) Form 3468. The taxpayer reporting the credit is then compared to manufacturers awarded the credit to identify taxpayers who report the credit but are not eligible. The process also identifies manufacturers awarded the credit that report more than the amount awarded.

Our review of claims for the Advanced Energy Credits for Tax Years 2009 through 2011 identified 99 business taxpayers that erroneously reported more than \$30.7 million in credits.



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These businesses were not eligible because they were not the manufacturers of the projects for which the credits were awarded. IRS compliance processes identified each of these 99 ineligible filers. Our review also determined that *****1*****

The Compliance Initiative Project does not address individual taxpayers who erroneously claim Advanced Energy Credits

While the IRS developed a Compliance Initiative Project to evaluate compliance of business taxpayers claiming the credit, the process does not include individual taxpayers reporting the credit. Our review identified 1,149 individual taxpayers who e-filed Forms 1040, U.S. Individual Income Tax Return, reporting more than \$3 million in Advanced Energy Credits on Form 3468 for Tax Year 2011¹³ and who do not seem to have a business relationship with a manufacturer that was awarded the credit. We compared these individual taxpayers with the taxpayers who are shareholders, partners, or beneficiaries related to the manufacturers of awarded credits.¹⁴ This comparison found no business relationships existed between the manufacturers awarded the credit and these individual taxpayers.

The IRS Compliance Initiative Project does not include individual taxpayers claiming the Advanced Energy Credits because the function within the IRS that developed this initiative has a primary focus on the compliance of business taxpayers. However, for taxpayers to be eligible for the Advanced Energy Credit, the credit must be for a project certified by the IRS, the manufacturer must have made a qualified investment in the advanced energy project, and the total amount of the Advanced Energy Credit is limited to the credit amount awarded.

Recommendations

The Commissioner, Large Business and International Division, should

Recommendation 3: Ensure a process to identify and verify that individual taxpayer tax returns claiming Advanced Energy Credits are valid.

¹³ Our analysis included Tax Years 2009 through 2011; however, additional tax assessments must generally be processed within three years from the date the return was due or from the date on which the return was actually filed, whichever is later. Therefore, the IRS generally cannot make or has limited time to make additional tax assessments for the individual taxpayers who are not eligible to receive the Advanced Energy Credits on their Tax Years 2009 and 2010 returns.

¹⁴ This does not include individual taxpayers related to two pass-through entities. We requested the paper-filed returns of the pass-through entities from IRS files but did not receive the returns to identify the owners of the pass-through entities.



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Management's Response: IRS management agreed with this recommendation. The IRS indicated it will determine whether a compliance strategy is warranted to address and prevent improper or fraudulent claims of individual taxpayers claiming the Advanced Energy Credit.

Recommendation 4: Verify whether the 1,149 individual taxpayers for Tax Year 2011 we identified as not related to a manufacturer of an awarded advanced energy project are entitled to receive the Advanced Energy Credit.

Management's Response: IRS management agreed with this recommendation. The IRS indicated that it will conduct an analysis based on the available data to assess individual taxpayer compliance risks associated with the Advanced Energy Credit. The IRS will consider 168 of the 1,149 individual taxpayers we identified. These 168 individual taxpayers claimed the majority of the total dollars associated with the 1,149 individual taxpayers. The IRS will make an appropriate risk assessment and determine those specific taxpayers to pursue to determine if the individual taxpayers' claims for the credit were indeed erroneous.

Guidance Did Not Fully Address Credit Recapture for Projects Partially Placed in Service

Our review of the I.R.C. and Notice 2009-72 found that the guidance did not fully address recapture requirements when manufacturers claim the Advanced Energy Credit for projects partially placed in service. Review of IRS project files identified seven manufacturers awarded \$56.1 million in Advanced Energy Credits that claimed \$34.5 million in credit for projects partially placed in service. Placing only a portion of a project into service may represent a significant change in the project's plans, and per Notice 2009-72, when deemed significant, the credit is forfeited. As a result, the credits claimed by these manufacturers may be subject to recapture, *i.e.* added back to income tax, if the entire project is not placed into service within three years of certification.

The following is a hypothetical example of a manufacturer claiming credit for a project partially placed in service, but the project is not placed into full service within the required three years:

A manufacturer of a qualifying project states in the executed agreement with the IRS that the project will include the installation of two new manufacturing lines to produce components for qualifying renewable energy sources. The IRS certifies this project in March 2011. As such, the manufacturer has until March 2014 to place the project into service (three years from the date of certification). During Tax Year 2011, the manufacturer places one of the new manufacturing lines in service and begins production of the components. The manufacturer reports the basis of the property placed into service and multiplies the basis of the property by 30 percent to arrive at the Advanced Energy Credit claimed on Form 3468.



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The manufacturer claims the credit on Form 3800 and Form 1120, U.S. Corporation Income Tax Return, for Tax Year 2011. The manufacturer does not place the remaining manufacturing line in service by March 2014, representing a project only partially placed in service and, as such, the manufacturer may be required to recapture the credit claimed.

Our review of tax return information identified 28 manufacturers that have claimed credits but provided no notification of the project being placed into service, and 48 manufacturers that have projects for which they have not claimed credits or notified the IRS of a project placed into service. Because tax return information alone does not distinguish between manufacturers partially placing projects in service from manufacturers claiming qualified progress expenditures, this issue may affect more manufacturers than the seven instances we identified.

We brought this issue to IRS management's attention on April 4, 2013. In response, IRS management indicated that the initial guidance was drafted under the assumption that partially placing a project in service by the deadline and fully completing the project after the deadline would not constitute a significant change. However, the IRS agreed that, in the event that these situations constitute a significant change, the credit is fully forfeited and must be recaptured if the project is not fully placed into service by the deadline. On September 10, 2013, the IRS updated the "Frequently Asked Questions"¹⁵ to address projects partially placed into service and now indicates that generally the credit is fully forfeited if the project is not fully placed into service by the deadline. The manufacturer may be allowed the credit for the portion of the project placed into service before the deadline for a project that is fully placed into service after the deadline and the change in the timing for placing the entire project into service is not a significant change.

¹⁵ The IRS provides information on the Advanced Energy Credit on the IRS website (www.irs.gov), which includes guidance in the form of a link to frequently asked questions.



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Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to assess the effectiveness of IRS efforts to ensure manufacturer compliance with Qualifying Advanced Energy Project Credit (hereafter referred to as the Advanced Energy Credit) requirements. To accomplish our objective, we:

- I. Determined whether the IRS has effective processes and procedures to ensure compliance with Advanced Energy Credit requirements.
 - A. Reviewed Section 1302 of the American Recovery and Reinvestment Act of 2009 (the Recovery Act),¹ I.R.C. § 48C, and IRS Notice 2009-72, *Qualifying Advanced Energy Project Credit*, to identify applicable requirements for Advanced Energy Credits.
 - B. Identified and evaluated processes and procedures the IRS established to ensure compliance with applicable requirements for Advanced Energy Credits.
 - C. Discussed with the IRS the steps taken to ensure that:
 1. Taxpayers awarded the credit meet the agreement, certification, and placed-in-service requirements.
 2. Only taxpayers awarded the credit are claiming the credit and only claim up to the amount of the credit awarded.
 - D. Performed a reconciliation to ensure that the IRS identified the correct number of projects and manufacturers.
- II. Determined whether the IRS effectively ensures that the taxpayers comply with the agreement, certification, and placed-in-service requirements as specified in IRS Notice 2009-72.
 - A. Identified the taxpayers for the 183 projects awarded the credit.
 1. Ascertained the tax filing requirements for these taxpayers and identified the pass-through relationships of the taxpayers awarded the credit that are partnerships, Subchapter-S corporations, and trusts.

¹ Pub. L. No. 111-5, 123 Stat. 115 (2009).



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- B. Determined whether taxpayers timely and properly comply with the agreement requirements and whether the IRS timely and properly executed those agreements.
 - 1. Determined whether the taxpayer provided the IRS with a completed and signed agreement by March 15, 2010.
 - 2. Determined whether the IRS reviewed the agreement to verify that the taxpayer's name and Taxpayer Identification Number were consistent with the initial award or allocation letter and were consistent with information present on the IRS Master File.²
 - 3. Determined whether the IRS reviewed the agreement to verify that the project description, location, and amount agreed with the information on the original award or allocation letter.
 - 4. Determined whether the IRS properly resolved any issues identified in the agreement review process.
 - 5. Determined whether the IRS properly executed an agreement and returned it to the taxpayer by April 16, 2010. If not, we determined whether this was due to issues identified by the IRS in reviewing the agreement.
- C. Verified whether taxpayers timely complied with the certification requirements.
 - 1. Determined whether the taxpayer provided the IRS supporting documentation needed to certify the project within one year of the date of the award or allocation letter (generally January 7, 2010, was the date of the allocation letter).
 - 2. Determined whether the information supplied by the taxpayer sufficiently shows that necessary permits were obtained and/or evidence that the taxpayer is completing steps that would result in placing the project in service within three years of the date of certification. If not, we determined whether the taxpayer provided a reasonable explanation of why these steps are not being completed.
 - 3. Verified that the date of the certification letter agrees with the information recorded by the IRS for the 151 projects certified by the IRS.
 - 4. Evaluated the timeliness of the IRS review and certification for each project.
 - 5. Evaluated the consistency of the certification process and the impact of changes in IRS policy.
 - a. Identified the reason or reasons the 32 projects were not certified.

² The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.



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- b. Evaluated whether changes in IRS policy may have affected the decision to not certify the projects.
- D. Identified and assessed whether changes to projects affected the credit awarded to the taxpayer.
1. Reviewed each of the project folders to identify any indication of changes to a project that required IRS review to assess whether the credit remained valid and, if so, whether a new agreement was required.
 2. For those projects identified with changes, determined the type of change such as project location change or ownership change/successor interest.
 3. Evaluated whether the IRS took appropriate action to determine whether the change voided the credit or whether a new agreement was necessary to retain the credit.
- E. Determined whether the IRS correctly recorded placed-in-service information and whether the qualified expenses and credit were consistent with the law and the taxpayer notification.
1. Reviewed each of the project folders for information that would indicate the taxpayer had placed the project in service. We identified 64 projects for which the taxpayer indicated the project had been placed in service as of March 11, 2013.
 2. For each project identified in Step II.E.1., determined whether the IRS had correctly recorded that the project had been placed in service.
 3. Determined whether the tax credit claimed was consistent with the date of notification for projects identified as placed in service.
- F. Determined whether the location of the project was at the location identified in the original application or at the revised location the IRS approved for 96 projects. This included 64 projects placed into service as of March 11, 2013, and 32 projects for which manufacturers claimed credits on their Tax Year³ 2009 through 2011 returns filed as of March 11, 2013, but had not notified the IRS that the projects were placed into service. We identified the location of the project through review of permits and/or invoices maintained in the IRS's project folders or through Internet research for news articles or by mapping of the location.

³ 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.



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- III. Determined whether the IRS accurately identified the appropriate amount of funds available for the Phase II allocation.
 - A. Determined whether the credit was forfeited by reviewing the 183 projects awarded the credit.
 - B. Assessed the accuracy of the IRS list of 32 forfeited projects totaling \$150,228,397.
 - C. Verified whether the IRS issued a letter to the taxpayer indicating the credit was forfeited and accurately described the reason or reasons for the forfeiture for each of the 32 forfeited projects.
- IV. Evaluated the accuracy of the Advanced Energy Credits claimed by business taxpayers awarded the credit.
 - A. Reviewed all business income tax returns related to the 183 projects awarded the credit (133 taxpayers) to identify the business taxpayers that claimed the Advanced Energy Credit.
 - B. Assessed whether the business taxpayers approved to claim the Advanced Energy Credit claimed no more than the amount of their awarded credit.
 - 1. Determined whether the IRS project list captured the placed-in-service date when applicable.
 - 2. Determined whether the IRS Compliance Initiative Project data identified the taxpayer as claiming the credit.
 - 3. For taxpayers claiming more than the award amount, determined whether the IRS Compliance Initiative Project process identified the excess amount claimed and what actions were taken.
 - 4. Determined whether individual taxpayers related to pass-through entities⁴ claiming awarded credit claimed the appropriate share of the awarded credit. For any individual taxpayers who claimed more than the appropriate share of the awarded credit, we determined whether the IRS Compliance Initiative Project process identified the excess amount claimed and what actions were taken.
 - C. Determined whether the taxpayers with a forfeited project claimed the Advanced Energy Credit. For any taxpayers claiming credits that were forfeited, we ascertained whether the IRS has a process to ensure that taxpayers recaptured the credit.

⁴ Pass-through entities include partnerships, S corporations, estates, and trusts in which the income, loss, deductions, and credits are passed on to the underlying owners. Owners of these entities may be partners, shareholders, beneficiaries, or investors.



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- V. Assessed the effectiveness of IRS processes to ensure that taxpayers reporting the Advanced Energy Credit meet eligibility requirements.
- A. Identified Tax Years 2009, 2010, and 2011 e-filed individual tax returns processed through March 23, 2013, reporting the Advanced Energy Credit on Form 3468, *Investment Credit*, Part II, line 7.
1. Compared individual taxpayers reporting the credit on 2,290 Forms 3468, Part II, line 7, to manufacturers and the related entities, *i.e.*, taxpayers who are shareholders, partners, or beneficiaries related to the manufacturers of awarded credits, identified in Steps IV.A. and IV.B.4.
- B. Identified Tax Years 2009, 2010, and 2011 e-filed business tax returns processed through December 31, 2012, reporting the Advanced Energy Credit on Form 3468, Part II, line 7.
1. Compared business taxpayers reporting the credit on 172 Forms 3468, Part II, Line 7, to manufacturers and the related entities, *i.e.*, taxpayers who are shareholders, partners, or beneficiaries related to the manufacturers of awarded credits, identified in Steps IV.A. and IV.B.4.

Data validation methodology

During this review, we relied on data extracted from e-filed individual tax returns reporting the Advanced Energy Credit on Form 3468 from the Individual Return Transaction File,⁵ the Tax Return Database,⁶ and the Modernized Tax Return Database for Processing Years⁷ 2010, 2011, and 2012 through March 23, 2013. We also relied on data extracted from e-filed business tax returns reporting the Advanced Energy Credit on Form 3468 from the Business Return Transaction File⁸ and from the Modernized Tax Return Database for Processing Years 2010, 2011, and 2012 through December 31, 2012. To assess the reliability of computer-processed data, programmers in the TIGTA Office of Investigations Strategic Data Services Division validated the Form 3468 data extracted from the IRS mainframes, and the programmers used run-to-run balancing which involves documenting the records read in and written out at each step of the file processing to ensure that all records were received and loaded. We validated the accuracy of the data on the computer extract by comparing a judgmental sample⁹ of 20 individual taxpayers and a judgmental sample of 23 business taxpayers to the IRS information residing on

⁵ The IRS database that contains data transcribed from initial input of the original individual tax returns during return processing.

⁶ The database containing tax return source information for e-filed tax returns and tax forms.

⁷ The calendar year in which the tax return or document is processed by the IRS.

⁸ The IRS database that contains data transcribed from initial input of the original business tax returns during return processing.

⁹ A judgmental sample is a nonstatistical sample, the results of which cannot be used to project to the population.



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the Integrated Data Retrieval System¹⁰ and the Modernized e-File Return Request and Display.¹¹ As a result of our testing, we determined that the data used in our review were reliable.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: the IRS's processes, procedures, and initiatives for processing the qualifying Advanced Energy Credit. We evaluated these controls by interviewing management and analysts, reviewing tax returns of taxpayers related to 183 projects, examining project files, and analyzing qualifying Advanced Energy Credit data.

¹⁰ IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.

¹¹ IRS system capable of retrieving e-filed tax returns on the Modernized e-File, a web-based system that allows electronic filing of tax returns through the Internet and uses the Extensible Markup Language format.



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Appendix II

Major Contributors to This Report

Russell P. Martin, Acting Assistant Inspector General for Audit (Returns Processing and Account Services)
Diana M. Tengesdal, Director
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John L. Hawkins, Senior Auditor
Ngan B. Tang, Auditor
Linda M. Valentine, Auditor



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Appendix III

Report Distribution List

Commissioner
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner (Domestic), Large Business and International Division SE:LB
Deputy Commissioner, Operations, Wage and Investment Division SE:W
Deputy Commissioner, Support, Wage and Investment Division SE:W
Director, Customer Account Services, Wage and Investment Division SE:W:CAS
Director, Natural Resources and Construction Industry, Large Business and International
Division SE:LB:NRC
Director, Planning, Analysis, Inventory, and Research, Large Business and International
Division SE:LB:P
Director, Shared Support, Large Business and International Division SE:LB:SS
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaisons:
 Chief, Program Evaluation and Improvement, Wage and Investment Division
 SE:W:S:PEI
 Large Business and International Division SE:LB:SS:DPORL



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Appendix IV

Outcome Measure

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

Type and Value of Outcome Measure:

- Revenue Protection – Potential; \$2,399,846 in erroneous Qualifying Advanced Energy Project Credits (hereafter referred to as Advanced Energy Credit) received by individual taxpayers who are unrelated to the manufacturers awarded the credit (see page 8).

Methodology Used to Measure the Reported Benefit:

We identified 2,222 individual taxpayers with Tax Year¹ 2009 through 2011 tax returns that claimed the Advanced Energy Credit on Form 3468, *Investment Credit*, Part II, line 7, as of March 23, 2013. From this population, we identified 38 individual taxpayers who were related to the manufacturers, *i.e.*, owners of the pass-through entities,² awarded the credit and reported credits. After this analysis, we identified 1,149 individual taxpayers reporting \$3,128,998 in Advanced Energy Credits during Tax Year 2011³ who are unrelated to the manufacturers awarded the credit and ineligible to claim the credit.

Our analysis also determined that 23 business taxpayers that reported the credit during Tax Year 2011 were not awarded the credit, but were pass-through entities. The IRS's Compliance Initiative Project process identified these 23 entities that reported \$729,152 in erroneous Advanced Energy Credits which may be passed through to the individual taxpayers we identified. Because tax adjustments made due to IRS enforcement actions taken as a result of the

¹ 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.

² Pass-through entities include partnerships, S corporations, estates, and trusts in which the income, loss, deductions, and credits are passed on to the underlying owners. Owners of these entities may be partners, shareholders, beneficiaries, or investors.

³ Our analysis included Tax Years 2009 through 2011; however, additional tax assessments must generally be processed within three years from the date the return was due or from the date on which the return was actually filed, whichever is later. Therefore, the IRS generally cannot make or has limited time to make additional tax assessments for the individual taxpayers who are not eligible to receive the Advanced Energy Credits on their Tax Years 2009 and 2010 returns.



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IRS's Compliance Initiative Project may also be passed through to the individual taxpayers, we reduced our estimate of the outcome to \$2,399,846 (\$3,128,998 - \$729,152).



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Appendix V

Management's Response to the Draft Report

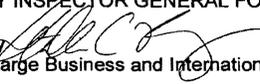


DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

January 9, 2014

COMMISSIONER
LARGE BUSINESS AND
INTERNATIONAL DIVISION

MEMORANDUM FOR ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

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

SUBJECT: Draft Audit Report – *Processes for Ensuring Compliance With
Qualifying Advanced Energy Project Credit Requirements Can
Be Strengthened* (Audit # 201340127)

We reviewed your draft report entitled, *Processes for Ensuring Compliance With Qualifying Advanced Energy Project Credit Requirements Can Be Strengthened* (audit # 201340127). The overall objective for this review was to assess the effectiveness of IRS efforts to ensure manufacturer compliance with the 2009 Recovery Act's Qualifying Advanced Energy Credit requirements. The Internal Revenue Code Section 48C and IRS Notice 2009-72, *Qualifying Advanced Energy Project Credit*, contain the three requirements that manufacturers must meet (Project Agreement submitted by March 15, 2010; Certification by January 7, 2011; and Place in Service reporting by August 31, 2014) to be eligible to claim the credit for income tax purposes. With respect to these requirements, I am pleased to know that your audit report findings indicate that the IRS:

1. Ensured the manufacturers complied with the Project Agreement and Certification requirements;
2. Developed a Compliance Initiative Project (CIP) to help identify business taxpayers erroneously claiming the credit; and
3. Identified those projects that did not meet the Agreement and/or Certification requirements and considered the credits allocated to the projects as forfeited, issued the manufacturers forfeit letters, and accounted for the \$150 million in Advanced Energy Credits allocated to these projects.

IRS agreed with TIGTA's recommendation one but believe we could utilize our current CIP to ensure that changes in projects are fully evaluated for significance and determination as to whether forfeiture of the credit is required. IRS also agreed with recommendation two to develop a process to ensure projects are placed into service at the locations specified in the manufacturer's agreement.



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TIGTA's recommendation four was to verify whether the 1,149 individual taxpayers for Tax Year 2011 TIGTA identified as not related to a manufacturer of an awarded advanced energy project are entitled to receive the Advanced Energy Credit. IRS did not agree to verify each of the 1,149 taxpayers TIGTA identified, as our analysis of this population shows that the credits claimed are not equally distributed. For example, of the 1,149 individual taxpayers identified by TIGTA, 168 claimed credits of roughly \$2.8 million while the remaining majority of individual taxpayers claimed credits of approximately \$263,000. The IRS agrees to consider this population, make an appropriate risk assessment, and determine those specific taxpayers to pursue. This effort will assist us in determining whether a compliance strategy is warranted, in direct response to TIGTA's third recommendation, to ensure a process to identify and verify that individual taxpayer tax returns claiming Advanced Energy Credit are valid.

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

Attachment



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Attachment

RECOMMENDATION 1:

Develop a process to ensure that changes in projects are fully evaluated for significance and determination as to whether forfeiture of the credit is required.

CORRECTIVE ACTIONS:

We agree to ensure that changes in projects are fully evaluated for significance and determination as to whether forfeiture of the credit is required. Taxpayers are only required to report significant changes. The Compliance Initiative Project (CIP) includes all returns in which Section 48C credits are claimed. For changes that are not voluntarily reported we can instruct CIP examiners to look for changes in projects and provide guidance on determination of significance and whether credit forfeiture is warranted. Changes in projects will continue to be evaluated as part of the CIP we have in place to identify noncompliance of business taxpayers claiming the credit. Return examinations will help us determine if the changes should result in credit forfeiture.

IMPLEMENTATION DATE:

February 15, 2015

RESPONSIBLE OFFICIAL(S):

Director, Natural Resources and Construction Industry, LB&I: NRC

CORRECTIVE ACTION(S) MONITORING PLAN:

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

RECOMMENDATION 2:

Develop a process to ensure manufacture compliance with project specifications, including that projects are placed into service at the locations specified in the manufacturer's agreement.

CORRECTIVE ACTIONS:

We agree to develop a process to ensure that projects are placed into service at the locations specified in the manufacturer's agreement.



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IMPLEMENTATION DATE:

February 29, 2015

RESPONSIBLE OFFICIAL(S):

Director, Natural Resources and Construction Industry, LB&I: NRC

CORRECTIVE ACTION(S) MONITORING PLAN:

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

RECOMMENDATION 3:

Ensure a process to identify and verify that individual taxpayer tax returns claiming Advanced Energy Credits are valid.

CORRECTIVE ACTIONS:

The findings from the analysis conducted to address recommendation four (below) will be used to determine whether a compliance strategy is warranted to address and prevent any individual taxpayers' improper or fraudulent claims for Advanced Energy Credits.

IMPLEMENTATION DATE:

February 28, 2016

RESPONSIBLE OFFICIAL(S):

Director, Examination Policy, SB/SE: Examination

CORRECTIVE ACTION(S) MONITORING PLAN:

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

RECOMMENDATION 4:

Verify whether the 1,149 individual taxpayers for Tax Year 2011 that TIGTA identified as not related to a manufacturer of an awarded advanced energy project are entitled to receive the Advanced Energy Credit.



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CORRECTIVE ACTIONS:

We will conduct an analysis based on the available data to assess individual taxpayer compliance risks associated with Qualifying Advanced Energy Project Credits. Our analysis of this population shows that the credits claimed are not equally distributed. For example, of the 1,149 individual taxpayers identified by TIGTA, 168 claimed credits of roughly \$2.8 million while the remaining majority of individual taxpayers claimed credits of approximately \$230,000. IRS agreed to consider this population, make an appropriate risk assessment, and determine those specific taxpayers to pursue to determine if their claims for the credit were indeed erroneous.

IMPLEMENTATION DATE:

June 15, 2015

RESPONSIBLE OFFICIAL(S):

Director, Examination Planning and Delivery, SB/SE: Examination

CORRECTIVE ACTION(S) MONITORING PLAN:

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