United States Government Accountability Office

GAO

Report to the Secretary of the Treasury

November 2011

FINANCIAL AUDIT

IRS's Fiscal Years 2011 and 2010 Financial Statements

U.S. Government Accountability Office
GAO 90 YEARS 1921-2011
ACCOUNTABILITY ★ INTEGRITY ★ RELIABILITY

GAO-12-165

GAO Accountability * Integrity * Reliability

Highlights

Highlights of GAO-12-165, a report to the Secretary of the Treasury

November 2011

FINANCIAL AUDIT

IRS's Fiscal Years 2011 and 2010 Financial Statements

Why GAO Did This Study

In accordance with authority granted by the Chief Financial Officers Act of 1990, GAO annually audits the financial statements of the Internal Revenue Service (IRS) to determine whether (1) the financial statements are fairly presented and (2) IRS management maintained effective internal control over financial reporting. GAO also tests IRS's compliance with selected provisions of significant laws and regulations and its financial systems' compliance with the Federal Financial Management Improvement Act of 1996 (FFMIA). IRS's tax collection activities are significant to overall federal receipts, and its financial management is of substantial interest to Congress.

What GAO Recommends

In prior financial statement audits, GAO made numerous recommendations to IRS to address internal control and compliance issues. Many of these issues continued to persist during fiscal year 2011. GAO will continue to monitor and will report separately on IRS's progress in implementing the 182 recommendations that remain open as of the date of this report. GAO will report separately on recommended actions to address new deficiencies identified in this year's audit.

In commenting on a draft of this report, IRS stated that it would continue to increase its focus on information security and internal control while improving financial reporting.

View GAO-12-165. For more information, contact Steven J. Sebastian at (202) 512-3406 or sebastians@gao.gov.

What GAO Found

In GAO's opinion, IRS's fiscal years 2011 and 2010 financial statements are fairly presented in all material respects. However, serious internal control and financial management systems deficiencies continued to make it necessary for IRS to use resource-intensive compensating processes to prepare its balance sheet. Because of these and other internal control, compliance, and system-related deficiencies, IRS did not, in GAO's opinion, maintain effective internal control over financial reporting as of September 30, 2011, and thus did not have reasonable assurance that losses and misstatements material to the financial statements would be prevented or detected and corrected timely.

During fiscal year 2011, IRS continued to make strides in addressing its deficiencies in internal control. For example, to address its information security deficiencies, IRS formed cross-functional working groups to identify and remediate specific at-risk information security control areas and made improvements in several system-level information security controls.

However, deficiencies remain concerning (1) material weaknesses in internal control over unpaid tax assessments and information security, (2) a significant deficiency in its internal control over tax refund disbursements, (3) a noncompliance with the law concerning the timely release of tax liens, and (4) financial management systems' lack of substantial compliance with FFMIA requirements. The continuing material weakness in internal control over unpaid tax assessments results primarily from IRS's reliance on financial management systems that do not substantially comply with FFMIA requirements and that affect IRS's ability to produce reliable financial statements without significant compensating procedures. IRS's continued material weakness in information security controls limit IRS's ability to provide reasonable assurance that (1) the financial statements are fairly presented; (2) financial management information relied on to support day-to-day decision making is current, complete, and accurate; and (3) proprietary information processed by these automated systems is appropriately safeguarded. These issues increase the risk of inappropriate access, alteration, or abuse of proprietary IRS programs and electronic data and taxpayer information.

Further, during fiscal year 2011, IRS continued to face management challenges in developing and institutionalizing the use of financial management information, specifically cost- and revenue-based, outcome oriented performance information, to assist it in making operational decisions and measuring the effectiveness of its programs. Sustained management efforts will be necessary to build on the progress made to date and to fully address IRS's remaining internal control, compliance, and systems deficiencies and remaining financial management challenges.

Contents

Abbreviations

CDDB	Custodial Detail Data Base
CFO	Chief Financial Officer
FASAB	Federal Accounting Standards Advisory Board
FFMIA	Federal Financial Management Improvement Act of 1996
FFMSR	*Federal Financial Management System Requirements*
FMFIA	Federal Managers' Financial Integrity Act of 1982
FTHBC	First-time Homebuyer Credit
IFS	Integrated Financial System
IRACS	Interim Revenue Accounting Control System
IRS	Internal Revenue Service
MD&A	Management Discussion and Analysis
OMB	Office of Management and Budget
ROI	Return on Investment
RRACS	Redesign Revenue Accounting Control System
TFRP	Trust Fund Recovery Penalty
USSGL	*U.S. Government Standard General Ledger*

Accountability * Integrity * Reliability
United States Government Accountability Office
Washington, D.C. 20548

November 10, 2011

The Honorable Timothy F. Geithner
Secretary of the Treasury

Dear Mr. Secretary:

The accompanying report presents the results of our audits of the financial statements of the Internal Revenue Service (IRS) as of, and for the fiscal years ending, September 30, 2011, and 2010. We performed our audit in accordance with authority granted by the Chief Financial Officers Act of 1990, as expanded by the Government Management Reform Act of 1994. This report contains our (1) unqualified opinions on IRS's financial statements, (2) opinion that IRS's internal control over financial reporting was not effective as of September 30, 2011, (3) conclusion that IRS did not comply with one of the legal provisions we tested, and (4) conclusion that IRS's financial management systems were not in substantial compliance with the requirements of the Federal Financial Management Improvement Act of 1996, as of September 30, 2011. The accompanying report also discusses other significant issues that we identified in performing our audit that we believe should be brought to the attention of IRS management, those charged with governance, and users of IRS's financial statements.

During fiscal year 2011, IRS continued to make progress in addressing its financial management challenges. Specifically, IRS formed cross-functional working groups to identify and remediate specific information security control areas identified as being at risk and made progress in integrating the principles of cost-based decision making into its business units.

However, despite these actions, deficiencies in internal control we identified over unpaid tax assessments and information security continued to constitute material weaknesses[1] in IRS's internal control. In addition, IRS also faces significant challenges in resolving a significant deficiency[2] in internal control over tax refund disbursements and in fully integrating return on investment–based decision-making into its tax collection enforcement operations.

In fiscal year 2011, IRS continued to have a material weakness in its internal control over unpaid tax assessments. We found a continuing deficiency in IRS's ability to maintain a subsidiary ledger for unpaid tax assessments supporting federal taxes receivable on its balance sheet and the related compliance assessments and write-off amounts in its required supplementary information. To compensate for this deficiency, IRS continued to rely on a resource-intensive statistical sampling process to estimate these amounts. As a result, IRS could not trace related amounts reported in its financial statements and required supplementary information through its general ledger back to underlying source documents on a transaction-by-transaction basis.

Also in fiscal year 2011, IRS continued to have a material weakness in internal control over information security. In particular, it had deficiencies in its controls over access to the automated systems and software applications it relies upon to process its financial transactions, produce its internal and external financial reports, and safeguard related sensitive information. As a result, IRS was limited in its ability to provide reasonable assurance that (1) its financial statements, taken as a whole, were fairly presented; (2) the financial information IRS relied on to make decisions on

[1]A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. Materiality represents the magnitude of an omission or misstatement of an item in a financial report that, when considered in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the inclusion or correction of the item.

[2]A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit the attention of those charged with governance.

a daily basis was accurate, complete, and timely; and (3) proprietary financial and taxpayer information was appropriately safeguarded.

In addition to these material weaknesses, IRS continued to have a significant deficiency in internal control over tax refund processing during fiscal year 2011. We continued to find deficiencies in internal control over the processing of manually prepared tax refunds and in the processing of claims for the First-time Homebuyer Credit that led to erroneous refund disbursements. These deficiencies in internal control over tax refund disbursements increased the risk of duplicate or otherwise erroneous tax refund payments being disbursed.

During fiscal year 2011, IRS also continued to experience challenges with respect to developing full cost information across all of its programs and activities, institutionalizing the use of cost accounting agencywide, and developing and routinely using cost-based (and where appropriate enforcement revenue-based) performance metrics to assist it in measuring the results of its efforts and in making resource allocation decisions. It is important that IRS continue to expand the availability and reliability of cost-benefit information, especially return on investment information, to its managers and to aggressively pursue the integration of such data and related performance metrics into both its long-term strategic and short-term routine decision-making processes in order to assist it in effectively managing its resources and to achieve comprehensive and lasting financial management reform.

We are sending copies of this report to the Chairmen and Ranking Members of the Senate Committee on Appropriations; Senate Committee on Finance; Senate Committee on Homeland Security and Governmental Affairs; Subcommittee on Financial Services and General Government, Senate Committee on Appropriations; Subcommittee on Federal Financial Management, Government Information, Federal Services, and International Security, Senate Committee on Homeland Security and Governmental Affairs; House Committee on Appropriations; House Committee on Ways and Means; House Committee on Oversight and Government Reform; Subcommittee on Financial Services and General Government, House Committee on Appropriations; and Subcommittee on Government Management, Organization, and Procurement, House Committee on Oversight and Government Reform. We are also sending copies of this report to the Chairman and Vice Chairman of the Joint Committee on Taxation, the Commissioner of Internal Revenue, the

Director of the Office of Management and Budget (OMB), the Chairman of the IRS Oversight Board, and other interested parties. The report is available at no charge on GAO's website at http://www.gao.gov.

If you have any questions concerning this report, please contact me at (202) 512-3406 or sebastians@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report.

Sincerely yours,

Steven J. Sebastian
Director
Financial Management and Assurance

United States Government Accountability Office
Washington, D.C. 20548

To the Commissioner of Internal Revenue

We audited the fiscal year 2011 and 2010 financial statements of the Internal Revenue Service (IRS) in accordance with authority granted by the Chief Financial Officers (CFO) Act of 1990, as expanded by the Government Management Reform Act of 1994.[1] IRS's financial statements report the assets, liabilities, net position, net costs, changes in net position, budgetary resources, and custodial activity related to the administration of its responsibilities for implementing federal tax legislation. The financial statements do not include an estimate of the dollar amount of taxes that are owed the federal government but have not been reported by taxpayers or identified through IRS's enforcement programs, often referred to as the tax gap,[2] nor do they include information on tax expenditures.[3]

In our audits of IRS's fiscal years 2011 and 2010 financial statements, we found

- the financial statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles;

- IRS's internal control over financial reporting was not effective as of September 30, 2011;

[1]See the CFO Act of 1990, Pub. L. No. 101-576, 104 Stat. 2838 (Nov. 15, 1990), codified, in relevant part, as amended, at 31 U.S.C. § 3521(g); see also the Government Management Reform Act of 1994, Pub. L. No. 103-356, 108 Stat. 3410 (Oct. 13, 1994), codified, in relevant part, as amended, at 31 U.S.C. § 3515(c). Under the authority of 31 U.S.C. § 3515, the Office of Management and Budget (OMB) requires IRS to issue annual audited financial statements that are separate from those of the Department of the Treasury. Although the CFO Act designates the agency's Inspector General, or, where applicable, an independent external auditor, as the responsible auditor of an agency's financial statements, the act also gives GAO the authority to perform such audits at its discretion. Based on that authority, we audit IRS's financial statements because of the significance of IRS's tax collections to the consolidated financial statements of the U.S. Government, which GAO is required to audit. See 31 U.S.C. § 331(e)(2).

[2]IRS includes an estimate of the tax gap in the other accompanying information to the financial statements. This estimate is based on a study conducted to measure the compliance rate of individual filers based on an examination of a statistical sample of tax returns filed for tax year 2001.

[3]Tax expenditures represent the amount of revenue that the government forgoes resulting from federal tax law provisions that (1) allow a special exclusion, exemption, or deduction from gross income, or (2) provide a special credit, preferential rate, or deferred tax liability.

- IRS did not comply with one of the legal provisions we tested; and

- IRS's financial management systems were not in substantial compliance with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA)[4] as of September 30, 2011.

In its role as the nation's tax collector, IRS has a demanding responsibility in collecting federal taxes, processing federal tax returns, and enforcing the nation's tax laws. IRS is a large and complex organization, posing unique operational and financial management challenges for its management. IRS employs over 100,000 people in its Washington, D.C., headquarters and over 700 offices in all 50 states and U.S. territories and in some U.S. embassies and consulates. In fiscal years 2011 and 2010, IRS collected about $2.4 trillion and $2.3 trillion, respectively, in federal tax payments, processed hundreds of millions of tax and information returns, and paid about $416 billion and $467 billion, respectively, in refunds to taxpayers.

In fiscal year 2011, for the 12th consecutive year, IRS's financial statements are fairly presented in all material respects. IRS continued to make progress in addressing its management challenges. For example, IRS formed cross-functional working groups to identify and remediate specific at-risk information security control areas, and it made progress in integrating the principles of cost-based decision-making into its business units. However, despite its progress, IRS continued to have (1) material

[4]Pub. L. No. 104-208, div. A, § 101(f), title VIII, 110 Stat. 3009, 3009-389 (Sept. 30, 1996).

weaknesses,[5] a significant deficiency,[6] and other deficiencies in its internal control; and (2) noncompliance with legal provisions.

In evaluating the materiality of identified deficiencies in internal control to determine whether they represent a material weakness or significant deficiency, the auditor assesses the risk and magnitude of potential misstatements that may not be prevented or be timely detected and corrected by the entity's internal control due to the existence of the identified deficiency or combination of deficiencies. Because the judgments of financial statement users encompass not only the amounts and disclosures contained in the financial statements but are also made in light of surrounding circumstances, materiality judgments necessarily involve both quantitative and qualitative considerations. Quantitative considerations refer to the dollar magnitude of actual or potential misstatements. Qualitative considerations include the sensitivity of the circumstances and perceived importance surrounding the actual or potential misstatement and the significance of the financial statement element(s) affected by the actual or potential misstatement. After considering both quantitative and qualitative factors, we concluded, as noted below, that deficiencies we identified in IRS's internal control over unpaid tax assessments[7] and information security constitute material weaknesses.

In our evaluation of deficiencies in internal control at IRS during fiscal year 2011, we identified the following:

[5]A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. Materiality represents the magnitude of an omission or misstatement of an item in a financial report that, when considered in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the inclusion or correction of the item.

[6]A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit the attention of those charged with governance.

[7]An unpaid tax assessment is a legally enforceable claim against a taxpayer and consists of taxes, penalties, and interest that have not been collected or abated (a reduction in a tax assessment).

- A continuing material weakness in internal control over unpaid tax assessments due to IRS's inability to rely on its financial management systems for tax-related transactions and its underlying subsidiary records to report taxes receivable, compliance assessments, or write-offs in accordance with federal accounting standards. These issues have also led to errors in taxpayer records, which can lead to increased taxpayer burden.

- A continuing material weakness in internal control over information security that limited IRS's ability to provide reasonable assurance that (1) the financial statements are fairly presented in conformity with U.S. generally accepted accounting principles; (2) financial information that management relies on to support day-to-day decision making is current, complete, and accurate; and (3) proprietary information processed by these automated systems is appropriately safeguarded. These issues increase the risk of unauthorized individuals accessing, altering, or abusing proprietary IRS programs and electronic data and taxpayer information.

- A continuing significant deficiency in internal control over tax refund disbursements that resulted from deficiencies in internal control over manual tax refunds[8] and the processing of claims for the First-time

[8]The preponderance of tax refunds are disbursed to taxpayers automatically by IRS's automated systems once a tax return is posted to the taxpayer's account and an overpayment to IRS is identified and calculated. However, tax refunds meeting certain defined criteria, such as those exceeding $10 million in dollar amount, are subject to manual review before disbursement and are known as manual tax refunds.

Homebuyer Credit (FTHBC)[9] that in some instances resulted in the disbursement of erroneous refunds.

In addition, we identified two instances of noncompliance with legal provisions. Specifically, (1) IRS did not always release federal tax liens against taxpayers' property within 30 days of the full satisfaction of the tax debt as required by the Internal Revenue Code, and (2) IRS's financial management systems did not substantially comply with the requirements of FFMIA.

Opinion on IRS's Financial Statements

IRS's financial statements, including the accompanying notes, present fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, IRS's assets, liabilities, and net position as of September 30, 2011 and 2010; and its net costs; changes in net position; budgetary resources; and custodial activity for the fiscal years then ended.

However, misstatements may nevertheless occur in other financial information reported by IRS and not be detected as a result of the deficiencies in internal control described in this report.

[9]To claim the FTHBC, a taxpayer must be either a first-time homebuyer or a "long-time resident." For purposes of the FTHBC, an eligible taxpayer is (1) a first-time homebuyer who did not own a principal residence during the 3 years ending on the purchase date of his/her home or (2) a homebuyer who meets the requirements for long-time resident status. A long-time resident is a taxpayer who has owned and used the same residence as a principal residence for any 5-consecutive-year period during the 8-year period ending on the date of the purchase of a subsequent principal residence. See FTHBC, 26 U.S.C. § 36. The FTHBC was originally authorized by section 3011 of the Housing and Economic Recovery Act of 2008. The new credit was originally available for a limited time only, applying to taxpayers who purchased a principal residence after April 8, 2008, and before July 1, 2009. Taxpayers were permitted to claim a fully refundable credit equal to 10 percent of the purchase price of the home, with a maximum available credit of $7,500. This credit was to be repaid within 15 years with payments beginning 2 years after the credit was claimed. Section 1006 of the American Recovery and Reinvestment Act of 2009 extended the FTHBC to include purchases made on or after January 1, 2009, and before December 1, 2009; increased the maximum credit to $8,000; and eliminated the repayment requirement as long as the taxpayer retains the residence for 36 months. Taxpayers qualifying for the revised credit may claim the $8,000 credit on either their 2008 or 2009 individual income tax returns. Section 11 of the Worker, Homeownership, and Business Assistance Act of 2009, as amended by section 2 of the Homebuyer Assistance and Improvement Act of 2010, extended the deadline for home purchases to May 1, 2010 (with the requirement that the taxpayer with a binding contract settle on the home purchase before October 1, 2010) and expanded eligibility for the credit (with a maximum available credit of $6,500) to qualifying long-time resident homebuyers.

In conformity with U.S. generally accepted accounting principles, IRS's financial statements reflect federal tax revenues collected during the fiscal year and related refunds disbursed, as well as the total unpaid federal taxes for which IRS and the taxpayers or courts agree on the amounts owed, less an allowance for an estimate of amounts considered to be uncollectible.[10] To the extent that taxes owed in accordance with the nation's tax laws are not reported by taxpayers and are not identified through IRS's various enforcement programs (often referred to as the tax gap), they are not reported in the financial statements or in required supplementary information to the financial statements; however, they are reported as other accompanying information. Tax expenditures, which represent the amount of federal tax revenue the federal government forgoes resulting from federal tax law provisions that (1) allow a special exclusion, exemption, or deduction from gross income, or (2) provide a special credit, preferential rate, or deferred tax liability, are also not reported in the financial statements, but rather are presented as other accompanying information.

Opinion on Internal Control

Because of the two material weaknesses in internal control over unpaid tax assessments and information security discussed below, IRS did not maintain, in all material respects, effective internal control over financial reporting as of September 30, 2011, and thus did not provide reasonable assurance that losses and misstatements that were material in relation to the financial statements would be prevented or detected and corrected on a timely basis. Our opinion is based on criteria established under 31 U.S.C. sec. 3512 (c), (d), commonly known as the Federal Managers' Financial Integrity Act of 1982 (FMFIA).

Despite its material weaknesses in internal control, IRS was able to prepare financial statements that were fairly presented in all material respects for fiscal years 2011 and 2010. Nonetheless, IRS continues to face significant challenges in addressing its material weaknesses in

[10]The allowance for uncollectible amounts is IRS's estimate of taxes receivable that it may not be able to collect. Cumulative unpaid federal tax assessments for which there is no future collection potential or for which there is no agreement on the amounts owed are not reported on the financial statements. Rather they are reported as write-offs and compliance assessments, respectively, in required supplementary information to IRS's financial statements.

internal control over (1) unpaid tax assessments and (2) information security, as described below.

The material weaknesses in internal control may adversely affect decisions by IRS's management that are based, in whole or in part, on information that is inaccurate because of these deficiencies. In addition, unaudited financial information reported by IRS, including budget information, may also contain misstatements resulting from these deficiencies. The issues constituting these material weaknesses were encompassed in the material weaknesses in IRS's fiscal year 2011 (1) FMFIA assurance statement to the Department of the Treasury, and (2) Management's Report on Internal Control over Financial Reporting. We considered these reported material weaknesses in determining the nature, timing, and extent of our audit procedures on IRS's fiscal years 2011 and 2010 financial statements.

In addition to the material weaknesses in internal control noted above and described in greater detail below, we identified several deficiencies in internal control related to IRS's disbursement of tax refunds, which collectively, although not a material weakness, we believe are important enough to be brought to the attention of those charged with IRS governance and which thus represent a significant deficiency in IRS's internal control. This significant deficiency is also described in greater detail below.

Material Weakness in Internal Control over Unpaid Tax Assessments

During fiscal year 2011, IRS continued to have a material weakness in internal control over unpaid tax assessments. This material weakness encompasses internal control deficiencies concerning IRS's (1) inability to rely on its general ledger system for tax transactions and underlying subsidiary records to report federal taxes receivable, compliance assessments, and write-offs in accordance with federal accounting standards without significant compensating procedures,[11] (2) lack of transaction traceability for the reported balance of taxes receivable that comprises over 80 percent of IRS's total assets as of September 30, 2011, and an effective transaction-based subledger for unpaid tax assessment transactions, and (3) inability to effectively prevent or timely detect and correct errors in taxpayer accounts. These internal control deficiencies are caused primarily by IRS's continued reliance on software applications that were not designed to provide accurate, complete, and timely transaction-level financial information, as well as errors in taxpayer accounts. Consequently, management lacks the information it needs to make well-informed decisions and to accumulate and report financial information in accordance with federal accounting standards. These problems are likely to continue to exist until these software applications are either significantly enhanced or replaced, and IRS remedies the control deficiencies that continue to result in significant errors in taxpayer accounts.

Material Weakness in Internal Control over Information Security

During fiscal year 2011, IRS continued to have a material weakness in internal control over information security. IRS made strides during the fiscal year in initiating efforts to address many of the internal control deficiencies that collectively comprise this material weakness. Notable among these efforts was the formation of cross-functional working groups tasked with the identification and remediation of specific at-risk control areas. Also, IRS improved several system-level controls, including the encryption of data transferred between some accounting systems, upgrades to critical network devices on the agency's internal network, and strengthening of the architecture of an important financial system to eliminate identified areas of weakness. However, despite these efforts and enhanced management attention toward controls, a majority of the known weaknesses in the agency's systems and internal network and physical security controls remained unresolved in fiscal year 2011. For example, (1) IRS continued to rely upon a procurement system that lacks reliable

[11]Federal accounting standards classify unpaid tax assessments into one of the following three categories for reporting purposes: federal taxes receivables, compliance assessments, and write-offs. Federal taxes receivable are taxes due from taxpayers for which IRS can support the existence of a receivable through taxpayer agreement or a favorable court ruling. Compliance assessments are tax assessments where neither the taxpayer nor the court has affirmed that the amounts are owed. Write-offs represent unpaid tax assessments for which IRS does not expect further collections because of factors such as the taxpayer's death, bankruptcy, or insolvency. Of these three classifications of unpaid tax assessments, only federal taxes receivable, net of an allowance for uncollectible amounts, are reported on the financial statements.

controls due to access control weaknesses and database maintenance that was not performed; (2) IRS continued to use unencrypted protocols for a sensitive tax processing application; and (3) many physical security control weaknesses identified in prior years had not been resolved.

The results of our testing during this audit were consistent with our findings in past years in that we identified additional deficiencies with the same significance as we identified in prior audits. Among the deficiencies we identified this year were weaknesses in (1) system access and configuration controls and (2) controls intended to compensate and mitigate for known deficiencies. For example, our testing showed that systems used to process tax and financial information did not effectively prevent access from unauthorized users or excessive levels of access for authorized users. These vulnerabilities were not known to IRS despite those systems being in compliance with the agency's policies on periodic control reviews and testing. As a result of these deficiencies considered collectively, IRS was (1) unable to rely upon its systems or compensating and mitigating controls to provide reasonable assurance that its financial statements are fairly presented, (2) unable to ensure the reliability of other financial management information produced by its systems, and (3) at increased risk of compromising confidential IRS and taxpayer information.

Significant Deficiency in Internal Control over Tax Refund Disbursements

During fiscal year 2011, we continued to identify deficiencies in IRS's internal control over tax refund disbursements. These deficiencies do not individually or collectively represent a material weakness, but in our judgment collectively represent a significant deficiency in the design or operation of internal control that adversely affects IRS's ability to meet the internal control objectives described in this report. Specifically, IRS has not effectively addressed the deficiencies in internal control over manual tax refunds that we have reported in previous years[12] and the processing of claims for the FTHBC we reported for fiscal year 2010. We also identified additional deficiencies in internal control over manual tax refunds during this year's audit, as well as continued deficiencies in IRS's internal control over processing of claims for the FTHBC. These deficiencies related to the monitoring of manual refunds, training of staff having key roles in refund

[12]We have reported these deficiencies and recommendations to address them in various management and status of recommendations reports to IRS. See GAO, *Internal Revenue Service: Status of GAO Financial Audit and Related Financial Management Report Recommendations*, GAO-11-536 (Washington, D.C.: June 22, 2011).

processing, and documentation of FTHBC claims. In some cases, these deficiencies resulted in erroneous tax refund disbursements. These deficiencies in internal control, coupled with the materiality of tax refunds to IRS's financial statements, led us to conclude that they collectively constitute a significant deficiency in IRS's internal control over tax refund disbursements. As a result, there is also an increased risk that in addition to those we identified, IRS may have disbursed other, undetected, erroneous tax refund payments.

We have reported on IRS's internal control weaknesses in prior audits and have provided IRS recommendations to address these and other less-significant issues.[13] As of the date of this report, 182 recommendations related to our financial statement audits were still open, of which 10 relate to the material weakness in internal control over unpaid tax assessments, 105 relate to the material weakness in internal control over information security, and 9 relate to issues encompassed by the significant deficiency in internal control over tax refund disbursements. For more details on the material weaknesses and the significant deficiency identified as a result of our audit, see appendix I.

During our fiscal year 2011 audit, we also identified other deficiencies in IRS's system of internal control that we do not consider to be material weaknesses or significant deficiencies. We have communicated these matters to IRS management informally and, as appropriate, will be reporting them to IRS separately at a later date.

Compliance with Laws and Regulations

Our tests of IRS's compliance with selected provisions of laws and regulations for fiscal year 2011 disclosed one area of noncompliance that is reportable under U.S. generally accepted government auditing standards. This area relates to IRS not always releasing federal tax liens against taxpayers' property within the 30-day legal requirement.[14] For more details on our findings with respect to this compliance issue, see appendix I.

[13]GAO-11-536 and GAO, *Information Security: IRS Needs to Enhance Internal Control over Financial Reporting and Taxpayer Data*, GAO-11-308 (Washington, D.C.: Mar. 15, 2011).

[14]Tax law requires IRS to release a federal tax lien within 30 days after the date the tax liability is fully satisfied or has become legally unenforceable, or the Secretary of the Treasury has accepted a bond for the assessed tax. See 26 U.S.C. § 6325(a).

Except as noted above, our tests for compliance with laws and regulations disclosed no other instances of noncompliance that would be reportable under U.S. generally accepted government auditing standards. However, the objective of our audit was not to provide an opinion on overall compliance with laws and regulations. Accordingly, we do not express such an opinion.

Systems' Compliance with FFMIA Requirements

We found that IRS's financial management systems did not substantially comply with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA) as of September 30, 2011.[15] Specifically, IRS's financial management systems did not substantially comply with (1) *Federal Financial Management System Requirements* (FFMSR) and (2) federal accounting standards (U.S. generally accepted accounting principles). IRS's financial management systems substantially complied with the *U.S. Standard General Ledger* (USSGL) at the transaction level. Our conclusion is based on criteria established under FFMIA for federal financial management systems, U.S. generally accepted accounting principles, and the USSGL.

The deficiencies resulting in IRS's financial management systems' lack of substantial compliance with the FFMIA requirements relate to the material weaknesses discussed previously. Further, IRS disclosed these deficiencies in its fiscal year 2011 (1) FMFIA assurance statement to the Department of the Treasury and (2) Management's Report on Internal Control over Financial Reporting. IRS's FFMIA remediation plan details its planned corrective actions for the weaknesses that render its financial management systems substantially noncompliant with the requirements of FFMIA. For more details on the IRS financial management systems' FFMIA compliance issue, see appendix I.

Consistency of Other Information

IRS's Management Discussion and Analysis and other required supplementary and other accompanying information contain a wide range of information, some of which is not directly related to the financial statements. We did not audit and do not express an opinion on this information. However, we compared this information for consistency with the financial statements and discussed the methods of measurement and

[15]Pub. L. No. 104-208, div. A, § 101(f), title VIII, 110 Stat. 3009, 3009-389 (Sept. 30, 1996).

presentation with IRS officials. On the basis of this limited work, we found no material inconsistencies with the financial statements, U.S. generally accepted accounting principles, or applicable requirements of OMB Circular No. A-136, *Financial Reporting Requirements*.

Other Financial Management Challenges

In addition to the challenge of addressing its internal control weaknesses, IRS also faces additional financial management challenges related to performance measurement and the safeguarding of taxpayer receipts and associated information.

Performance Measurement

During fiscal year 2011, IRS continued to face challenges in developing and institutionalizing the use of financial information to assist it in making operational decisions and in measuring the effectiveness of its programs. The Federal Accounting Standards Advisory Board's (FASAB) Statement of Federal Financial Accounting Concepts No. 1, *Objectives of Federal Financial Reporting*,[16] provides that federal entities' financial data should facilitate accountability and decision making on the costs and the outputs and outcomes achieved, and for evaluating service efforts, costs, and accomplishments. A key objective of the CFO Act is for federal agencies to routinely provide and ensure the use of appropriate financial management information needed to evaluate program effectiveness, make fully informed operational decisions, and ensure accountability. IRS's existing performance metrics only partially achieve these goals because its metrics are focused primarily on process-oriented workload measures rather than on metrics that measure program outcomes, such as specific IRS enforcement programs' return on investment (ROI).

Although IRS made progress during fiscal year 2011 in implementing cost-based performance information into its operational decision-making processes, the agency has not yet reached a level of implementation indicative of full integration of this type of performance data such that it becomes a routine part of managers' decision-making process throughout all of IRS's business units and its externally reported performance metrics.

[16] FASAB Statement of Federal Financial Accounting Concepts 1, *Objectives of Federal Financial Reporting,* as codified in FASAB *Statements of Federal Financial Concepts and Standards, Pronouncements as Amended* (Washington, D.C.: June 30, 2010).

During the fiscal year, IRS continued to add to the number of programs and activities for which full cost, and ROI,[17] information has been developed, and IRS has for the past several years annually updated the data for each set of such information. Additionally, over the last several years, IRS's Office of Chief Financial Officer (CFO) has been the driving force in developing and promoting the use of full cost (and revenue) information for IRS's programs and activities within IRS's various business units, leadership that it continued to provide during fiscal year 2011. The CFO's efforts have resulted in progress during fiscal year 2011 in that the management teams of several of IRS's business units began expressing their own interest in, and have made requests to the CFO for, full cost information on outputs from their business units' programs and activities, and they reported that they are exploring ways in which to include such data in their decision-making processes.

However, the use of programmatic full cost and ROI information, and related performance metrics, has not yet extended to IRS's primary business unit responsible for developing and directing IRS's corporate-wide enforcement activities to collect unpaid taxes. The integration of such information into both IRS's strategic and routine enforcement-related management decisions could greatly enhance IRS's ability to evaluate the efficiency and cost-effectiveness of its programs and activities, including comparing the efficiency and effectiveness of various existing enforcement collection strategies, staffing levels, and proposed changes.

We acknowledge that IRS faces challenges in integrating the use of full cost data into its routine decision-making processes, especially the use of ROI performance metrics within IRS's enforcement business units. We also recognize that such integration will involve combining the use of ROI metrics with other factors, such as the fairness of its implementation of the tax code and the impact on voluntary compliance into its decision-making processes. However, including the use of ROI performance metrics would better position IRS to evaluate the effectiveness of its programs and activities and optimize the allocation of resources among them. It would also provide IRS better information with which to defend its budgets and

[17]To date, IRS's ROI calculations have limitations that reflect the challenges of estimating ROIs. For example, they do not include benefits of improved voluntary compliance. In addition, the "investment" or costs should ideally recognize not only IRS's costs but also any costs borne by others. IRS's ROI estimates provide useful information but, given the limits of current data, are not complete estimates of benefits and costs.

more credibly demonstrate to Congress and the public that it is using its appropriations efficiently and effectively. Achieving the full integration of ROI data into routine as well as strategic decision making throughout the agency will require sustained leadership from senior IRS executives and throughout the agency.

Safeguarding Taxpayer Receipts and Associated Information

Although levels of electronic filing of tax and information returns have been steadily increasing, IRS continues to face an ongoing management challenge due to the millions of hard-copy tax returns it continues to receive and process each year, along with hundreds of billions of dollars in associated taxpayer payments it receives. As long as IRS continues to receive such large volumes of hard-copy taxpayer payments and supporting data, there will continue to be a significant risk to the government and taxpayers alike that loss of receipts or inappropriate disclosure or compromise of taxpayer information may occur during this process. Safeguarding these taxpayer receipts and associated taxpayer information to prevent such events are among IRS's most important and demanding responsibilities, and congressional and taxpayer expectations in this regard are justifiably high. During our financial audits, including our fiscal year 2011 audit, we continue to identify deficiencies in IRS's internal control over safeguarding of taxpayer receipts and information which, while not individually or in the aggregate constituting a significant deficiency or material weakness, nonetheless are sensitive matters requiring attention. We have made numerous recommendations to address these issues,[18] to which IRS has been responsive. Nonetheless, it is critical that IRS maintain effective internal control to mitigate this risk, including ongoing monitoring of key internal controls to verify that they do not deteriorate over time.

Objectives, Scope, and Methodology

IRS management is responsible for (1) preparing the financial statements in conformity with U.S. generally accepted accounting principles, (2) establishing and maintaining effective internal control over financial reporting and evaluating its effectiveness, (3) ensuring that IRS's financial management systems substantially comply with FFMIA requirements, and (4) complying with applicable laws and regulations. IRS management

[18] We have reported these deficiencies and recommendations to address them in various management and status of recommendations reports to IRS. See GAO-11-536.

evaluated the effectiveness of IRS's internal control over financial reporting as of September 30, 2011, based on the criteria established under FMFIA. IRS management's assertion based on its evaluation is included in appendix II.

We are responsible for planning and performing the audit to obtain reasonable assurance and provide our opinion about whether (1) IRS's financial statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, (2) IRS management maintained, in all material respects, effective internal control over financial reporting as of September 30, 2011, and (3) IRS's financial management systems substantially comply with FFMIA requirements. We are also responsible for (1) testing compliance with selected provisions of laws and regulations that have a direct and material effect on the financial statements, and (2) performing limited procedures with respect to certain other information accompanying the financial statements.

In order to fulfill these responsibilities, we

- examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements; this included selecting statistical samples of unpaid tax assessments, revenue, refunds, payroll and nonpayroll expenses, property and equipment, and undelivered order transactions;[19]
- assessed the accounting principles used and significant estimates made by IRS management;
- evaluated the overall presentation of IRS's financial statements;
- obtained an understanding of IRS and its operations, including its internal control over financial reporting;

[19]These statistical samples were selected primarily to determine the validity of balances and activities reported in IRS's financial statements. We projected any errors in dollar amounts to the population of transactions from which they were selected. In testing some of these samples, certain attributes were identified that indicated deficiencies in the design or operation of internal control. These attributes, where applicable, were statistically projected to the appropriate populations.

- considered IRS's process for evaluating and reporting on (1) internal control over financial reporting based on criteria established under FMFIA, and (2) financial management systems under FFMIA;

- assessed the risk of (1) material misstatement in IRS's financial statements and (2) material weakness in its internal control over financial reporting;

- tested relevant internal control over IRS's financial reporting;

- evaluated the design and operating effectiveness of IRS's internal control over financial reporting based on the assessed risk;

- tested compliance with selected provisions of the following legal provisions: Internal Revenue Code; Anti-Deficiency Act, as amended; Purpose Statute; Prompt Payment Act; Pay and Allowance System for Civilian Employees; Federal Employees' Retirement System Act of 1986, as amended; Social Security Act of 1935, as amended; Federal Employees Health Benefits Act of 1959, as amended; Full-Year Continuing Appropriations Act, 2011, which incorporates, by reference, certain provisions of the Financial Services and General Government Appropriations Act, 2010; Federal Employees' Compensation Act; Civil Service Retirement Act; and the Tax Relief Unemployment Insurance Reauthorization and Jobs Creation Act of 2010;

- tested whether IRS's financial management systems substantially complied with the three FFMIA requirements; and

- performed such other procedures as we considered necessary in the circumstances.

An entity's internal control over financial reporting is a process affected by those charged with governance, by management, and by other personnel, the objectives of which are to provide reasonable assurance that (1) transactions are properly recorded, processed, and summarized to permit the preparation of financial statements in conformity with U.S. generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition; and (2) transactions are executed in accordance with the laws governing the use of budget authority and other laws and regulations that could have a direct and material effect on the financial statements.

We did not evaluate all internal control relevant to operating objectives as broadly established under FMFIA, such as controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to testing controls over financial reporting. Our internal control testing was for the purpose of expressing an opinion on the effectiveness of internal control over financial reporting and may not be sufficient for other purposes. Consequently, our audit may not identify all deficiencies in internal control over financial reporting that are less severe than a material weakness. Because of inherent limitations in internal control, internal control may not prevent or detect and correct misstatements due to error or fraud, losses, or noncompliance. We also caution that projecting any evaluation of effectiveness to future periods is subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with policies or procedures may deteriorate.

We did not test compliance with all legal provisions applicable to IRS. We limited our tests of compliance to those laws and regulations that have a direct and material effect on the financial statements for the fiscal year ended September 30, 2011. We caution that noncompliance may occur and not be detected by these tests and that such testing may not be sufficient for other purposes. Also, our work on FFMIA would not necessarily disclose all instances of noncompliance with FFMIA requirements.

We performed our audit in accordance with U.S. generally accepted government auditing standards. We believe our audit provides a reasonable basis for our opinions and other conclusions.

Agency Comments and Our Evaluation

In commenting on a draft of this report, IRS stated that it was pleased that we recognized its progress in strengthening controls. Specifically, IRS noted that we recognized it had (1) established enterprise-wide security initiatives that improved management's ability to measure the state of controls, (2) developed cross-functional working groups with knowledge of internal systems and the ability to assess risk areas, and (3) made improvements in performance measures and the timely release of tax liens. IRS also commented that it had continued to make improvements in the areas of cash management, cost allocations, upward and downward adjustments to prior year obligations, and undelivered orders. Our prior audits identified deficiencies in each of these areas.

Further, while IRS acknowledged that challenges remain, IRS also stated it had a solid management team dedicated to promoting the highest standard of financial management, and would continue to increase the focus on information security and internal controls while improving financial reporting.

We will evaluate the effectiveness of IRS's corrective actions during our audit of IRS's fiscal year 2012 financial statements. The complete text of IRS's response is included in appendix III.

Sincerely yours,

Steven J. Sebastian
Director
Financial Management and Assurance

November 4, 2011

Management Discussion and Analysis

The Internal Revenue Service FY 2011 Management Discussion and Analysis

AT A GLANCE

Douglas Shulman became the 47th Commissioner of Internal Revenue on March 24, 2008. He presides over the nation's tax administration system, which annually collects over $2 trillion in tax revenue that funds most government operations and public services.

History

The IRS is one of the oldest bureaus in the United States Government. Article 1, Section 8 of the Constitution gave the Federal Government the power to "lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States…" In 1862, President Lincoln and the Congress established the Bureau of Internal Revenue and the nation's first income tax. In 1953, the Bureau of Internal Revenue's name was changed to the Internal Revenue Service (IRS).

Vision

Funding America's future by strengthening our system of voluntary tax compliance.

Mission

Provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.

Organization

The IRS organizational structure (Appendix A) closely resembles the private sector model of organizing around customers with similar needs. The scope of IRS operations includes collection of individual and corporate taxes, examination of returns, taxpayer assistance, oversight of tax-exempt organizations, as well as tax credits such as the Earned Income Tax Credit program, the nation's largest federally administered means-tested benefits program.

Operating Divisions

- **Wage and Investment**
- **Small Business and Self-Employed**
- **Large Business and International**
- **Tax-Exempt and Government Entities**

Employees

The IRS employs over 100,000 employees.

Location

The IRS is headquartered in Washington, DC. The IRS also has employees located at over 700 offices in all states and territories and some U.S. embassies and consulates.

IRS FY 2011 Statistics	
Total Revenue Collected	$2.4 trillion
Total Enforcement Revenue Collected	$55.2 billion
Total Refunds	$415.9 billion
Number of Hits on IRS.gov	1.6 billion
Number of Downloads from IRS.gov	229.2 million
Number of Returns Filed	237 million
"Where's My Refund?" Usage	77.9 million
Number of Taxpayers Assisted	82.9 million
Number of Returns Filed Electronically	126 million
Average Individual Refund	$2,927
Number of Customers served at Taxpayer Assistance Centers	6.4 million

Financial Resources

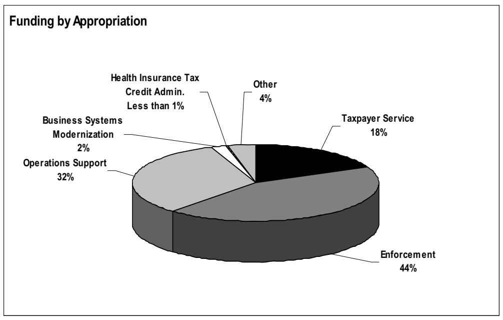
The IRS FY 2011 budget was $12.12 billion in direct appropriations, supplemented by $324.4 million in user fee revenue and $138.9 million in reimbursable resources for a total operating level of $12.6 billion.

Internet

The IRS provides tax information, taxpayer services, forms, and publications at www.IRS.gov.

"Taxes are the price we pay for living in a civilized society"
US Supreme Court Justice Oliver Wendell Holmes

IRS RESOURCES



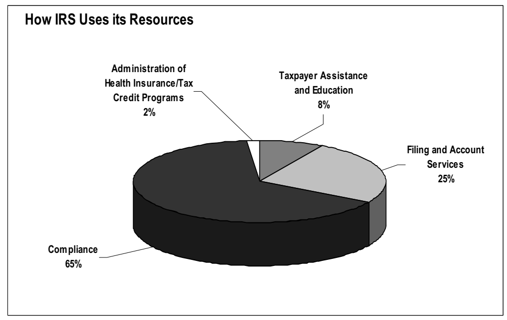
Funding by Appropriations ($ thousands)

In FY 2011, funding for the three core operating appropriations was allocated as follows:

- **Taxpayer Services** *[$2,274,272]* funds processing tax returns and related documents, and assistance for taxpayers in filing returns and paying taxes due.
- **Enforcement** *[$5,492,992]* funds examination of tax returns, collection of balances, the administrative and judicial settlement of taxpayer appeals of examination findings, as well as providing resources for strengthened enforcement to reduce invalid claims and erroneous filings associated with the Earned Income Tax Credit (EITC) program.
- **Operations Support** *[$4,075,716]* funds administrative services, policy management and IRS-wide support. The appropriation also funds staffing, equipment, and related costs to manage, maintain, and operate critical information systems that support tax administration.

In addition to the core appropriations, the IRS has the following appropriations:

- **Business Systems Modernization** *[$263,369]* funds capital asset acquisitions of information technology systems to modernize key tax administration systems.
- **Health Insurance Tax Credit Administration** *[$15,481]* funds the administration of the Health Coverage Tax Credit (HCTC).
- **Other: Mandatory Appropriation (Special Funds):** User Fees *[$324,477]* are receipts from payment for services provided and reimbursable agreements *[$138,855]*.



How IRS Uses its Resources

The Statement of Net Cost reflects the use of IRS resources in conducting its major programs. The IRS uses a cost allocation methodology to assign support and overhead costs to each program described below. The Statement of Net Cost reports the full cost of these programs in accordance with the Statement of Federal Financial Accounting Standards No. 4, "Managerial Cost Accounting."

- **Taxpayer Assistance and Education** activities include taxpayer education and outreach, tax publication issuance and distribution.
- **Filing and Account Services** activities include filing tax returns, maintaining customer accounts, and processing taxpayer information.
- **Compliance** activities include pre-filing agreements, document matching, examination, collection, and criminal investigation activities.
- **Administration of Health Insurance/Tax Credit Programs** includes costs for Earned Income Tax Credit (EITC) and HCTC program activities.

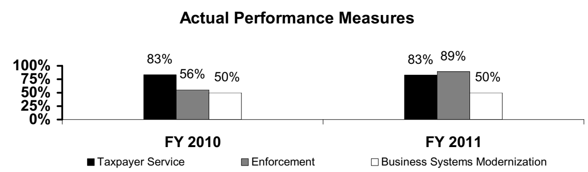
The following table shows FY 2011 and 2010 data on the use of IRS resources by major programs:

Use of Resources ($ thousands)		
Program	**FY 2011**	**FY 2010**
Taxpayer Assistance and Education	$1,132,508	$793,492
Filing and Account Services	$3,365,832	$3,527,840
Compliance	$8,763,891	$9,330,435
Administration of Health Insurance/Tax Credit Programs	$208,716	$249,577

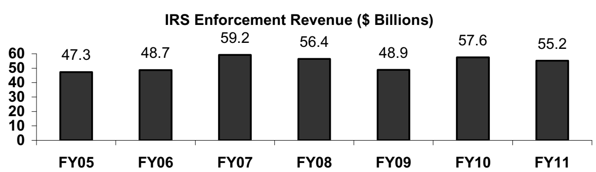
INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2011

Fiscal Year (FY) 2011 Performance

In FY 2011, the IRS achieved an overall success rate of 84% in meeting or exceeding the targets for 27 of its 32 performance measures, a 27% increase compared to FY 2010. Two of the five measures that fell below the target were within 1% of the target. Detailed information on performance is contained in Appendix B, Performance Measurement Data; and Appendix C, Explanation of Shortfalls.



Collections related to enforcement activities totaled $55.2 billion for FY 2011, a 17% increase over FY 2005.



Research studies and analytics provide measures of taxpayer compliance and the tax gap, which influences taxpayer compliance and IRS enforcement activities. In FY 2011, the National Research Program (NRP) completed individual reporting compliance studies that will be used to update tax gap estimates scheduled to be released in FY 2012. Updated estimates also incorporate an enhanced methodology to calculate the individual income tax nonfiling gap. NRP also delivered data for the S-corporation reporting compliance study and updated payment compliance estimates for tax years 2006 through 2009. For the first time in 30 years, the IRS also began designing a corporate income tax reporting compliance study to obtain valuable information on the compliance behaviors of corporate filers. The study will cover a sample of corporate returns from tax year 2010.

The IRS continues to improve its methods to identify noncompliance. In FY 2011, the Compliance Data Warehouse (CDW), an IRS system that integrates tax data from numerous sources to enable quick and easy access by IRS researchers via third-party tools, was named the 2011 Best Practices Awards winner, in the category of government/non-profit, by the Data Warehousing Institute. CDW was honored for demonstrating best practices in business intelligence, data warehousing, or related areas of data management. This is the fourth industry award for CDW in the last four years.

Return Preparer Initiative

One of the most important initiatives that the IRS has undertaken in recent memory is the return preparer initiative, which is now being implemented. In September 2010, the IRS launched the new online PTIN (Preparer Tax Identification Number) application system. The system is up and running with over 735,000 preparers already registered in the system. More than just an identification number, the PTIN registration process gives the IRS an important and better line of sight into the return preparer community than the IRS has ever had before. It allows for leveraging information to better communicate, analyze trends, spot anomalies, and potentially detect fraud. The registration process will help IRS build, in several years, a publicly-accessible database of preparers who are authorized to prepare returns. This is an extremely important tool for consumers as they will be able to search the database to ensure that their preparer is registered. In 2011, the IRS also:

- Amended Circular 230 to create a new registered tax return preparer credential, extend ethical rules to all paid preparers, create new rules applicable to continuing education providers, broadened the definition of practice to include return preparation, and numerous other revisions.

The IRS provided return preparer initiative outreach and education by arranging to have agency officials make presentations and provide outreach at key stakeholder events and use a range of communication tools for sharing information.

The IRS also maintains an enforcement presence in the return preparer community. FY 2011 accomplishments include:

- Completing 240 undercover visits.
- Conducting 93 Knock and Talk visits with identified at-risk preparers.
- Initiating 378 Return Preparer Program (RPP) investigations.
- Achieving 163 RPP convictions.
- Issuing 10,000 letters and visiting more than 5,000 preparers for noncompliance with multiple areas of concern that include EITC, e-file, and certified acceptance agents.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2011

Strategic Goal
Improve Service to Make Voluntary Compliance Easier

OBJECTIVES

- ***Incorporate Taxpayer Perspectives To Improve All Service Interactions.***
- ***Expedite And Improve Issue Resolution Across All Interactions With Taxpayers, Making It Easier To Navigate The IRS.***
- ***Provide Taxpayers With Targeted, Timely Guidance And Outreach.***
- ***Strengthen Partnerships With Tax Practitioners, Tax Preparers, And Other Third Parties In Order To Ensure Effective Tax Administration.***

Taxpayer Service Facts

The IRS assists taxpayers with meeting their federal tax obligations by providing alternative service delivery methods. In FY 2011, the IRS:

- Launched a Toll-Free telephone line giving callers direct access to the automated transcript application and implemented a new web application on IRS.gov that allows taxpayers to order copies of previously filed and processed tax returns. Over 1.96 million taxpayers ordered transcripts in FY 2011.
- Provided 100 Facilitated Self-Assistance (FSA) kiosks at 37 Taxpayer Assistance Centers (TAC). FSA kiosks are self-serve computer terminals connected to the internet that allows taxpayers to help themselves to the IRS tax-related services found on IRS.gov. More than 41,500 taxpayers used this service.
- Posted Volunteer Income Tax Assistance site locations on IRS.gov, which in prior years was only available via the IRS toll-free number. There were almost 168,000 hits to the listing on IRS.gov.
- Extended hours of service in more TAC sites, attracting more than 16,000 taxpayers.

Improve Service to Make Voluntary Compliance Easier

Providing taxpayers top-quality service and helping them understand and meet their tax responsibilities remain top priorities for the IRS. In FY 2011, the IRS met or exceeded 83% (10 of 12) of the Taxpayer Service performance targets.

During FY 2011, the IRS updated forms to help taxpayers comply with filing requirements, converted forms for visually impaired taxpayers, translated more tax products into multiple languages, and reduced telephone wait time. Expanding information on IRS.gov and social media sites provides information in alternative mediums taxpayers are looking for. For the second year, the IRS worked with its banking partners to offer refunds on pre-paid debit cards so taxpayers without bank accounts could receive their refunds quicker.

Highlights of the 2011 Filing Season

The IRS delivered another successful filing season in 2011, rising to challenges posed by tax legislation enacted in late December 2010. The IRS took the necessary steps to minimize disruptions for taxpayers and ensure a smooth filing season. Results of the 2011 filing season included:

- Processing over 144.7 million individual returns and issuing more than 109.3 million refunds totaling $345.0 billion compared to 109.5 million refunds totaling $366 billion for the same period in 2010.
- Achieving a 70.1% telephone level of service, while answering 34.2 million assistor calls.
- Answering 42.3 million automated calls, a 20.5% increase from 2010.
- Responding accurately to 93.4% of tax law questions and 96% of account questions received via the telephone.
- Processing over 2.7 million free file returns.
- Processing 45,499 savings bond requests, an increase of 103.3% from 2010, totaling $11.2 million.

The IRS electronic filing program offers a more efficient and secure way for taxpayers to file more accurate returns and get their refunds quicker. In FY 2011, for the first time, the IRS e-file program processed more than 100 million individual e-filed returns in a single season and passed the one billion mark for individual tax returns processed since the program began in 1986. Encouraged by the record-breaking results in electronic filing, President Obama used the IRS as a model for how federal agencies can successfully provide customer-friendly technology to the public. Filing season results targeting electronic filing included:

- Individual returns electronically filed increased to 76.9% up from 69.3% in 2010, with total returns reaching 111.3 million.
- Home-Computer filing increased to 39.6 million returns, up from 34.6 million in 2010.

Taxpayer Service through Social Media

The IRS expanded and refined the use of social media and technology to meet the needs of taxpayers. By employing social media, the IRS was able to reach taxpayers with important service and compliance messages. Social media outlets used include:

- YouTube, to post informative videos on many tax topics in multiple languages, including American Sign Language. In FY 2011, videos were viewed almost 1.2 million times.
- Twitter, to tweet on the latest news and information for taxpayers in both English and Spanish. Tweets were also produced to provide tax guidance and other information to return preparers and other tax professionals. The IRS had more than 25,000 Twitter followers in FY 2011.
- ITunes, where 17 podcasts were available for a total of 18,226 downloads. Topics covered included:
  - Earned Income Tax Credit.
  - Last Minute Tax Tips.
  - Flexible Spending Arrangements.

In FY 2011, the IRS released the IRS2GO Smartphone application, which lets taxpayers interact with the IRS using their mobile Apple and Google Android devices. This new Smartphone application engages taxpayers where they want and when they want it, allowing them to check the status of their refund and get easy to understand tax tips beyond traditional channels. During the 2011 filing season, IRS2Go averaged 4 out of 5 stars in hundreds of reviews and had more than 360,000 downloads.

- Business returns were filed electronically at a rate of 31.8%, up from 25.5% in 2010.
- Tax professional use of e-file increased 15% from the previous year, reaching 71.7 million returns.

The IRS continued to increase the amount of tax information and services provided to taxpayers through IRS.gov. In FY 2011, the IRS received a Compuware Gomez “Best of the Web” award, which recognized IRS.gov as one of the best websites in government for performance and quality and first in consistency. In FY 2011, taxpayers used IRS.gov to:

- View web pages. Web pages were viewed over 1.6 billion times.
- Check on refunds. More than 77.9 million taxpayers used “Where’s My Refund?” an increase of 16.4% from 2010.
- Get forms and publications. Over 229 million tax products were downloaded, an increase of 7.5% from 2010.
- Link to EFTPS. The Electronic Federal Tax Payment System (EFTPS) processed more than 129.8 million electronic tax payments totaling over $2 trillion.
- Get answers. More than 241,962 taxpayers accessed the Interactive Tax Assistant in order to receive answers to tax law questions.

Taxpayer Education and Outreach

The IRS continues to improve and expand on its outreach and educational services through partnerships with state taxing authorities, volunteer groups, and other organizations. Free tax assistance was provided for the elderly, disabled, and limited English proficient individuals and families at various Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) sites. In FY 2011, more than $18 million in VITA and TCE Grants were awarded to a total of 210 organizations, a 23% increase in the number of organizations from 2010. Assistors at more than 9,000 VITA and TCE Grant sites across the nation prepared more than one million tax returns.

The IRS conducted "Open House” events, both during and after the filing season. At these events taxpayers could get help with preparing current and prior year federal and state tax returns, resolving account and balance due issues, and making Installment Agreement arrangements. Taxpayers took advantage of:

- Two open house events held during the filing season at 96 Taxpayer Assistance Center (TAC) locations. More than 16,300 taxpayers were helped and more than 4,300 returns were prepared.
- One open house event was held after the filing season at 74 TAC locations. More than 4,000 taxpayers participated.

In the struggling economy, more and more individual taxpayers face financial hardship. In FY 2011, the IRS took steps to assist these

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2011

Improving Taxpayer Experience

The IRS continually looks for ways to improve tax products and the services provided to taxpayers to make the return filing process a positive experience. Actions taken in FY 2011 include:

- Launching a Multilingual Gateway to provide a user-friendly website that offers tax information in Chinese, Korean, Vietnamese, and Russian.
- Expanding the preparation of State income tax returns from 27 to 35 states, adding Kentucky, Michigan, Minnesota, Nebraska, New Jersey, Ohio, Pennsylvania, and Virginia.
- Enrolling almost 11,500 new participants in the Health Coverage Tax Credit (HCTC) program, handling 202,000 calls, making over $170 million in payments, and posting over $6 million in reimbursement credits to HCTC participants accounts.
- Implementing the HCTC ePayment Processing System to allow taxpayers to make payments electronically and receive immediate acknowledgement of the payment, eliminating the need to call the Program Office to verify receipt. More than 44,300 payments totaling $12.8 million were received via this web-based, self-service tool.
- Expanding Paper Check Conversion nationwide to all 401 TACs, allowing paper checks to be converted to electronic transactions. The conversion improves the payment process and expedites resolution to taxpayer account issues. In FY 2011, 3.6 million remittances were processed for more than $7.8 billion.
- Partnering with the Bureau of Public Debt and the Department of the Treasury to allow taxpayers to purchase savings bonds for others from their tax refunds and adding an option to receive the balance of their tax refund in the form of a paper check.

individuals by implementing a Fresh Start initiative. Fresh Start helps taxpayers who owe money by providing greater access to installment agreements and easing regulations on lien filing. The changes included:

- Increasing the dollar threshold at which liens are generally issued.
- Making it easier for taxpayers to obtain lien releases after paying a tax bill.
- Withdrawing liens in most cases where a taxpayer enters into a Direct Debit Installment Agreement.
- Creating easier access to Installment Agreements for struggling small businesses.
- Expanding a streamlined Offer in Compromise program to cover more taxpayers.

The Earned Income Tax Credit (EITC) is one of the Federal Government's largest benefit programs, providing help to low-income wage earners. In FY 2011, the IRS once again reached out to taxpayers eligible for this tax credit through its 5th EITC Awareness Day. Efforts included 660 separate outreach activities like news conferences, news releases, newsletters, and e-mails. Through these efforts:

- Nationwide coverage was achieved at national and local events through 16 English and 15 Spanish satellite media tour broadcasts, reaching an audience of 1.8 million.
- Print media conference calls in English and Spanish hit over 2.4 million in circulation.
- Nationwide radio interviews in English and Spanish reached over 1,300 affiliate markets.
- Two EITC Saturdays were held at 170 TACs in order to help taxpayers complete their returns and make payments. As a result, more than 15,000 taxpayers were assisted with over 5,100 returns being prepared.

In FY 2011, the IRS released redesigned notices in multiple languages. In April, the Center for Plain Language awarded the IRS the Grand Prize ClearMark Award for its efforts to produce easy-to-understand taxpayer notices. Notice redesign efforts included:

- Completing design/redesign of 104 notices, representing 72% of the more than 220 million notices sent each year, to provide a clear, simple explanation of the purpose of the notice and what actions the taxpayer must take to resolve the issue.
- Providing corresponding IRS.gov web links for each notice attracting 989,985 visits. The links provide more information on the notice, answer common questions, and provide tips to help taxpayers with tax filings in the future. Higher volume notices were also translated into five languages (Spanish, Chinese, Korean, Vietnamese, and Russian).

Strategic Goal
Enforce the Law to Ensure Everyone Meets Their Obligation to Pay Taxes

OBJECTIVES

- ***Proactively Enforce The Law In a Timely Manner While Respecting Taxpayer Rights And Minimizing Taxpayer Burden***
- ***Expand Enforcement Approaches And Tools***
- ***Meet The Challenges Of International Tax Administration***
- ***Allocate Compliance Resources Using A Data-Driven Approach To Target Existing And Emerging High-Risk Areas***
- ***Continue Focused Oversight Of The Tax-Exempt Sector***
- ***Ensure That All Tax Practitioners, Tax Preparers, And Other Third Parties In The Tax System Adhere To Professional Standards And Follow The Law***

Enforcement Facts

- Increased revenue from enforcement programs by 17%, from FY 2005 to FY 2011, yielding a 4.6 to 1 return on investment based on the $55.2 billion in enforcement revenue with a budget of $12.12 billion.
- Completed 4,697 criminal investigations, an 8.6% increase over FY 2010.
- Closed over three million collection cases.
- Completed 50,139 tax-exempt and government entities compliance contacts.
- The Federal Payment Levy Program (FPLP) collected $614 million in FY 2011, a decrease of 0.6%, and has collected over $3.26 billion since implementation in 2000.

Enforce the Law to Ensure Everyone Meets Their Obligation to Pay Taxes

Just as service is essential to enhance voluntary compliance, so is enforcement. IRS programs like examination and collection ensure that taxpayers pay what they owe and assist those individuals who may have trouble meeting their tax liability because of hardship situations.

Highlights of Enforcement Performance

The IRS met 89% (16 of 18) enforcement performance measures in FY 2011.

The IRS has shown progress in several key enforcement programs including increases in:

- High income audits, 14.5%.
- Small business audits (assets <$10 million), 8.6%.
- Automated Underreporter contact closures, more than 8.5%.
- Collection case closures, 6.7%.
- Tax Exempt and Government Entities compliance contacts, 21%.
- Large corporate audits, 3.4%

The IRS made significant strides in cracking down on international tax evasion, striking a landmark deal with the government of Switzerland, that for the first time, provided information on thousands of Americans hiding assets in Swiss bank accounts. In FY 2011, the IRS continued to work cases resulting from the 2009 Offshore Voluntary Disclosure Program (OVDP) that encouraged taxpayers with hidden offshore assets and income to voluntarily come back into the tax system. There were approximately 15,000 voluntary disclosures from individuals who came in under the OVDP resulting in approximately $2.2 billion in additional tax, interest, and penalties. Since the 2009 Program closed, an additional 3,000 voluntary disclosures from individuals with bank accounts from around the world have been received; prompting the IRS to announce a special Offshore Voluntary Disclosure Initiative (OVDI) in February 2011. The OVDI has an increased penalty framework whereby participating taxpayers must file all original and amended returns and include payment for taxes, interest, and accuracy-related penalties by the September 9, 2011, ending date.

The 2011 OVDI resulted in over 12,000 applications being afforded a penalty structure as outlined in the February announcement, many of which involve significant amounts of previously unpaid tax. However, collecting additional revenue for past offenses is not the only vital consideration, but more importantly is the success in bringing thousands of U.S. taxpayers back into the system so they properly report and pay their taxes on their offshore accounts for years to come.

The IRS continued to implement strategies to address international

International Tax Compliance

As part of the overall strategy to improve offshore compliance, in FY 2011, the IRS realigned its former Large and Mid-size Business Division into the new Large Business and International (LB&I) Division with the intent of strengthening international tax compliance and promoting greater collaboration across the IRS on matters relating to global tax administration.

In addition, the IRS created the Office of International Operations whose mission is to develop and support domestic and international criminal investigations and critical IRS programs through an expanded international workforce and increased sharing of information within IRS and with external bodies, such as other law enforcement entities and foreign nations. With the LB&I realignment and the creation of the Office of International Operations, the IRS has formed a cohesive team dedicated to the highly specialized international arena and to the development of new leads in ongoing criminal tax and financial crimes investigations.

FY 2011 results included the Deutsche Bank being order to pay over $400 million for taking part in fraudulent tax shelters that allowed clients to hide billions of dollars overseas, and the Department of Justice being granted permission to summon HSBC of India and the UBS AG to gain information on U.S. taxpayers using their accounts to evade U.S. tax obligations.

Foreign Bank and Financial Accounts

The Bank Secrecy Act (BSA) and Currency Transaction Reporting (CTR) Operations have implemented a multi-faceted approach to improve the customer experience and service regarding Foreign Bank and Financial Accounts (FBAR) preparation and filing. The IRS created a FBAR hotline which allows international callers the ability to reach a customer service representative to assist with understanding the preparation and filing of FBAR reports. In FY 2011, the IRS also:

- Revised Publication 4261, "Do You Have a Foreign Financial Account?"
- Created a short video publicizing new FBAR regulations posted to the IRS Video Portal.
- Delivered a one-hour live webinar.

issues in the tax-exempt arena as well, including expanding education to internal and external audiences, improving intra-governmental coordination, expanding IRS presence in U.S. territories, and enhancing compliance measures using customer-tailored strategies. In addition, the following actions were completed in FY 2011:

- Issuing guidance on foreign issues and assisting other U.S. territory tax departments.
- Increasing international examination activities, closing over 197 examination returns compared to 75 in FY 2010.
- Collaborating with other government agencies to train immigration agents.
- Continuing participation in the international Charity Regulator Conference with representatives from England, Wales, Ireland, Scotland, and Australia.

The IRS criminal investigation program scrutinizes egregious tax, money laundering, currency violations, terrorist financing, and other financial crimes that adversely affect tax administration. Using its unique statutory jurisdiction and financial expertise, the IRS makes significant contributions to important national law enforcement priorities. Performance in the IRS criminal investigation program remained high in FY 2011, as the IRS:

- Completed 4,697 criminal investigations, an 8.6% increase over 2010.
- Achieved a conviction rate of 92.7%, a 2.5 percentage point increase over 2010.
- Maintained a Department of Justice acceptance rate of 94.5%, with a U.S. Attorney acceptance rate of 89.9%, which compares favorably with other federal law enforcement agencies.
- Obtained 2,350 convictions, exceeding the FY 2011 target.

In FY 2011, the IRS worked with the Department of Justice on a New York bid rigging investigation that resulted in settlements with three banks for a total of $97.3 million. Bidding agents steered public bond monies to predetermined banks for investment and a non-competitive bidding process, which misled the public and caused municipalities to lose millions of dollars.

The IRS Accounts Management Taxpayer Assurance Program (AMTAP) and Questionable Refund Program (QRP), which are designed to identify and stop fraudulent return filings and refunds, continued to show positive results in FY 2011 by:

- Using the Electronic Fraud Detection System to identify almost 1.8 million fraudulent returns and stopped over $14 billion in fraudulent claims (AMTAP).
- Identifying 1,058 QRP schemes consisting of almost one million individual returns.

Compliance Innovations

In FY 2011, the IRS made its six-year old Compliance Assurance Process (CAP) pilot program permanent. CAP allows large corporate taxpayers to resolve tax issues prior to filing a tax return. Since the IRS started CAP, the number of participating corporations has grown each year to the current 140 participants. Participating corporations cite their primary interest in CAP is the opportunity to achieve tax certainty sooner and the focus on current issues. The IRS also announced that the CAP program would expand to include two additional components:

A new pre-CAP program that provides interested taxpayers with a clear roadmap of the steps required for gaining entry into CAP; and a new CAP maintenance program intended for taxpayers who have been in CAP, have fewer complex issues, and have established a track record of working cooperatively.

The IRS also created a Compliance Self-Assessment Tool to assist government entities in reviewing federal tax law and to identify compliance issues. The document gives special attention to social security coverage issues and provides links to sources that contain additional information, as well as how to voluntarily disclose an identified error and solicit a resolution.

Another innovative strategy and tool is the Industry Issue Resolution (IIR) strategy, which addresses frequently disputed or burdensome business tax issues that affect a significant number of taxpayers. By issuing clear guidance, the taxpayer can reduce time and expense associated with resolving issues during tax examinations. This issue-focused compliance strategy improves the ability to identify and address areas of significant noncompliance. In FY 2011, the IRS issued guidance in the form of Regulations, Revenue Procedures, and Industry Director Directives for the following three tax issues:

1. Unit of Property for Network Assets in the Telecommunications Industry, a safe harbor provision.
2. Appropriate Class Life for Wireless Telecommunications Assets.
3. Vendor Markdown under Retail Inventory Method.

- Detecting and preventing almost $7 billion in fraudulent QRP refunds.
- Achieving a 96.7% conviction rate, a 78.3% incarceration rate, and a 91.7% publicity rate on QRP adjudicated cases.

In FY 2011, the IRS kicked-off its Prisoner Compliance program, with an overall mission to increase prisoner tax compliance, reduce erroneous refunds, and increase the effectiveness for the management of prisoner tax returns. The IRS collected and consolidated prisoner information and developed an IT application to assist in identifying prisoners and preventing false claims. The IRS secured agreements with the Federal Bureau of Prisons in 21 states and is in negotiations with corrections officials in the 29 remaining states and the District of Columbia to exchange prisoner tax information to improve the accuracy and completeness of tax returns. During FY 2011, the IRS identified 260,806 fraudulent returns and stopped more than $2.6 billion in fraudulent refund claims by prisoners.

The IRS ushered in a new relationship with corporate taxpayers in FY 2011, with a major focus on creating forums and venues where issues can be resolved faster and provide more certainty. The impetus for this new approach stems from the simple shared belief that at the end of the day, taxpayers and tax authorities want much of the same thing - a balanced tax administration system that provides:

- Certainty regarding a taxpayer's tax obligations sooner rather than later.
- Consistent treatment across taxpayers.
- An efficient use of government and taxpayer resources by focusing on the issues and taxpayers that pose the greatest risk of tax noncompliance.

There are several interlocking pieces that will help advance this transformation. It requires more transparency on both sides, a re-tooling of the audit approach, a commitment to resolving issues quickly, and clarifying uncertainty in the law.

The IRS now has a number of innovative, forward-thinking programs and forums, such as the Industry Issue Resolution program, Compliance Assurance Program, Fast Track Settlement and Uncertain Tax Positions reporting requirements that are focused as a package on the goals of faster issue resolution and greater certainty for those taxpayers who want to be transparent.

Strategic Foundations
Invest For High Performance

OBJECTIVES

- ***Make The IRS The Best Place To Work In Government.***
- ***Build And Deploy Advanced Information Technology Systems, Processes, And Tools To Improve IRS Efficiency And Productivity.***
- ***Use Data And Research Across The Organization To Make Informed Decisions And Allocate Resources.***
- ***Ensure The Privacy And Security Of Data And Safety And Security Of Employees.***

Strategic Foundation Facts

- Delivered more than 200 filing season applications and modernization projects.
- Received nearly 1.5 million Fed-State returns from 28 participating states.
- Refreshed over 9,700 laptops and 12,700 desktops.
- Processed and mitigated emerging threats posed by more than 2,100 cyber incidents.
- Blocked more than 4,200 websites to prohibit malicious or unauthorized software from affecting security.

The IRS energy and environmental programs scored green in all categories on the agency sustainability and energy scorecard. In FY 2011, the IRS exceeded or met the Treasury targets in all categories including:

- Green House Gas Consumption.
- Energy Intensity.
- Renewable Energy.
- Water Consumption.
- Petroleum Use. Reduced the number of vehicles in use as well as invested in alternative fuel vehicles.
- Sustainable Green Buildings.

Strategic Foundations: Invest For High Performance

Business Systems Modernization (BSM)

IRS modernization efforts focus on building and deploying advanced information technology systems, processes, and tools to improve efficiency and productivity. In FY 2011, the IRS achieved 50 percent (1 of 2) of its Business System Modernization targets. The target for the projects within +/-10% Cost Variance was missed as the result of initial cost estimates being too high for one of the releases.

The following highlights the BSM accomplishments in FY 2011:

- Customer Account Data Engine (CADE). Current CADE Release 6.2 successfully deployed in January 2011, providing technical improvements to the infrastructure and availability of the system. CADE also facilitated a mid-season re-start in February to implement Extender legislative changes affecting individual taxpayers. CADE posted more than 40 million tax returns and issued more than 35.1 million refunds totaling in excess of $65.6 billion. CADE also posted 4.4 million payments submitted with taxpayer returns.
- Modernized e-File (MeF) Release 6.2 deployed in January 2011 to deliver Business Master File (BMF) returns. The Individual Master File (IMF) component was also delivered on schedule in January 2011. MeF accepted almost 18.5 million returns in 2011, a 262% increase compared to the same period in calendar year 2010. The growth was due to an increase in electronic 1040 returns, resulting from the IRS, for the first time, not mailing tax form packages to individuals and businesses, and more transmitters and states developing software to meet MeF filing requirements.
- Customer Account Data Engine 2 (CADE 2). The IRS completed logical and physical designs for CADE 2 on time in December 2010 and April 2011, respectively. CADE 2 remains on track to deliver a daily processing capability and single authoritative database for all individual taxpayer records, moving the IRS away from its legacy flat-file data storage model in January 2012.

Physical, Information, and Cyber Security

The IRS collects a tremendous amount of sensitive information and protecting this information is vital to maintaining the public trust. Early detection and prevention activities take place daily to reduce online fraud against the IRS and its taxpayers.

Monitoring, identifying, and mitigating intrusion attempts by fraudulent sites and phishing scams, ensures the IRS protects its systems and taxpayers from increasing and evolving online fraud schemes and helps to reduce the number of taxpayers who fall victim to these schemes. The general public can now report suspicious websites, emails, and phone

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2011

Identify Theft

For the 2011 filing season, the IRS significantly increased the number of returns identified as fraudulent. Identity theft indicators and business rules isolated 324,725 returns for additional screening to validate whether the true taxpayer filed the return, a 297% increase from the prior year. As a result, the IRS prevented over $1.3 billion from being paid out in fraudulent refunds.

Since initiation in 2009, fraudulent returns, as a percentage of total unposted returns, increased from 19% in 2009 to 75% in 2011.

Legitimate returns as a percentage of total unposted returns dropped from 81% (2009) to 40% (2010) to 25% in 2011. The average number of days to manually review a legitimate return has dropped significantly, from 85 days (2009) to 55 days (2010) to 30 days in 2011.

IRS Implementation of the Patient Protection and Affordable Care Act (ACA) of 2010

The Affordable Care Act (ACA) of 2010 represents the largest set of tax law changes in more than 20 years, with more than 40 provisions that amend the tax laws. Although the new law goes into effect gradually over many years, numerous provisions required the IRS to take immediate action. During FY 2011, the IRS:

- Disbursed over $960 million to taxpayers with Qualifying Therapeutic Discovery applications.
- Completed the first filing season for Small Business Health Care Tax Credit, enhanced adoption credit and tanning tax.
- Implemented the first of the ACA industry fees (Branded Prescription Drugs), raising $2.5 billion for Calendar Year 2011.
- Partnered with HHS on outreach, guidance, business processes, and IT deployment relating to the insurance market reforms and insurance exchange system.
- Identified impacted stakeholders and commenced outreach activities on all aspects of implementation including individuals, employers, states, insurers, tax professionals, and other third parties.

numbers they receive to an IRS established public inbox, Phishing@irs.gov for further investigation and action.

During FY2011, the IRS disabled 9,272 fraudulent phishing/malware websites, compared to 3,444 in FY2010, as well as 352 fax numbers and 534 email drop boxes.

The IRS takes the issue of identity theft seriously. In a continuous effort to protect taxpayers' personal information, the IRS successfully used barcodes in notices to taxpayers in 2011 through its Social Security Number Elimination and Reduction 2-D Barcoding Project pilot. Instead of showing taxpayers' entire Social Security Numbers, the notices only showed the last four digits, leaving the rest masked by a barcode. The project piloted 13 non-payment notices on over 11 million pieces of outgoing correspondence.

To help those who have fallen victim to identity theft and combat federal income tax related identity theft, the IRS launched the Identity Protection Personal Identification Number (IPPIN) pilot, revising the 1040 series electronic tax forms to allow for the entry of a six-digit IPPIN beginning with tax year 2010. The purpose of the IPPIN is to avoid delays in processing and filing federal tax returns. In January 2011, the IRS sent letters containing IPPINs to 56,000 taxpayers who had contacted the IRS and been verified as victims.

Stemming from the Austin tragedy in 2010, the IRS has taken a number of steps to ensure the safety of over 100,000 employees and 700 facilities across the nation. In FY 2011, the IRS implemented a 10-point security plan designed to strengthen physical security and incident reporting capabilities. Part of the plan included conducting in-depth security reviews of all facilities, which resulted in the implementation of a number of measures designed to enhance security at those facilities. In addition, the IRS established the Threat Information and Critical Response Initiative (TIRC) to provide more proactive responses to threats to the IRS and a more robust reporting process. Several IRS offices partnered to create a TIRC incident tracking tool. This tool will provide capability for a system of record, real-time business impact analysis and reports, and employee incident notifications.

Human Capital

The IRS continued pursuing its goal of making the IRS the best place to work in government and ensuring that five years from now, the Service has the leadership and workforce ready for the next fifteen years.

The Workforce of Tomorrow group formed in 2009 continued its momentum, hosting several Workforce Summits to identify actions to further improve the IRS workplace. In FY 2011:

- Four field events held with more than 600 employees participating,

Veteran Hiring and Employment

In FY 2011, the IRS continued to support Veterans transitioning into the civilian workforce. Veterans now comprise 22.1% of the total full-time permanent workforce, while hiring of disabled veterans exceeded the FY 2011 goal of 2%.

The IRS participates in several Veterans Employment Programs designed to transform the federal government into the model employer of America's veterans. In FY 2011, the IRS:

- Fully implemented the Warrior Intern Program (WIP). WIP provides returning veterans who are ill, injured, or wounded developmental training for intern positions at the IRS. The program provides four to six months of non-paid on-the-job training, flexible work hours, and mentoring. WIP is designed to help veterans transition back into civilian life by building their confidence and giving them skills they will need to build successful careers.
- Initiated a Non-Paid Work Experience program, which allows veterans to gain knowledge, skills, and abilities necessary to improve their odds of obtaining permanent employment.
- Launched the Military Spouse Program, which facilitates entry of military spouses into the Federal Civil Service. The program is designed to minimize disruption when military families move due to relocations and honors service members who become disabled or die during active duty.

"Best Place to Work in Government"

To achieve the goal of becoming the "Best Place to Work in Government," IRS efforts focused on having engaged employees who are respected and challenged and whose managers support them, help them do their job, and hold them accountable.

Employee engagement scores improved with IRS jumping from 8th out of 14 large agencies in 2008, to 3rd out of 14 in 2010. The improvement is due to higher scores in job satisfaction, satisfaction with the overall organization, and willingness of employees to recommend the IRS as the best place to work.

resulted in more than 2,400 ideas and actions for six focus areas (planning a dynamic people strategy, growing future leaders, enhancing the role of managers, valuing and retaining our people, attracting the best, and streamlined hiring).

- Over 500 more employees shared their thoughts and ideas on the workforce of tomorrow through an online feedback site.

In FY 2011, the IRS fully implemented its Leadership Succession Review (LSR) process, a structured program designed to identify and develop leaders to provide for leadership continuity and effective organizational performance. The LSR was available to all employees who aspire to be leaders and focused on providing learning need assessments.

The IRS also initiated an Issue Practice Group (IPG) pilot project to tap employee technical expertise. The group is comprised of subject matter experts that share knowledge and develop and maintain technical expertise. The IPG project marks the beginning of a robust knowledge management strategy that supports the IRS strategic foundation of investing for high performance.

Attracting, recruiting, and retaining outstanding talent to achieve the optimum mix of employee skill sets and a diverse workforce representative of the taxpaying public was a focus in FY 2011. Recruitment and retention accomplishments included:

- Creating a "Face of the IRS" initiative using IRS employees who represent the workforce diversity at recruiting events to offer personal accounts of their IRS careers in specific occupations.
- Launching a Career Pathways website to support prospective employees. The site includes an experience calculator to assist applicants in determining how they measure up to the basic and specialized experience qualifications.

The IRS received a 2011 ClearMark Award from the Center for Plain Language for its IRS Careers website. In addition, the International Academy of Digital Arts and Sciences selected the IRS as an Official Honoree for the 15th Annual Webby Awards, which signified the outstanding caliber of work in the employment category.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2011

OMB Circular A-123, "Management's Responsibility for Internal Control"

The IRS conducted the required evaluation of the effectiveness of its internal control over financial reporting in accordance with OMB Circular A-123. In FY 2011, the IRS:

- Tested 18 transaction processes material to Treasury's Consolidated Financial Statements which included:
  - Ten administrative processes covering material portions of the $12.6 billion in annual administrative transactions.
  - Five information system processes.
  - Three custodial processes related to over $2.4 trillion in tax revenue.
- Performed supplemental testing of the FY 2011 transactions in the fourth quarter to verify that controls remained effective throughout the year.
- Reviewed controls over financial reporting, including Treasury Information Executive Repository reporting, and determined controls are primarily in place and effective.
- Conducted a self-assessment of the IRS internal control environment using GAO's Abbreviated Internal Control Evaluation Checklist.
- Reviewed IRS compliance with applicable laws and regulatory requirements regarding financial reporting and internal control.

Based on the results of the A-123 evaluation, the IRS provides qualified assurance that its internal control over financial reporting was operating effectively.

The qualified assurance is based on the fact that the IRS has two material weaknesses in internal control over financial reporting currently being addressed in corrective action plans. The IRS developed compensating procedures, which are tested in the A-123 internal controls review program to produce financial statements that are fairly stated and on which GAO issued an unqualified opinion.

Systems Controls and Legal Compliance

The IRS continued to enhance financial management and appropriate controls that are an integral component of all IRS programs.

Federal Managers' Financial Integrity Act (FMFIA)

The IRS provides qualified assurance that the systems of management control objectives, in accordance with the internal control requirements of the Federal Managers' Financial Integrity Act (FMFIA), the Federal Financial Management Improvement Act (FFMIA), the Office of Management and Budget (OMB) Circular A-123, and the Reports Consolidation Act of 2000, were achieved during FY 2011.

The systems of management control for the IRS organizations are designed to ensure that:

- Programs achieve their intended results.
- Resources are used consistent with the overall mission.
- Programs and resources are free from waste, fraud, and mismanagement.
- Laws and regulations are followed.
- Controls are sufficient to minimize improper and erroneous payments.
- Performance information is reliable.
- System security is in substantial compliance with all relevant requirements.
- Continuity of operations planning in critical areas is sufficient to reduce risk to reasonable levels.
- Financial management systems are in compliance with federal financial systems standards, i.e., FMFIA Section 4 and FFMIA.

The qualified assurance is based on the fact that the IRS has two material weaknesses in internal control over financial reporting and the financial management systems do not substantially comply with FFMIA. This assurance is provided relative to FMFIA Sections 2 and 4.

The IRS is monitoring the following two material weaknesses in internal control over financial reporting and the corresponding corrective action plans:

- Unpaid Tax Assessments
- Information Security

Federal Financial Management Improvement Act (FFMIA)

In order to address the Unpaid Tax Assessments Material Weakness, in February 2011, the IRS implemented programming in the Custodial Detail Data Base (CDDB) to improve classification when either the business or related Trust Fund Recovery Penalty individual modules are removed from the Unpaid Assessments inventory, and to reduce the

Federal Information Security Management Act (FISMA)

In accordance with the requirements of the Federal Information Security Management Act (FISMA), the IRS maintained an agency-wide information security program and provided a comprehensive framework for ensuring the effectiveness of information security controls over information resources that support IRS business operations and goals. Specifically, the IRS inventory of FISMA reportable systems is compliant with security requirements from OMB, the National Institute of Standards and Technology, the Department of the Treasury, and the IRS. These systems have compliant annual security control tests, security authorizations, and Plans of Actions and Milestones (POA&M).

Additionally, the IRS met or exceeded all FISMA goals for 2011; this includes timely POA&M closure and Specialized IT Security Training received by employees.

Actions	Status
Certification and Testing of Systems	100%
Systems Accreditation	99%
Specialized training	99%
Annual Awareness Training	99%
Contractor Systems Reviews	100%
Annual Security Controls Testing	100%
Annual IT Contingency Plan Testing	100%
Privacy Impact Assessment	100%
System of Record Notice	100%

In addition to the sustained performance from last year:

The Computer Security Material Weakness (CSMW) Program is an enterprise effort to resolve the weakness. The CSMW Program Office coordinates, manages, and oversees all aspects of the program, including quarterly and annual reporting to oversight. The CSMW Plan was refocused toward risk management and mitigation processes and mapped to the IRS critical business processes. This refocusing ensures that our mitigation activities are prioritized and have the necessary security impact on our business processes.

The IRS has established enterprise repeatable processes, continuous monitoring activities to identify and mitigate risks, a compliance validation and oversight program to perform self-inspections, and executive governance that oversees and manages the progress and application of corrective actions.

amount of adjustments to the financial statements. The programming change improved classification of instances where, according to past practice, multiple tax periods were rolled up into one module.

To address the Information Security material weakness, the IRS commissioned cross-functional working groups with knowledge of the IRS internal systems to evaluate and document the computer security and compensating controls in place to address nine GAO-identified areas considered at risk. The groups also provided evidence and assurance of continuous monitoring and controls for IT systems owned or operated by external entities for risks to IRS financial systems or access to taxpayer or other sensitive information the IRS maintains. As a result of this work, the IRS demonstrated it has controls and processes in place to mitigate the risks for many of the nine areas, and has made significant improvements in the other areas.

Lien Release Non-Compliance Issue

As of September 30, 2011, the IRS did not consistently comply with section 6325 of the Internal Revenue Code regarding the timely release of federal tax liens. The IRS Financial and Management Controls Executive Steering Committee (FMC ESC) continues to monitor the action plan, which addresses lien release issues identified by the IRS, Government Accountability Office (GAO), and the Treasury Inspector General for Tax Administration (TIGTA).

Reports Consolidation Act of 2000

In accordance with the Reports Consolidation Act of 2000, the IRS provides assurance that the IRS Critical Performance Measures are reliable. Internal Revenue Manual 1.5.1, “Managing Statistics in a Balanced Measurement System, The IRS Balanced Performance Measurement System,” provides a detailed template that documents each measure’s definition, formula, reliability, and reporting frequency. These controls ensure the data are consistently and accurately collected over time.

Continuity of Operations (COOP)

The IRS enhanced its disaster recovery program to further ensure the continuity and resiliency of its critical business processing systems, completed an assessment by critical business process of its ability to meet business requirements, and made strategic investments to improve recovery capability. The IRS also developed disaster recovery plans for all of the FISMA master inventory systems, implemented a centralized repository for all business continuity plans, updated all IT contingency plans, and executed over 400 tests and exercises.

Major Management Challenges and High-Risk Areas

GAO and TIGTA identified several Management Challenges and High-

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2011

Overview of Revenue and Administrative Accounts

The IRS FY 2011 financial statements received an unqualified audit opinion for the twelfth consecutive year.

The Balance Sheet reflects total assets of $43 billion of which $35 billion (81.4%) are Federal Taxes Receivable, which represents amounts expected to be collected from past due accounts. The majority of IRS liabilities consist of amounts due to Treasury related to Federal Taxes Receivable.

The Statement of Custodial Activity shows that IRS programs collected $2.4 trillion in federal tax receipts.

Progress Made on Business Systems Modernization (BSM) FMFIA Material Weakness

In FY 2011, the IRS completed the necessary actions to support a downgrade of the FMFIA Material Weakness for Business Systems Modernization (BSM). Actions taken in FY 2011 in support of the downgrade include:

- Received external accreditation for CMMI level 2.
- Delivered 4 of 4 project segments within a 10% schedule threshold.
- Delivered 4 of 4 project segments at or below cost.
- Exited CADE 2 Transition State 1 Milestone 3 (logical design) in December 2010 and Milestone 4a (physical design) in April 2011, on time and without conditions.
- Exited MeF R6.2 Milestone 4b on time for the 2011 Filing Season.
- Implemented current CADE Release 6.2 into production on schedule in January 2011.

The GAO reviewed the IRS progress and agreed they will not oppose a downgrade. The BSM FMFIA Material Weakness was downgraded on April 20, 2011.

Risk Areas facing the IRS. The IRS is addressing these issues through its existing program activities. Measures of these program activities serve to show progress in addressing the management challenges and high-risk areas. The following are the management and performance challenges identified by GAO in its January 2009 High Risk Series Update and by TIGTA in the October 15, 2010, memorandum titled Management and Performance Challenges Facing the Internal Revenue Service for Fiscal Year 2011.

- GAO High Risk Areas for IRS
  - IRS Business Systems Modernization
  - Enforcement of Tax Laws
- TIGTA Management Challenges
  - Security
  - Modernization
  - Tax Compliance Initiatives
  - Implementing Health Care and Other Tax Law Changes
  - Providing Quality Taxpayer Service Operations
  - Human Capital
  - Erroneous and Improper Payments and Credits
  - Globalization
  - Taxpayer Protection and Rights
  - Leveraging Data to Improve Program Effectiveness and Reduce Costs

Limitations of Financial Statements

The principal financial statements have been prepared to report the results of IRS operations, pursuant to the requirements of 31 U.S.C. 3515(b). The statements were prepared from the books and records of the IRS in accordance with generally accepted accounting principles for Federal entities and the format prescribed by OMB. The statements are in addition to the financial reports used to monitor and control budgetary resources, which are prepared from the same books and records. The statements should be read with the realization that the IRS is a component of the U.S. Government, a sovereign entity.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2011

Financing Sources

The IRS receives the majority of its funding through annual and multi-year appropriations, which are available for use within certain specified statutory limits. Besides appropriations, the IRS used other financing sources. These included net transfers from other federal agencies and revenue from user fees for direct services provided to customers (for example, installment agreement fees, photocopy fees, and letter rulings and determinations fees).

Financial Highlights

Revenue and Refund Trend Information

FY 2011 revenue receipts collected by IRS remained constant at $2.4 trillion. Federal tax revenues are collected through six major classifications: individual income and FICA/SECA, corporate income, excise taxes, estate and gift taxes, railroad retirement, and federal unemployment taxes.

FY 2011 tax refund activity totaled $415.9 billion, representing a decrease of approximately 11% from FY 2010. Federal tax refunds include refunds of tax overpayments, payments for interest, and disbursements for refundable tax credits such as Earned Income Tax Credit and the Additional Child Tax Credit.

Excise Tax Trust Fund

The Quarterly Federal Excise Tax Return, Form 720, reports taxpayer liability for excise taxes. Taxpayers make periodic deposits in advance of filing the return. These deposits are classified as Federal Excise Tax. After the IRS receives and processes the returns, the IRS certifies amounts for several trust funds. Amounts reported on the Statement of Custodial Activity are for fiscal year collections (October 1 through September 30). Because Form 720 reporting requirements are completed after receipt of most of the deposits, the certification amounts will not match the amounts collected in the fiscal year. The table below shows revised receipts certified to the Airport and Airway Trust Fund, Black Lung Disability Trust Fund, and the Highway Trust Fund for the eight liability quarters from December 2008 through September 2010. The Department of the Treasury prepares the warrants and allocations to the trust funds.

	Liability Quarter Ended	
	December 2008 – September 2009	December 2009 – September 2010
Airport & Airway Trust Fund	$10,533,488,000	$11,045,715.000
Black Lung Disability Trust Fund	631,138,000	610,068,000
Highway Trust Fund	36,445,773,000	36,911,353,000
Total	**$47,610,399,000**	**$48,567,136,000**

Analysis of Unpaid Assessments – Most Unpaid Assessments Are Not Receivables and Are Largely Uncollectible

The unpaid assessment balance includes amounts owed by taxpayers who file returns without sufficient payment as well as amounts assessed through the IRS enforcement programs. As reflected in the supplemental information to the IRS FY 2011 Financial Statements, the unpaid assessment balance was $356 billion as of September 30, 2011, and $194 billion (54%) of this balance consists of interest and penalties. Furthermore, the total outstanding balance of IRS unpaid assessments is largely uncollectible because it is composed mostly of compliance

16

Integrated Financial System (IFS)

FY 2011 accomplishments include:

- Upgraded the Business Warehouse (BW) for improved performance and reporting capabilities.
- Improved security of IFS by upgrading to Oracle 11g.

assessments and write-offs. Under federal accounting standards, unpaid assessments require taxpayer or court agreement to be considered federal taxes receivable. Assessments not agreed to by taxpayers or the courts are considered compliance assessments and are not considered federal taxes receivable. Assessments considered to have no future collection potential are called write-offs. The following provides detail on unpaid assessments:

- Taxes receivable represent $147 billion (41%) of unpaid assessments and increased $9 billion (7%) from $138 billion as of September 30, 2011. About $112 billion (76%) of this balance is estimated to be uncollectible due primarily because of the economic situations of the taxpayers. Except for bankruptcy situations, the IRS may continue collection actions for 10 years after the assessment. About $35 billion (24%) of taxes receivable is estimated to be collectible.

- Compliance assessments of $103 billion represent amounts that have not been agreed to by either the taxpayer or a court. These assessments result primarily from various IRS enforcement programs promoting voluntary compliance.

- Write-off amounts of $106 billion include amounts owed by defunct corporations with no assets and failed financial institutions. The remaining amounts are owed by taxpayers with extreme economic and/or financial hardships, deceased taxpayers, and taxpayers who are insolvent due to bankruptcy.

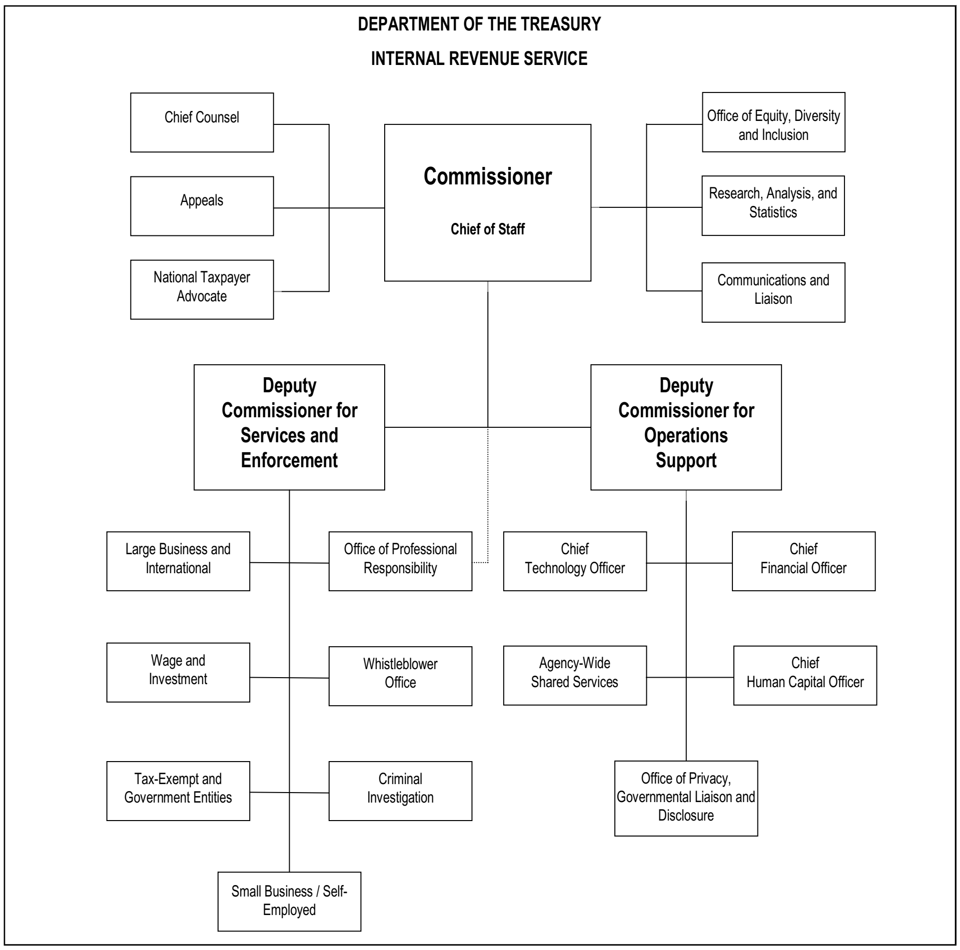
The Integrated Financial System (IFS)

The IFS is the financial management system for the administrative activities in IRS. IFS also provides timely financial statements and reports in accordance with the federal accounting and reporting standards including information for budgeting, analysis, and government-wide reporting.

In addition, IFS provides the core processes of General Ledger, Accounts Payable, Accounts Receivable, Budget Execution, Cost Accounting, Administrative Tax and Travel Accounting, Cost Allocations, some tax processing functionality for Health Coverage Tax Credit (HCTC) payments, Budget Formulation, Labor Forecasting and Budget Execution decision support.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2011

Appendix A
Organization Chart



18

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2011

Appendix B

Performance Measurement Data[1]

Measure	2008	2009	2010	2011 Target	2011 Actual
Goal 1: Improve Service to Make Voluntary Compliance Easier					
Customer Service Representative (CSR) Level of Service	52.8%	70.0%	74.0%	71.0%	70.1%
Customer Contacts Resolved per Staff Year	12,634	12,918	10,744	12,074	12,419
Percent of Eligible Taxpayers Who File for EITC (CY)	*	NA	*	75%-80%	*
Customer Accuracy – Tax Law Phones	91.2%	92.9%	92.7%	92.7%	93.4%
Customer Accuracy – Customer Accounts (Phones)	93.7%	94.9%	95.7%	95.0%	96.0%
Timeliness of Critical Individual Filing Season Tax Products to the Public	92.4%	96.8%	95.3%	94.0%	96.3%
Timeliness of Critical TE/GE and Business Tax Products to the Public	89.5%	95.2%	97.7%	91.0%	96.4%
Percent Individual Returns Processed Electronically	57.6%	65.9%	69.3%	74.0%	76.9%
Cost per Taxpayer Served ($) (HCTC)	$16.94	$13.79	$9.52	$10.00	$12.36
Sign-Up Time (Days) – Customer Engagement (HCTC)	94.0	91.3	124.0	124.0	117.0
Percent Business Returns Processed Electronically	19.4%	22.8%	25.5%	27.0%	31.8%
Refund Timeliness – Individual (Paper)	99.1%	99.2%	96.1%	97.0%	99.4%
Taxpayer Self Assistance Rate	66.8%	69.3%	64.4%	68.7%	70.1%
Goal 2: Enforce the Law to Ensure Everyone Meets Their Obligation to Pay Taxes					
Examination Coverage – Individual	1.0%	1.0%	1.1%	1.1%	1.1%
Field Examination National Quality Review Score	86.0%	85.1%	84.9%	83.7%	85.8%
Office Examination National Quality Review Score	90.0%	92.1%	91.6%	90.4%	90.4%
Examination Quality – Industry	88.0%	88.0%	87.0%	89.0%	90.0%
Examination Quality – Coordinated Industry	97.0%	95.0%	95.0%	96.0%	96.0%
Examination Coverage – Business (Corps. >$10M)	6.1%	5.6%	5.7%	5.3%	6.2%
Examination Efficiency – Individual (1040)	138	138	140	134	139
Automated Underreporter (AUR) Efficiency	1,982	1,905	1,924	1,980	2,007
Automated Underreporter (AUR) Coverage	2.6%	2.6%	3.0%	3.3%	3.3%
Collection Coverage – Units	55.2%	54.2%	50.1%	49.1%	50.0%
Collection Efficiency – Units	1,926	1,845	1,822	1,824	1,952
Field Collection National Quality Review Score	79.0%	80.5%	80.6%	81.0%	80.3%
Automated Collection System (ACS) Accuracy	95.3%	94.3%	95.9%	94.0%	94.9%
Criminal Investigations Completed	4,044	3,848	4,325	3,900	4,697
Number of Convictions	2,144	2,105	2,184	2,135	2,350
Conviction Rate	92.3%	87.2%	90.2%	92.0%	92.7%
Conviction Efficiency Rate ($)	$315,751	$327,328	$324,776	$350,000	$310,029
TE/GE Determination Case Closures	100,050	96,246	105,247	97,151	91,205
Strategic Foundations: Invest for High Performance					
Percent of BSM Projects within +/- 10% Cost Variance	92.0%	60.0%	40.0%	90.0%	71.4%
Percent of BSM Projects within +/- 10% Schedule Variance	92.0%	90.0%	100.0%	90.0%	100.0%

*The methodology for estimating the Percent of Eligible Taxpayers Who File for EITC is being revised and data is not available for FY 2011.

19

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2011

Appendix C
Explanation of Shortfalls

Customer Service Representative Level of Service (CSR LOS): Although demand was 109% higher than planned, Assistor Services Provided was 9.4% over plan and Assistor Calls Answered was almost 8.0%, or 2.5 million calls greater than plan. By August 2011, paper inventories reached over 1.2 million pieces of correspondence. In order to continue to address the high telephone demand and significant paper inventories, resources were realigned to respond to taxpayers' paper inquires. By the end of the fiscal year, the IRS achieved a LOS of 70.1%, within 1% of target, and reduced the paper end of year inventory to 920,768.

Cost per Taxpayer Served: The primary reason for the shortfall was due to a continued decrease in monthly taxpayers served as the American Recovery and Reinvestment Act (ARRA) provisions expired and fewer candidates and participants contacted the program. Higher costs can also be attributed to an increase in costs associated with post-ARRA transition back to a maintenance & operations environment. Staffing adjustments were made in the summer to help curtail cost, but with fewer candidates and a decrease in participates, the target was not achieved.

Field Collection National Quality Review Score: In previous years, attribute 709 - Case File Folder was reviewed in roughly 80% of cases and scored consistently at 90% accuracy. In mid-FY 2010, NQRS began conducting "ICS History Only" reviews which resulted in a rating of "N/A" for attribute 709. Through the end of FY 2011, attribute 709 was only rated in 23% of cases reviewed. Additionally, 13.8% of the cases reviewed this year have been older than the normal Collection Field function case closure time of six to eight months. Plans are underway to improve the sampling and reduce the reliance on ICS History Only reviews resulting in a more complete review process for FY 2012 coupled with further revisions to the attributes.

TE/GE Determination Case Closures: A series of factors continue to contribute to a shortfall in determination closures. In Exempt Organizations (EO), a shift in processing methods continues to result in more time applied than anticipated to the intermediate processing category. In addition, EO has shifted resources to process full development cases, which take longer to process, in order to reduce aging inventory. In Employee Plans, agents have shifted to work more complex Individually Designed Plans and Preapproved Plan receipts.

Percent of BSM Projects within +/- 10% Cost Variance: Five out of seven releases met the cost variance measure. MeF Release 7 Milestone 3 (-24%) came in under expected cost ($3.75 million) as a result of lower than expected hardware and software costs, as well as lower than expected contract expenditures. CADE R6.2 Milestone 4b (-15%) came in under expected cost ($3.33 million) as a result of lower than expected development, test, and integration costs associated with implementing filing season and legislative changes.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2011

Appendix D
Performance Measures Descriptions

Goal 1: Improve Service to Make Voluntary Compliance Easier	
Customer Service Representative (CSR) Level of Service	The number of toll free callers that either speak to a Customer Service Representative or receive automated informational messages divided by the total number of attempted calls.
Customer Contacts Resolved per Staff Year	The number of Customer Contacts resolved in relation to time expended.
Percent of Eligible Taxpayers Who File for EITC	The number of taxpayers who claim the Earned Income Tax Credit (EITC) compared to the number of taxpayers who appear to be eligible for the EITC.
Customer Accuracy – Tax Law Phones	The percentage of correct tax law answers given by a live assistor on Toll-free tax law inquiries.
Customer Accuracy – Customer Accounts (Phones)	The percentage of correct account answers given by a live assistor on Toll-free account inquiries.
Timeliness of Critical Individual Filing Season Tax Products to the Public	The percentage of critical individual filing season tax products (tax forms, schedules, instructions, publications, tax packages, and certain notices required by a large number of filers to prepare a complete and accurate tax return) available to the public in a timely fashion.
Timeliness of Critical TE/GE & Business Tax Products to the Public	The percentage of critical other tax products, paper and electronic, available to the public in a timely fashion.
Percent Individual Returns Processed Electronically	The number of electronically filed individual tax returns divided by the total individual returns filed.
Cost per Taxpayer Served ($) (HCTC)	The costs associated with serving the taxpayers including program kit correspondence, registration, and program participation.
Sign-Up Time (Days) – Customer Engagement (HCTC)	The length of time between the first Program Kit mailing and the first payment received.
Percent Business Returns Processed Electronically	The percentage of electronically filed business tax returns divided by the total business tax returns filed.
Refund Timeliness – Individual (Paper)	The percentage of refunds resulting from processing Individual Master File paper returns issued within 40 days or less.
Taxpayer Self Assistance Rate	The percentage of taxpayer assistance requests resolved using self-assisted automated services.
Goal 2: Enforce the Law to Ensure Everyone Meets Their Obligation to Pay Taxes	
Examination Coverage – Individual (1040)	The sum of all individual 1040 returns closed by SB/SE, W&I, TEGE and LB&I (Field Exam and Correspondence Exam programs) divided by the total Full-Time Equivalent (FTE) expended in relation to those individual returns.
Field Examination National Quality Review Score	The score awarded to a reviewed field examination case by a Quality Reviewer using the National Quality Review System quality attributes.
Office Examination National Quality Review Score	The score awarded to a reviewed office examination case by a Quality Reviewer using the National Quality Review System quality attributes.
Examination Quality – Industry	Average of the scores of Industry Cases reviewed. Case scores are based on the percentage of elements passed within each auditing standard.
Examination Quality – Coordinated Industry	Average of the scores of Coordinated Industry Cases reviewed. Case scores are based on the percentage of elements passed within each auditing standard.
Examination Coverage – Business (Corps. >$10M)	The number of LB&I returns (C and S Corporations with assets over $10 million and all partnerships) examined and closed by LB&I during the current fiscal year divided by the number of filings for the preceding calendar year.
Examination Efficiency – Individual (1040)	The total number of SB/SE, W&I, LB&I and TEGE contact closures (a closure resulting from a case where IRS made contact) divided by the total FTE, including overtime.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2011

Appendix D
Performance Measures Descriptions (Continued)

Goal 2: Enforce the Law to Ensure Everyone Meets Their Obligation to Pay Taxes (Continued)	
Automated Underreporter (AUR) Efficiency	The total number of SB/SE and W&I contact closures (a closure resulting from a case where IRS made contact) divided by the total FTE, including overtime.
Automated Underreporter (AUR) Coverage	The percentage representing the total number of SB/SE and W&I contact closures (a closure resulting from a case where IRS made contact) divided by the total return filings for the prior year.
Collection Coverage – Units	The volume of collection work disposed compared to the volume of collection work available.
Collection Efficiency – Units	The volume of collection work disposed divided by total collection FTE.
Field Collection National Quality Review Score	The score awarded to a reviewed collection case by a Quality Reviewer using the NQRS embedded quality attributes.
Automated Collection System (ACS) Accuracy	The percent of taxpayers who receive the correct answer to their ACS question.
Criminal Investigations Completed	The total number of subject criminal investigations completed during the fiscal year, including those that resulted in prosecution recommendations to the Department of Justice as well as those discontinued due to a lack of prosecution potential.
Number of Convictions	The number of criminal convictions.
Conviction Rate	The percent of adjudicated criminal cases that result in convictions.
Conviction Efficiency Rate ($)	The cost of Criminal Investigation's (CI) program divided by the number of convictions.
TE/GE Determination Case Closures	The number of cases closed in the Employee Plans or Exempt Organizations Determination programs, regardless of type of case or type of closing.
Strategic Foundations: Invest for High Performance	
Percent of Major BSM Projects within +/- 10% Cost Variance	The percentage of Major BSM projects that are within the +/- 10% threshold for cost. The cost variance is measured from the initial cost estimate versus current cost estimate.
Percent of Major BSM Projects within +/- 10% Schedule Variance	The percentage of Major BSM projects that are within the +/- 10% threshold for schedule. The schedule variance is measured from the initial schedule estimate versus current schedule estimate.

22

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2011

Appendix E
Major Management Challenges and High-Risk Areas With Future Challenges

Over the last several years GAO, TIGTA, and the OIG for Treasury have identified several Management Challenges and High-Risk Areas facing the IRS. The IRS has identified specific steps and actions to address these issues through its existing program activities. Measures of these program activities serve to show progress in addressing the management challenges and high-risk areas. The following summarizes each Management Challenge and High-Risk Issue, FY 2011 accomplishments, actions identified for completion in FY 2012 and beyond, and future challenges. These have been arranged in the order of priority as determined by the TIGTA.

Challenge / Issue	Actions Taken in FY 2011 and Actions Planned or Underway
Security of the Internal Revenue Service	
Strengthening the security infrastructure and the applications that guard sensitive data.	**Actions Taken:** • Improved processing of taxpayer accounts impacted by identity theft by deploying additional account “markers” used to (1) distinguish legitimate returns from fraudulent returns, (2) track taxpayers with identity theft-related tax problems and issues encountered by identity theft victims, and (3) prevent victims from facing the same problems every year. • Increased the number of returns identified as fraudulent. Identity theft indicators and business rules isolated 324,725 returns for additional screening to validate whether the true taxpayer filed the return, a 297% increase from the prior year. As a result, the IRS prevented over $1.3 billion from being paid out in fraudulent refunds. • Launched an Identity Protection Personal Identification Number (IPPIN) pilot to ensure that taxpayers who were subject to identity theft in the past do not encounter delays in processing their tax returns, sending IPPINs to approximately 56,000 taxpayers for use during the FY 2011 filing season. • Enhanced compliance monitoring and security controls by completing the Information Technology Security Compliance Monitoring project. • Generated more than 500 advisories, bulletins, and alerts informing the responsible business units and system administrators of current vulnerabilities and threats that could have impacted the IRS enterprise on a large scale. • Disabled over 10,000 fraudulent IRS-related scams using the IRS name or likeness to entice victims, including 9,272 phishing/malware websites (with a median takedown time of 67 minutes), 352 fax numbers, and 534 email drop boxes. • Completed a Disaster Recovery Site in Martinsburg, WV for CI that will provide recovery of the IT infrastructure, network, hardware, systems, applications, and operating systems. **Actions Planned or Underway for FY 2012 and Beyond:** • Use the results of the FY 2011 IPPIN pilot to improve and expand the IPPIN to additional taxpayers. • Schedule virtual hardware setup, configuration, and Storage Area Network (SAN) storage for the CI Disaster Recovery environment. • Deploy the enterprise Authorization (e-Auth) project to provide a framework to register individual identities and validate credentials for electronic access to IRS systems and applications.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2011

Modernization of the Internal Revenue Service (Computerized Systems and Business Structure) and IRS Business Systems	
Bring the IRS's business systems and financial systems to a level that provides management current and reliable information to support informed decision making. GAO, in its 2011 High Risk Series update, continues to list the IRS Business Systems Modernization as a high risk area.	**Actions Taken:** • Delivered Modernized e-File (MeF) Release 6.2, the second phase of the U.S. Individual Income Tax Return (Form 1040) implementation, which ensured electronic tax returns were timely and accurately processed. MeF accepted nearly 18.5 million returns, a 262% increase compared to FY 2010. • Deployed current Customer Account Data Engine (CADE) Release 6.2 to deliver the 2011 filing season tax law changes affecting individual taxpayers, and to provide technical improvements to the infrastructure and availability of the current system. o Posted more than 40 million tax returns and issued more than 35.1 million refunds totaling in excess of $65.6 billion. o Processed refunds, on average, five days faster than the IMF/legacy master files. • Implemented a Remittance Strategy for Paper Check Conversion (RS-PCC) system allowing paper checks to be converted into electronic transactions, processing nearly 3.6 million checks, totaling $7.8 billion. • Implemented an automated transcript process allowing taxpayers to request mailing of account and return transcripts through IRS.gov eliminating the need to contact IRS. The application processed 755,831 transcripts. • Deployed a decision support tool that provided a centralized repository for all critical Business Continuity and Disaster Recovery plans. • Completed Logical and Physical Design of CADE2 Transition State 1. **Actions Planned or Underway for FY 2012 and Beyond:** • Deploy Transition State 1 of CADE2 for Filing Season 2012, which supports daily versus weekly processing and relational account database. • Begin development of a strategy to consolidate all Treasury Bureaus' IT systems at IRS data centers as part of the Data Center Consolidation Initiative 2012 plan. • Commence the "Send A Transcript" proof of concept, which allows taxpayers to make online requests to send official transcripts to banks and other financial institutions without the need to call or complete a paper form (Form 4506).

Tax Compliance Initiatives	
Administer programs to deal with tax gap issues, especially those resulting from corporate and high-income individual taxpayers, as well as domestic and offshore tax and financial criminal activity. Address the evolving challenge of unpaid taxes and continuing Earned Income Tax Credit (EITC) non-compliance.	**Individuals and Businesses** **Actions Taken:** • Updated Adoption Credit policies and developed training material. Selected almost 70,000 cases with adoption credit issues for examination. • Completed a case selection model to use closed examination post-refund data to determine the best First-Time Home Buyer Credit cases for examination. • Completed testing an enhanced Automated Underreporter (AUR) case identification and selection analytics tool to be used in selection of TY 2010 returns. • Continued testing soft notices as alternatives to conducting examinations, issuing 27,000 AUR soft notices in FY 2011. Results showed a 46% response rate with approximately 30% of the taxpayers filing an amended return. • Grouped actions of the Return Preparer Initiative (RPI) into two phases. Implemented Phase 1 of the RPI, which made it mandatory that beginning January 1, 2011, paid return preparers register with the IRS and use a Preparer Tax

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2011

	Identification Number (PTIN) to sign returns, with over 735,000 already registered. • Built a Return Review Program and established a task workforce to enable expansion of IRS revenue protection and scheme detection capabilities, improving fraud detection at the time of filing, before the refund is released. • Continued the matching program for Forms 1042, 1042-S, 8804, and 8805. Created a database of Form 1042-S data reported by U.S. businesses and third-party payers to match payments and verify the validity of refunds before they are issued. • Closed several athlete and entertainer return examinations received as a result of the Offshore Voluntary Disclosure Program, with millions of dollars of additional tax assessed. • Identified high-risk tax return preparers using the new risk-based scoring resulting in more than 10,000 letters being issued and more than 5,000 preparers being visited for noncompliance with multiple areas of concern, including Earned Income Tax Credit (EITC), e-file, and certified acceptance agents. • Conducted 101 Limited English Proficiency (LEP) Leveraged Small Business Tax Workshops (LSBTW) to improve compliance; 88 in Spanish, five Chinese dialects, one Hindi/Nepalese, and seven other LEP proficiency LSBTWs. • Continued testing the effects of education, compliance notices, and telephone contacts on the accuracy of returns prepared for EITC first-time and low-risk paid preparers. • Expanded participation in the Compliance Assurance Process (CAP) to improve the identification and resolution of tax issues prior to the filing of tax returns for large corporations. In FY 2011, the number of participants increased from 112 to 140 and included two additional components: ○ A pre-acceptance phase (Pre-CAP), which provides interested taxpayers an opportunity to work with the IRS towards becoming eligible for the CAP. ○ A CAP maintenance phase that is intended for taxpayers who have been in the CAP program for several years and have established a track record of working cooperatively with the IRS. • Continued the selection and examination of locally hired employees of foreign embassies who did not elect to participate in settlement initiatives. For FY 2011, 1,965 returns have been examined and closed with over $23.4 million in additional tax assessed. • Conducted six electronic town hall meetings that included discussing and answering questions regarding the Quality Examination Process (QEP) initiative that is designed to strengthen communication with taxpayers and improve the consistency of examination practices by better engaging taxpayers in the audit process. • Launched multiple compliance analytics pilot projects to explore new methods of using data and analytics to improve compliance programs. **Actions Planned or Underway for FY 2012 and Beyond:** • Continue to modify Examination case selection and modeling to include cases where taxpayers claimed the First-Time Home Buyer Credit. • Continue testing soft notices as alternatives to conducting examinations in AUR case selections. • Continue to refine case selection filters to identify high-risk taxpayers within the global high-wealth population and further refine the definition of high-wealth taxpayers. • Continue to explore ways to translate the Small Business Tax Workshop material into different languages identified as underserved to improve compliance. • Update the Virtual Small Business Tax Workshops (VSBTW) content to include

new tax law information and to finalize the VSBTW International lesson.
- Emphasize to employees the importance of using the Quality Examination Process for better communication with taxpayers and greater taxpayer involvement throughout the examination process.
- Complete the transition of making the CAP a permanent element of the IRS compliance strategy by launching Pre-CAP in TY 2011 followed by the launch of the Compliance Maintenance Phase.
- Continue the selection and examination of locally-hired employees of foreign embassies who did not elect to participate in settlement initiatives.
- Implement a cross-functional compliance and outreach strategy to address prisoner tax noncompliance.
- Implement Phase 2 of the Return Preparer Initiative requiring paid return preparers, except attorneys, certified public accountants, and enrolled agents, to pass a competency test and complete continuing professional education of 15 hours per year.

Tax-Exempt and Government Entities

Actions Taken:

- Completed over 46% of examinations of college and university unrelated business income and compensation issues identified by the Colleges and Universities project that focused on unrelated business income and executive compensation.
- Initiated a 401(k) project questionnaire on 1,200 plan sponsors and opened examinations on 54 nonresponders.
- Conducted compliance reviews of 144 of the largest private foundations and began examinations of 17 very large private foundations.
- Continued to participate in fraud and conspiracy investigations conducted by the Department of Justice on municipal bond contracts which resulted in three closing agreements, nine guilty pleas, and indictments of ten former financial services executives.
- Addressed fraud and potential promoters of abusive transactions involving retirement plans, including identifying potential promotions evidenced in Form 8886 disclosures and developing a corporate strategy to improve promoter investigation referral processing.
- Completed the statutorily-required revocation of approximately 386,000 organizations whose tax exempt status was revoked based on rules established by the Pension Protection Act of 2006.
- Developed a Fraud Report to identify fraud schemes and monitor operational effectiveness of fraud detection and mitigation methodologies.
- Completed over 2,500 examinations for the National Research Program study of employment tax compliance.
- Developed and approved recommendations to improve the staggered determination letter process for employee plans.

Actions Planned or Underway for FY 2012 and Beyond:

- Continue to identify and address emerging international compliance issues, including internationally sponsored pension plans, the movement of in-kind charitable gifts offshore, and cross-border commerce using Indian reservations and casinos.
- Complete examinations of college and university unrelated business income and compensation issues and prepare a final report.
- Continue regular updates to the public listing of exempt organizations that are

	revoked based on the Pension Protection Act of 2006. • Continue to identify and effectively address abusive promoter transactions by publishing new IRM information on promoter investigations to finalize the process for reviewing potential leads. • Improve compliance by identifying the needs of small exempt organizations and by performing post reviews of Form 990-N filers ineligible to file the e-postcard. • Continue to assist the Department of Justice in developing criminal cases and in preparing prosecutions on abusive tax-exempt bond transactions. • Identify non-compliant exempt organizations based upon data from the redesigned Form 990. • Finalize the 401(k) project report and continue work on examinations of the questionnaire nonresponders. • Continue to investigate potential promoters of abusive transactions involving retirement plans. • Implement recommendations to improve the staggered determination letter process for employee plans, with anticipated completion in FY 2013.

Implementing Health Care and Other Tax Law Changes	

Implementing tax law changes correctly is critical for an effective filing season. Many programs, activities and resources must be planned and managed effectively for successful implementation.	**Actions Taken:**
	
	• Delivered a successful 2011 filing season, processing 144.7 million individual returns and issuing 109.3 million refunds totaling $345.0 billion.
	• Continued to identify erroneous and fraudulent claims and schemes on returns claiming new tax law credits.
	  ○ Implemented procedures to process the first year of the required 15-year repayment for 2008 homebuyers who claimed the First-Time Home Buyer Credit, including the math error authority when the repayment was not identified on the return.
	  ○ Promoted accurate self-reporting in anticipation of the filing season by sending approximately 1.5 million reminder notices to taxpayers.
	• Implemented early provisions of the Affordable Care Act (ACA) including the revision of approximately 60 tax products and the creation of three new tax forms and release of applicable guidance related to:
	  ○ Small employer tax credit.
	  ○ Excise tax on indoor tanning services.
	  ○ Adoption Credit.
	  ○ Branded Pharmaceutical Fee.
	  ○ Qualified Therapeutic discovery credit.
	  ○ New charitable hospital requirements.
	• Disbursed over $960 million to taxpayers with Qualifying Therapeutic Discovery applications.
	• Completed the first filing season for Small Business Health Care Tax Credit, enhanced adoption credit and tanning tax.
	• Implemented the first of the ACA industry fees (Branded Prescription Drugs), raising $2.5 billion for Calendar Year 2011.
	• Partnered with the Department of Health and Human Services (HHS) on outreach, guidance, business processes, and IT deployment relating to the insurance market reforms and insurance exchange system.
	• Identified impacted stakeholders and commenced outreach activities on all aspects of implementation, including individuals, employers, states, insurers, tax professionals, and other third parties.
	• Implemented a strategy with outreach, education, and compliance components to

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2011

	administer the newly refundable Adoption Credit for TY 2010. • Published new Internal Revenue Manual (IRM) provisions to clarify the processes for handling rebate refund cases for tax-exempt bonds. • Implemented new Build America Bonds and other direct-pay bonds voluntary compliance procedures to resolve tax law violations. **Actions Planned or Underway for FY 2012 and Beyond:** • Continue to identify erroneous and fraudulent claims and schemes on returns claiming new tax credits. • Support the Return Preparer Strategy by working with professional tax preparer affiliations to implement new EITC due diligence guidance and requirements to reduce EITC errors and increasing the quality and accuracy of EITC returns. • Implement new Merchant Card and Security Cost Basis reporting legislation in FY 2012. • Continue implementing ACA related form changes, guidance, notices, and compliance monitoring. • Continue work on the ACA provisions with early effective dates, such as the Small Business Health Care Tax Credit, Branded Prescription Drug Fee, and tax-exempt hospital requirements. • Partner with HHS on ACA outreach, guidance, business processes, and IT deployment relating to the insurance market reforms and insurance exchange system. Coordinate issues such as data infrastructure, eligibility, enrollment, customer service, communications, and payment of premium tax credits. • Identify impacted ACA stakeholders and commence outreach activities on all aspects of implementation, including individuals, employers, states, insurers, tax professionals, and other third parties. • Prepare implementation of other ACA mid-horizon provisions such as: o Patient-Centered Outcomes Research Trust Fund (6301). o Medical Device Manufacturer Excise Tax (1405). o Hospital Insurance Tax on High Income Taxpayers (9015). o Net Investment Income Tax (1402). o Expenses Allocable to Medicare Part D (9012). o Itemized Deduction for Medical Expenses (9013). o Imposition of Annual Fee on Health Insurance Providers (9010). o Executive Remuneration Paid by Certain Health Insurance Providers (9014).

Providing Quality Taxpayer Service Operations	
Providing top quality service to every taxpayer in every transaction is an integral part of the IRS strategic and modernization plans.	**Actions Taken:** • Completed a new toll-free number for taxpayer transcript requests and a new web application that allows taxpayers to order transcripts on IRS.gov, resulting in a 708% increase in transcript completions compared to FY 2010. • Released the IRS2Go Smartphone application which lets taxpayers interact with the IRS using their mobile devices. IRS2Go averaged 4 out of 5 stars in hundreds of reviews and had more than 360,000 downloads. • Increased the number of Limited English Proficiency (LEP) products, translating key notices into the top five LEP languages and delivering an enhanced multilingual web site that offers an array of tax information. • Broadened awareness of accessible tax products that serve and support hearing and visually impaired taxpayers, through partnership with the Library of Congress

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2011

	and National Library Service for the Blind and Physically Handicapped. • Continued to provide extended service hours and alternative service delivery methods to expand service to taxpayers. o Delivered 100 Facilitated Self-Assistance kiosks at 37 Taxpayer Assistance Centers. 41,500 taxpayers used the kiosks. o Increased the number of locations providing extended hours of service from 16 locations in 2010 to 36 locations in 2011. o Posted the location of Volunteer Income Tax Assistance (VITA) and non-AARP sites to IRS.gov, an alternative to using the toll-free number to obtain information. o Hosted three successful Open House events both during and after the filing season, including one event that focused on financially struggling taxpayers who needed a "Fresh Start." • Engaged partners and provided greater access to available services through Saturday service events and other special service days like EITC awareness days. o National and local partners hosted 940 news conferences and news releases highlighting EITC Awareness Day. • Participated in 22 outreach events to educate partners and the public about the tax treatment of the 2010 Gulf Oil Spill payments. In the Gulf region, over 169,000 individuals and businesses received emergency advance payments for lost income or profits in 2010. • Continued implementation of Taxpayer Assistance Blueprint (TAB) service improvements, including: o Modified the IRS.gov home page layout to improve visitors' experiences. o Established a separate phone line containing informational messages on the major provisions of the ACA. o Expanded traditional TAC services to 31 volunteer locations. • Implemented new quality initiatives at TACs and volunteer return preparation sites using sampling reviews of selected returns to determine the accuracy of returns prepared. • Gathered feedback from professional organizations that represent external stakeholders (i.e. Accountants, Reporting Agents, etc.) to simplify forms and the tax filing process. **Actions Planned or Underway for FY 2012 and Beyond:** • Implement the changes necessary to support the roll-out of Customer Accounts Data Engine 2 (CADE 2). • Continue to engage IRS partners to disseminate information and simplify forms and the tax filling process. • Release an updated version of IRS2Go with improved functionality. • Increase the number of Limited English Proficiency (LEP) products. • Continue to engage partners in support of special service days and outreach efforts with advocacy groups that serve and support the visually and hearing impaired.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2011

Human Capital	

The IRS's ability to meet expectations in personnel management area, such as recruiting, training, and retaining employees.	**Actions Taken:**
	• Implemented the Criminal Investigation (CI) pilot of the Accelerated Leadership Program to test a "fast track" training program for identified high potential candidates.
	• Continued efforts to finalize a strategy for the IRS to become the Best Place to Work in Government, including holding several 2011 Workforce of Tomorrow Summits.
	• Implemented the Hiring Reform initiative.
	  ○ Transitioned from a "reinvestigation" background investigation program to a "one-stop shop" with streamlined and efficient services that significantly reduced the time required for background investigations by 30 days.
	• Improved technology and communication tools to enhance recruitment and deliver a more diverse applicant pool.
	  ○ A "Face of the IRS" (FOTI) initiative was created that provides opportunities for IRS employees to provide potential candidates with realistic job perspectives at recruiting events.
	  ○ Increased awareness of IRS recruiting practices and job openings by using social media tools and participating in social networks such as the GovLoop Recruitment 411 blog, Facebook, Twitter, and LinkedIn.
	  ○ Deployed the IRS Second Life Careers Island of conference centers, with video and slide show displays for use by IRS stakeholders and a Career Explorer Fit Check Tool, allowing one to determine one's "fit" for IRS occupations based on an analysis of experience and skill sets.
	• Continued an emphasis on veteran hiring, with veterans comprising 7% of total hires in FY 2011.
	• Implemented the Warrior Intern Program (WIP), previously piloted in FY 2010, and the Non-Paid Work Experience (NPWE) program, conducted in partnership with the Department of Defense and Veteran Affairs, to provide qualified veterans with quantifiable work experience at the IRS through non-paid internship opportunities.
	• Continued improvements to the Leadership Succession Review process, focusing on providing learning needs assessments, including implementing a new Leadership Competency Model, with four core competencies and 13 supporting behaviors.
	• Established a Telework Program Office and expanded telework opportunities to over 36,000 employees to further enhance recruitment, development, and retention of employees.
	
	Actions Planned or Underway for FY 2012 and Beyond:
	• Continue to improve processes and leverage systems to streamline hiring.
	• Continue the use of cutting edge technologies and communication tools to increase the breadth of recruitment to better deliver a diverse applicant pool.
	• Explore new technologies to conduct pre-screening of applicants and rapidly bring critical hires on board.
	• Educate internal and external IRS stakeholders on recruitment by providing the Careers Pathway website tool to assist applicants and career development outreach to enhance internal recruitment efforts.
	• Build a diverse talent management pipeline by deploying low cost recruitment strategies.
	• Develop and document an IRS-wide approach to ensure effective monitoring on the adequacy of the acquisition workforce.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2011

Erroneous and Improper Payments and Credits	

Reduce improper payments that include base compliance activities and redesign efforts.	**Actions Taken:**
	• Protected over \$3.7 billion in revenue through EITC enforcement efforts, including the examination of almost 484,000 original and amended returns claiming EITC, almost 1.2 million document matching reviews, and 300,000 math error process corrections.
	• Used the Electronic Fraud Detection System to identify almost 1.8 million fraudulent returns and stopped over \$14 billion in fraudulent claims.
	• Increased EITC paid preparer due diligence visits; resulting in a 100% increase in the number of preparers penalized over FY 2010 and proposed penalties of more than \$10.6 million.
	• Improved the accuracy of EITC returns by refining EITC paid preparer treatment activities, including doubling the number of due diligence audits, increasing visits by revenue and criminal investigation agents by 50%, and increasing educational and compliance notices to first-time and experienced preparers by 25%, to influence the accuracy of EITC returns filed.
	  o Completed four expedited injunctions, stopping preparers from filing future erroneous claims and preventing over \$60 million in erroneous payments.
	  o Penalized over 90% of preparers audited, proposing \$10.6 million in penalties.
	• Increased marketing and outreach efforts for the 5th EITC Awareness Day to increase overall participation, targeting the underserved and distressed taxpayers affected by the economic downturn. Provided Public Service Announcement campaigns in English and Spanish, utilizing TV, radio, and print ads with almost 43,000 airings/insertions.
	• Used social media, including Twitter, Facebook, and My Space, to reach over 57,000 people.
	  o Generated more than 600 activities in support of EITC Awareness Day, including news conferences and releases, email blasts, and newsletters.
	  o Provided assistance at local IRS offices to over 15,000 taxpayers during two EITC Saturdays during the filing season.
	  o Increased EITC dollars distributed by 1.4% over the same period in 2010.
	• Completed activities for year six of the EITC Return Preparer Study, including:
	  o Analyzed short-term outcomes, including penalties assessed and collected, and return accuracy.
	  o Conducted the annual lessons learned case review and identified program improvements for FY 2012.
	• Identified outreach and education opportunities for known patterns of noncompliance using AUR data.
	• Initiated a test on Additional Child Tax Credit (ACTC) returns with dependent issues not selected for examination to assist in developing the ACTC compliance strategy moving forward.
	• Required documentation to accompany returns claiming the Adoption Credit to reduce fraud, and developed new cross-functional procedures to minimize delays in return processing.
	
	Actions Planned or Underway for FY 2012 and Beyond:
	• Hold a sixth annual EITC Awareness Day to increase eligible taxpayers' awareness, stakeholder partnerships, and media coverage.
	• Implement the requirement that EITC paid preparers attach Form 8867, *Paid Preparer's Earned Income Credit Checklist*, to their clients' returns to encourage preparer compliance with EITC due diligence requirements.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2011

	• Continue to focus on EITC paid preparer treatments, including due diligence audits, visits by agents, streamlined injunctions, and educational and compliance notices to first-time and experienced preparers to influence the accuracy of EITC returns filed. ○ Analyze short-term outcomes, including penalties and the accuracy of returns. • Assess the 2011 EITC marketing/awareness campaigns that target EITC eligible and noncompliant populations to refine/focus efforts to increase overall participation and improve compliance. • Pilot a streamlined statutory notice process to cover more credits and under-tolerance refunds by providing the IRS with upstream and downstream cost data, revenue protection data, and data on taxpayer treatment. • Identify opportunities to increase upfront detection of fraudulent refunds and identify related treatment streams. • Expand capabilities to accept the return of erroneous refunds from banks and other financial institutions. • Utilize AUR data to improve Identity Theft procedures and to inform taxpayers, practitioners, AUR employees, and IRS stakeholders of the issues related to identity theft.

Globalization	

International tax compliance is a key challenge as reflected by IRS's recent enforcement initiatives, as well as its prominence in the IRS Strategic Plan. The IRS has placed unprecedented focus on detecting and bringing to justice those taxpayers who hide assets overseas to avoid paying tax.	**Actions Taken:**
	
	• Completed realignment of the IRS international operations by integrating international expertise into the new Large Business and International organization.
	• Improved income estimation calculations for examination.
	• Conducted examinations of taxpayers who applied under the Offshore Voluntary Disclosure Program.
	  ○ Initiated the FY 2011 Offshore Voluntary Disclosure Initiative (OVDI), a continuation (second phase) of the FY 2009 OVDP.
	  ○ Conducted examinations of noncompliant taxpayers identified in conjunction with the John Doe bank summons process.
	• Continued to combat international illicit money networks and professional money launderers via the Global Illicit Financial Team by further developing policies, targeting criteria, and case development procedures.
	• Reviewed OVDP applications and interviewed taxpayers who identified financial institutions that engaged in activities in the U.S. that facilitated taxpayers' non-compliance.
	• Coordinated joint audits and strengthened relations with foreign tax administrations, including seeking additional opportunities to improve and expand the Joint Audit initiative with foreign tax administrations and taxpayers.
	• Continued to ensure that residents of Puerto Rico properly pay U.S. Self-Employment Tax on their earnings.
	  ○ For tax year 2009 (worked in FY11), issued 25,634 soft letters requesting a total of $11 million of additional tax.
	  ○ Also examined 12,880 non-filers for tax year 2009, resulting in additional taxes of $25.6 million.
	• Addressed emerging tax-exempt compliance issues including internationally sponsored pension plans, the movement of in-kind charitable gifts offshore, cross-border commerce using Indian reservations, and foreign bank account reporting for charities.
	• Produced three tailored webinars for stakeholders on payments to foreign persons by government entities, international activities of charitable organizations, and

	international issues that impact employee plans.
	• Responded to tax treaty exchange requests from India and Australia on tax-exempt issues received through the Joint International Tax Shelter Information Centre.
	• Shared global issues impacting retirement plans with the Department of Labor, the Pension Benefit Guaranty Corporation, U.S. territories, and foreign governments.
	• Identified and investigated several large international financial crime cases generally perpetrated by organized crime syndicates.
	
	Actions Planned or Underway for FY 2012 and Beyond:
	
	• Continue examinations of taxpayers who applied under the Offshore Voluntary Disclosure Initiative.
	• Continue developing cases for examination on high-income foreign athletes and entertainers who have been identified as non-filers.
	• Continue to enhance relationships with treaty partners and international organizations to improve international compliance.
	• Continue to identify and address emerging tax-exempt compliance issues, including internationally sponsored pension plans, the movement of in-kind charitable gifts offshore, and cross-border commerce using Indian reservations and casinos.
	  o Ensure that charities adhere to requirements for foreign bank accounts.
	  o Expand coordination of employment tax compliance with foreign countries.
	• Continue to combat international illicit money networks and professional money launderers via the Global Illicit Financial Team by further developing policies, targeting criteria, and case development procedures.

Taxpayer Protection and Rights	

The IRS has made significant progress in complying with the Internal Revenue Service Restructuring and Reform Act of 1998, and most provisions pertaining to taxpayer protection and rights have been implemented. Significant management attention is still required to ensure that remaining issues have been addressed.	**Actions Taken:**
	
	• Implemented Phase 1 of the Return Preparer Initiative which required paid return preparers to register with the IRS and use a Preparer Tax Identification Number (PTIN) to sign returns. In the first year, 735,000 have already registered.
	• Identified high risk tax return preparers using new risk-based scoring, resulting in more than 10,000 potential noncompliance letters being issued and more than 5,000 preparers visited to address multiple areas of concern including EITC filings, e-file, and questionable certified acceptance agents.
	• Engaged in compliance, enforcement, and outreach efforts as part of the Return Preparer Implementation Project, with specific emphasis on the impact of the new registration requirements on Foreign Preparers.
	• Produced 104 redesigned/new notices, including the Taxpayer Delinquent Account collection notices, containing new language to help taxpayers more clearly understand the collection process and available payment options.
	• Continued efforts to remove or redact Social Security Numbers from outgoing taxpayer correspondence.
	  o Initiated a pilot project to replace the printed SSN on taxpayer notices with a two-dimensional barcode. The project will pilot on 13 non-payment notices, masking taxpayer SSNs on over 11 million pieces of outgoing correspondence, leaving only the last four digits of the SSN visible.
	  o Developed a strategy to mask the SSN with the 2-D Barcode on payment notices and developing a process to read 2-D Barcodes and extract information for payment processing.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2011

	• Continued to reinforce culture of taxpayer protection and nights through leadership messages at all levels of the organization. **Actions Planned or Underway for FY 2012 and Beyond:** • Improve IRS assistance services to taxpayers who are victims of identity theft outside the tax system, but who encounter IRS issues because of that theft. • Continue to engage in compliance, enforcement, and outreach efforts as part of the Return Preparer Implementation Project, with a specific emphasis on the impact of the new registration requirements on Foreign Preparers. • Continue efforts to remove or redact Social Security Numbers from outgoing correspondence, including masking the SSN with the 2-D Barcode on payment notices and developing a process to read 2-D Barcodes and extract information for payment processing. • Continue to redesign notices and produce new notices containing language that clearly explains the collection process and available payment options.

Leveraging Data to Improve Program Effectiveness and Reduce Costs	
The absence of accurate and complete management information hinders the IRS's ability to produce timely, accurate and useful information needed for day-to-day decisions.	**Actions Taken:** • Started an initiative to develop standard operating procedures that will address the need for storage, the length of storage, and the future use of stored property. • Updated procedures used by the business units to calculate their unemployment trust fund (UTF) administrative expenses, required audit files are maintained for a minimum of 3 years; and instituted periodic Chief Financial Officer (CFO) reviews of the business units UTF expense submissions and supporting documentation. • Continued using the managerial cost accounting system to conduct cost-benefit analyses that provides timely, accurate, and useful data for decision making by business units. • Expanded the use of cost accounting information to improve program effectiveness, including the analysis of programs within the Chief Financial Officer (CFO) function, the notice process, Combined Annual Wage Reporting/Federal Unemployment Tax Act (CAWR/FUTA) and 6020(b) programs, and certain criminal investigation processes. • Implemented a number of cost savings initiatives as part of the Postage and Printing cost reduction strategy, including the elimination of tax packages for individual taxpayers and the elimination/reduction of direct mailing of a number of tax packages to businesses. These eliminations/reductions have resulted in postage and printing cost savings in excess of $20 million. • Deployed the paper check conversion technology to 401 TACs to process checks through electronic transmission. The project improved reporting systems, reduced the amount of time to process checks that were previously mailed to central locations for processing, and reduced lost remittances from transshipments. • Enhanced electronic receipt of background investigation cases through eDelivery, resulting in a cost savings of $820,621 and significant improvements in data communications with the Office of Personnel Management (OPM). • Closed of the Atlanta Submission Processing center, the fifth such closure in recent years, reflecting the success of the IRS e-File program, and the reduced need for paper processing.

	Actions Planned or Underway for FY 2012 and Beyond: • Continue to review internal operations, conducting additional cost benefit analyses and development of performance measures to improve program evaluation and decision making. • Integrate W-2 data received from the Social Security Administration into pre-refund data matching systems to use in compliance activities. • Enhance the Prisoner Data file creation process by developing a model to cleanse electronic prisoner data files received from the Federal Bureau of Prisons/state departments of corrections, and implement a better means to collect and validate prisoner data to summarize data errors that can be corrected by prison bureaus.

Financial Statements

Principal Financial Statements

The principal financial statements have been prepared to report the financial position and results of operations of the Internal Revenue Service (IRS), pursuant to the requirements of the *Chief Financial Officers Act of 1990* (P.L. 101-576), the *Government Management Reform Act of 1994* and the Office of Management and Budget (OMB) Circular No. A-136, *Financial Reporting Requirements*, as amended. The responsibility for the integrity of the financial information included in these statements rests with the management of the IRS. The audit of the IRS principal financial statements was performed by the Government Accountability Office (GAO).

The IRS principal financial statements for fiscal years 2011 and 2010 are as follows:

- The **Balance Sheet** presents the assets, liabilities and net position.
- The **Statement of Net Cost** presents the net cost of operations by program. It includes the gross costs less any exchange revenue earned from activities.
- The **Statement of Changes in Net Position** presents the change in net position resulting from the net cost of operations, budgetary financing sources other than exchange revenues, and other financing sources.
- The **Statement of Budgetary Resources** presents the budgetary resources; the status of those resources; the change in obligated balances during the year; and the outlays. Additional detail by major budget accounts is available in the Required Supplementary Information section.
- The **Statement of Custodial Activity** presents the sources and disposition of non-exchange federal tax revenues collected and refunds disbursed.

Internal Revenue Service
Balance Sheet
As of September 30, 2011 and 2010

(In Millions)

	2011	2010
Assets		
Intragovernmental:		
Fund Balance with Treasury (Note 2)	$ 2,608	$ 2,562
Due from Treasury (Note 6)	3,981	4,133
Other Assets (Note 3)	126	136
Total Intragovernmental	**6,715**	**6,831**
Cash and Other Monetary Assets (Notes 4, 6)	321	295
Federal Taxes Receivable, Net (Notes 5, 6)	35,000	35,000
Property and Equipment, Net (Note 7)	1,213	1,060
Other Assets (Note 3)	19	12
Total Assets	**$ 43,268**	**$ 43,198**
Liabilities		
Intragovernmental:		
Due to Treasury (Note 5)	$ 35,000	$ 35,000
Other Liabilities (Note 8)	231	235
Total Intragovernmental	**35,231**	**35,235**
Federal Tax Refunds Payable	3,981	4,133
Other Liabilities (Note 8)	2,048	2,003
Total Liabilities	**41,260**	**41,371**
Net Position		
Unexpended Appropriations	1,471	1,531
Cumulative Results of Operations	537	296
Total Net Position	**2,008**	**1,827**
Total Liabilities and Net Position	**$ 43,268**	**$ 43,198**

The accompanying notes are an integral part of these statements.

Internal Revenue Service
Statement of Net Cost
For the Years Ended September 30, 2011 and 2010

(In Millions)

	2011	2010
Program		
Taxpayer Assistance and Education		
Gross Cost	$ 1,132	$ 793
Earned Revenue	(12)	(7)
Net Cost of Program	**1,120**	**786**
Filing and Account Services		
Gross Cost	3,366	3,528
Earned Revenue	(78)	(70)
Net Cost of Program	**3,288**	**3,458**
Compliance		
Gross Cost	8,764	9,331
Earned Revenue	(388)	(378)
Net Cost of Program	**8,376**	**8,953**
Administration of Tax Credit Programs		
Gross Cost	209	250
Earned Revenue	-	-
Net Cost of Program	**209**	**250**
Net Cost of Operations (Note 11)	**$ 12,993**	**$ 13,447**

The accompanying notes are an integral part of these statements.

2

Internal Revenue Service
Statement of Changes in Net Position
For the Years Ended September 30, 2011 and 2010

(In Millions)

	2011		2010	
	Cumulative Results of Operations	Unexpended Appropriations	Cumulative Results of Operations	Unexpended Appropriations
Beginning Balances	**$ 296**	**$ 1,531**	**$ 237**	**$ 1,675**
Budgetary Financing Sources:				
Appropriations Received		12,150		12,154
Appropriations Transferred In/Out		-		-
Other Adjustments		(136)		(153)
Appropriations Used	12,074	(12,074)	12,145	(12,145)
Other Financing Sources:				
Imputed Financing	1,182		1,390	
Transfers In/Out Without Reimbursement	30		35	
Transfers to General Fund	(52)		(64)	
Total Financing Sources	**13,234**	**(60)**	**13,506**	**(144)**
Net Cost of Operations	**(12,993)**		**(13,447)**	
Net Change	**241**	**(60)**	**59**	**(144)**
Ending Balances	**$ 537**	**$ 1,471**	**$ 296**	**$ 1,531**

The accompanying notes are an integral part of these statements.

3

Internal Revenue Service
Statement of Budgetary Resources
For the Years Ended September 30, 2011 and 2010

(In Millions)

	2011	2010
Budgetary Resources:		
Unobligated Balance, Brought Forward, October 1	$ 816	$ 887
Recoveries of Prior Year Unpaid Obligations	121	90
Budget Authority		
Appropriations	12,475	12,444
Spending Authority from Offsetting Collections	185	151
Nonexpenditure Transfers, Net	-	-
Permanently Not Available	(136)	(153)
Total Budgetary Resources	**$ 13,461**	**$ 13,419**
Status of Budgetary Resources:		
Obligations Incurred (Note 12)	$ 12,571	$ 12,603
Unobligated Balance – Available (Note 2)	292	241
Unobligated Balance – Not Available (Note 2)	598	575
Total Status of Budgetary Resources	**$ 13,461**	**$ 13,419**
Change in Obligated Balance:		
Obligated Balance, Net, Brought Forward, October 1	$ 1,752	$ 1,587
Obligations Incurred	12,571	12,603
Gross Outlays	(12,481)	(12,324)
Recoveries of Prior Year Unpaid Obligations, Actual	(121)	(90)
Change in Uncollected Customer Payments from Federal Sources	3	(24)
Obligated Balance, Net, End of Period	**$ 1,724**	**$ 1,752**
Net Outlays:		
Gross Outlays	$ 12,481	$ 12,324
Offsetting Collections	(189)	(127)
Distributed Offsetting Receipts	(285)	(283)
Net Outlays	**$ 12,007**	**$ 11,914**

The accompanying notes are an integral part of these statements.

4

Internal Revenue Service
Statement of Custodial Activity
For the Years Ended September 30, 2011 and 2010

(In Billions)

	2011	2010
Revenue Activity		
Collections of Federal Tax Revenue (Note 13)		
Individual Income, FICA/SECA, and Other	$ 2,102	$ 1,989
Corporate Income	243	278
Excise	49	47
Estate and Gift	9	20
Railroad Retirement	5	5
Federal Unemployment	7	6
Total Collections of Federal Tax Revenue	**2,415**	**2,345**
Increase in Federal Taxes Receivable, Net	-	6
Total Federal Tax Revenue	**$ 2,415**	**$ 2,351**
Distribution of Federal Tax Revenue to Treasury	**$ 2,415**	**$ 2,345**
Increase in Amount Due to Treasury	-	6
Total Disposition of Federal Tax Revenue	**2,415**	**2,351**
Net Federal Revenue Activity	**$ -**	**$ -**
Federal Tax Refund Activity		
Total Refunds of Federal Taxes (Note 14)	$ 416	$ 467
Appropriations Used for Refund of Federal Taxes	(416)	(467)
Net Federal Tax Refund Activity	**$ -**	**$ -**

The accompanying notes are an integral part of these statements.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2011 and 2010

Note 1. Summary of Significant Accounting Policies

A. Reporting Entity

The Internal Revenue Service (IRS) is a bureau of the U.S. Department of the Treasury (Treasury). The IRS originated in 1862, when Congress established the Office of the Commissioner of the Internal Revenue. In 1952, the Bureau of Internal Revenue was reorganized by Congress and became the Internal Revenue Service in 1953.

The mission of the IRS is to provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.

The IRS consists of organizations and major programs which administer the nation's tax laws and annually collects over 90 percent of the revenues funding the Federal government.

Organizations

Operating Divisions
There are four operating divisions. Wage and Investment (W&I) provides customer support, submission processing and compliance activities with respect to individuals with wage and investment income. Small Business and Self-Employed (SBSE) administers compliance activities for small businesses, self-employed individuals and others with income from sources other than wages. Tax-Exempt and Government Entities (TEGE) oversees and assists employee plans, tax exempt organizations, and government entities in complying with tax laws and regulations. Large Business and International (LB&I) serves corporations, subchapter S corporations, and partnerships with assets greater than $10 million on complicated issues involving tax law and accounting principles, and conducts business in an expanding global environment.

Functional Divisions
The five functional divisions are Appeals, Criminal Investigation, Communications and Liaison, Taxpayer Advocate Service and the IRS Office of Chief Counsel. These divisions provide enforcement services supporting both internal and external operations. They are independent of the operating divisions and other units of the IRS. The National Taxpayer Advocate Service reports directly to Congress and the IRS Office of Chief Counsel reports to the Secretary of the Treasury.

Support Divisions
The eight support divisions are Modernized Information Technology Services, Agency Wide Shared Services, Stewardship, Wage & Investment-Stewardship, Executive Leadership and Direction, Human Capital Office, Human Capital Office Corporate Programs and Chief Financial Officer. These divisions provide shared services support to all of the IRS organizations.

Major Programs

- Taxpayer Assistance and Education
- Filing and Account Services
- Compliance
- Administration of Tax Credit Programs

The major programs are discussed in Note 1.J., Program Costs.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2011 and 2010

B. Basis of Accounting and Presentation

The financial statements have been prepared from the accounting records of the IRS in conformity with accounting principles generally accepted in the United States and in accordance with the Office of Management and Budget (OMB) Circular No. A-136, *Financial Reporting Requirements*, as amended. Accounting principles generally accepted for Federal entities are the standards prescribed by the Federal Accounting Standards Advisory Board (FASAB), which is the official body for setting accounting standards of the Federal government.

These comparative financial statements and related notes consist of the Balance Sheet, the Statement of Net Cost, the Statement of Changes in Net Position, the Statement of Budgetary Resources and the Statement of Custodial Activity.

The accounting structure of Federal agencies is designed to reflect both accrual and budgetary accounting transactions. Under the accrual method of accounting, revenues are recognized when earned and expenses are recognized when incurred, without regard to receipt or payment of cash. Budgetary accounting facilitates compliance with legal constraints and controls over the use of Federal funds. The Statement of Custodial Activity is presented on the modified cash basis of accounting. Cash collections and disbursements to Treasury are reported on a cash basis and the change in Federal tax receivables and refunds payable are reported on an accrual basis.

Certain assets, liabilities, earned revenues and costs have been classified as intragovernmental throughout the financial statements and notes. Intragovernmental is defined as exchange transactions made between two reporting entities within the Federal government.

C. Fund Balance with Treasury

The fund balance with Treasury is the aggregate of funds in the accounts of the IRS, primarily appropriated funds, from which the IRS is authorized to make expenditures and pay liabilities.

The status of fund balance with Treasury represents amounts obligated and unobligated. The obligated balances not yet disbursed include the amount of funds against which budgetary obligations have been incurred, but disbursements have not been made. Unobligated balances, available represent amounts in unexpired appropriations as of the end of the current fiscal year. Unobligated balances become available when apportioned by the OMB. Unobligated balances, unavailable represent amounts in expired appropriations and amounts not apportioned for obligation as of the end of the current fiscal year.

D. Other Assets

Accounts receivable consist of amounts due to the IRS from the public and Federal agencies. Accounts receivable are recorded and reimbursable revenues are recognized as the services are performed and costs are incurred. The allowance for uncollectible accounts is based on an annual review of groups of accounts by age for accounts receivable balances older than one year.

Advances to government agencies primarily represent funds paid to the Treasury Working Capital Fund (WCF). Centralized services funded through the WCF consist primarily of telecommunication

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2011 and 2010

services, payroll processing, security and employee programs. Advances to the public are cash outlays for criminal investigations and employee travel.

Forfeited property held for sale is acquired as a result of forfeiture proceedings or foreclosure sales to satisfy a tax liability. The Federal Tax Lien Revolving Fund, established in accordance with Title 26 United States Code, Section 7810, is used to redeem real property foreclosed upon by a holder of a lien. The IRS may sell the property, reimburse the revolving fund in an amount equal to the redemption and apply the net proceeds to the outstanding tax obligation.

E. Cash and Other Monetary Assets

Imprest funds are maintained by headquarters and field offices in commercial bank accounts. Other monetary assets consist primarily of offers in compromise, voluntary deposits received from taxpayers pending application of the funds to unpaid tax assessments and seized monies pending the results of criminal investigations.

F. Federal Taxes Receivable, Net and Due to Treasury

Federal taxes receivable, net and the corresponding liability, due to Treasury, are not accrued until related tax returns are filed or assessments are made by the IRS and agreed to by either the taxpayer or the court. Accruals are made to reflect penalties and interest on taxes receivable through the balance sheet date.

Taxes receivable consist of unpaid assessments (taxes and associated penalties and interest) due from taxpayers. The existence of a receivable is supported by a taxpayer agreement, such as filing of a tax return without sufficient payment, or a court ruling in favor of the IRS. The allowance reflects an estimate of the portion of total taxes receivable deemed to be uncollectible.

Compliance assessments are unpaid assessments which neither the taxpayer nor a court has affirmed the taxpayer owes to the Federal government. Examples include assessments resulting from an IRS audit or examination in which the taxpayer does not agree with the results. Write-offs consist of unpaid assessments for which the IRS does not expect further collections due to factors such as taxpayers' bankruptcy, insolvency, or death. Compliance assessments and write-offs are not reported on the balance sheet. Statutory provisions require the accounts to be maintained until the statute for collection expires.

Tax Assessments
Under the Internal Revenue Code (26 USC) Section 6201, the Secretary of the Treasury is authorized and required to make inquiries, determinations, and assessments of all taxes imposed and accruing under any internal revenue law which have not been duly paid including interest, additions to the tax, and assessable penalties. The Secretary has delegated this authority to the Commissioner of the IRS. Unpaid assessments result from taxpayers filing returns without sufficient payments and from the enforcement programs of the IRS, such as examination, under-reporter, substitute for return, and combined annual wage reporting.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2011 and 2010

Abatements
Section 6404 of the Internal Revenue Code (26 USC), authorizes the Commissioner of the IRS to abate certain paid or unpaid portions of assessed taxes, interest, and penalties. Abatements occur for a number of reasons and are a standard part of the tax administration process.

Abatements may be allowed for qualifying corporations claiming net operating losses which create a credit when carried back and applied against a prior year's tax liability. Additionally, abatements can correct previous assessments from enforcement programs, eliminate taxes discharged in bankruptcy, reduce or eliminate taxes encompassed in offers in compromise, eliminate penalty assessments for reasonable cause, eliminate contested assessments made due to mathematical or clerical errors and eliminate assessments contested after the liability has been satisfied. Abatements may result in claims for refunds or a reduction of the unpaid assessed amount.

G. Property and Equipment

Property and equipment is recorded at historical cost. It consists of tangible assets and software. The IRS depreciates property and equipment on a straight line basis over its estimated useful life. In the first and final years, one-half year depreciation is taken. Disposals are recorded when deemed material.

The IRS capitalization policy for property and equipment is presented by asset class and capitalization threshold.

Asset Class	Capitalization Threshold
ADP equipment	Capitalized regardless of acquisition cost
Non-ADP equipment	Assets with bulk cost of $50 thousand or greater
Furniture	Capitalized regardless of acquisition cost
Investigative equipment	Assets with bulk cost of $50 thousand or greater
Vehicles	Capitalized regardless of acquisition cost
Major systems	Projects with costs of $20 million or greater
Internal Use Software	Major business systems modernization projects with an estimated cost of $5 million per year or $50 million over the life cycle.
Leasehold Improvements	Improvements with bulk cost of $50 thousand or greater
Assets under capital lease	Assets with bulk cost of $50 thousand or greater

ADP Equipment includes related commercial off-the-shelf (COTS) software with a bulk cost of $50 thousand or greater. Major systems was a category for large-scale computer systems prior to Statement of Federal Financial Accounting Standards No. 10 (SFFAS No. 10), *Accounting for Internal Use Software*. Prior to fiscal year (FY) 2011, the IRS capitalized COTS software and leasehold improvements regardless of cost, and furniture, non-ADP equipment and investigative equipment with an individual asset cost of $5 thousand or greater.

Internal Use Software captures the costs of major Business Systems Modernization projects in accordance with SFFAS No. 10. It encompasses software design, development and testing of projects adding significant new functionality and long-term benefits. Costs for developing internal use

9

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2011 and 2010

software are accumulated in work in process until final acceptance and testing are successfully completed. When the software is completed and placed into service, the costs are transferred to depreciable property.

H. Federal Tax Refunds Payable and Due from Treasury

Federal tax refunds payable is a fully funded liability and is offset with a corresponding asset due from Treasury. The IRS records an amount due from Treasury to designate approved funding to pay year-end tax refund liabilities to taxpayers.

I. Financing Sources and Revenues

Appropriations Received

The IRS receives the majority of its funding through annual, multi-year, and no-year appropriations available for use within statutory limits for operating and capital expenditures. Appropriations are recognized as budgetary financing sources when the related expenses are incurred.

Appropriations

- Taxpayer Services
- Enforcement
- Operations Support
- Other Appropriations

Taxpayer Services provides funds for the direct costs of the Taxpayer Assistance and Education and the Filing and Account Services Programs discussed in Note 1. J., Program Costs.

Enforcement provides resources for the direct costs of the Compliance Program discussed in Note 1. J., Program Costs. Additionally, it funds the direct costs of administration of the Earned Income Tax Credit Program (EITC).

Operations Support funds the indirect costs of all programs. Activities include executive planning and direction; shared service support for facilities, rent, utilities and security; procurement; printing; postage; headquarters activities such as strategic planning, finance, human resources and Equal Employment Opportunity; research and statistics of income; and information systems, data processing and telecommunication.

Other Appropriations include Business Systems Modernization (BSM), Administrative Expenses-Recovery Act and Health Insurance Tax Credit Administration. BSM provides resources for the planning and capital asset acquisition of information technology to modernize the business systems. Additionally, BSM is obligated pursuant to an expenditure plan submitted to Congress. Administrative Expenses-Recovery Act supports the funding for the administration of new and expanded tax credit programs of the *American Recovery and Reinvestment Act of 2009* (ARRA). Health Insurance Tax Credit Administration provides funding for health insurance and refundable tax credits to qualified individuals. Beginning with calendar year 2010, the IRS administers various tax provisions included in the *Affordable Care Act of 2010* (ACA).

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2011 and 2010

Exchange Revenues
Exchange revenues recognized by the IRS represent reimbursements and user fees. Reimbursements are recognized as the result of costs incurred for services performed for Federal agencies or the public under reimbursable agreements. User fees are derived from transactions with the public and are recognized when the fees are collected.

Imputed Financing Sources
Other financing sources include imputed financing sources to offset the imputed costs recognized for goods or services received from other Federal agencies without reimbursement from the IRS. The imputed costs are pension and other benefit costs administered by the Office of Personnel Management, costs of processing payments and collections by the Financial Management Service and legal judgments paid by the Treasury Judgment Fund.

J. Program Costs

Taxpayer Assistance and Education provides services to taxpayers before returns are filed to assist them in preparing correct returns. Primary activities include interpretations, preparing and disseminating tax publications and information, taxpayer education programs, researching customer needs, pre-filing agreements and determinations, and initiatives to promote electronic tax filing. Exchange revenues include user fees from enrolled agent and actuary fees, and reimbursable revenues from services provided to other Federal agencies.

Filing and Account Services performs account maintenance functions of processing tax returns, recording tax payments, issuing refunds, and maintaining taxpayer accounts. The scope extends to all tax returns and taxpayer accounts regardless of type and method of filing. Program activities include providing field assistance in preparing tax returns and supplying tax forms to the public. Exchange revenues include user fees from photocopy and income verification fees, and reimbursable revenues from services provided to other Federal agencies.

Compliance administers compliance activities after a return is filed in order to identify and correct possible errors or underpayments. This program includes issuing agreements, rulings and determinations, automated and field collection activities, appeals and tax litigation, desk and field examination of returns, international and criminal investigations, and document matching. Earned revenues are primarily from user fees for installment agreements, letter rulings and determinations, return preparer fees, and reimbursable revenues from services provided to other Federal agencies.

Administration of Tax Credit Programs administers EITC and Health Coverage Tax Credit (HCTC) programs. EITC includes expanded customer service, public outreach, enforcement, and research efforts to reduce claims and erroneous filings associated with the program. EITC comprises pre-filing, filing and account services associated with the program. EITC payments actually refunded to individuals or credited against tax liabilities are not included in program costs. HCTC activities are focused on implementing the health insurance tax credit program set out in the *Trade Adjustment Assistance Reform Act of 2002* (Trade Act of 2002). These costs do not encompass payments made to health insurance carriers on behalf of participants or tax credits refunded to qualifying individuals. (See Other Accompanying Information - unaudited for discussion of refundable tax credits.)

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2011 and 2010

K. Custodial Activity

Non-exchange Revenues
The IRS collects custodial non-exchange revenues for taxes levied against taxpayers for: individual and corporate income, Federal Insurance Contributions Act (FICA) and Self-Employment Contribution Act (SECA), excise, estate, gift, railroad retirement and Federal unemployment taxes. These collections are not available to the IRS for obligation or expenditure and are recognized as custodial revenues when collected. The sources of Federal tax revenue and their distribution to the general fund of the U.S. Treasury are reported on the Statement of Custodial Activity.

Permanent Indefinite Appropriations
The IRS was granted permanent and indefinite budgetary authority through legislation to disburse tax refund principle and related interest as they become due. The permanent and indefinite appropriations are not subject to budgetary ceilings set by Congress during the annual appropriation process.

Refunds due to taxpayers are reported as Federal tax refunds payable on the Balance Sheet. The IRS records an offsetting asset, due from Treasury, to reflect the year-end budget authority to pay this liability.

Disbursements for tax refunds and related interest, reported on the Statement of Custodial Activity, are offset by appropriations used for refunds. Disbursements for refunds are not a cost to the IRS, but rather a cost to the Federal government as a whole.

L. Earmarked Funds

Earmarked funds are financed by specifically identified revenues which remain available over time. These specifically identified revenues are required by statute to be used for designated activities, benefits or purposes and must be accounted for separately from the Federal government's general revenues.

The Federal Tax Lien Revolving Fund (20X4413) was established pursuant to section 112(a) of the *Federal Tax Lien Act of 1966*, to serve as the source of financing for the redemption of real property by the United States.

The Private Collection Agent Program (20X5510) was established under the *American Jobs Creation Act of 2004*. In March 2009, the IRS Commissioner announced the program would not renew the contracts with the private debt collection agencies. Unobligated funds from prior year collection of delinquent Federal tax liabilities have been retained by the IRS to fund ongoing enforcement activities.

M. Allocation Transfers

The IRS is a party to allocation transfers from the Department of Transportation's (Transportation) Federal Highway Administration and the Department of Health and Human Services (HHS) as a receiving entity. Obligations and outlays incurred by the IRS are charged to the allocation account as it executes the delegated activity on behalf of Transportation and HHS. Financial activity for the allocation transfers are reported in the financial statements of Transportation and HHS.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2011 and 2010

N. Fiduciary Activities

Fiduciary activities are the collection or receipt, and the management, protection, accounting, investment and disposition by the Federal government of cash or other assets in which non-Federal individuals or entities have an ownership interest the Federal government must uphold.

The IRS fiduciary activities include the net collections for a taxable year from United States military and Federal employees working in the United States (U.S.) territories of the Northern Mariana Islands, the U.S. Virgin Islands, Guam and American Samoa. These fiduciary assets are not assets of the IRS.

O. Employee Compensation and Benefits

Accrued Annual, Sick, and Other Leave

Annual and compensatory leave is expensed with an offsetting liability as it is earned and the liability is reduced as leave is taken. Each year, the balance in the accrued annual leave liability account is adjusted to reflect current pay rates. To the extent current or prior year appropriations are not available to fund annual and compensatory leave earned but not taken, funding will be obtained from future financing sources. Sick leave and other types of non-vested leave are expensed as taken.

Federal Employees Compensation Act

The Federal Employees Compensation Act (FECA) provides income and medical cost protection to covered Federal civilian employees injured on the job, to employees who have incurred work-related occupational diseases, and to beneficiaries of employees whose deaths are attributable to job-related injuries or occupational diseases. The FECA program is administered by the U.S. Department of Labor (DOL), which pays valid claims and subsequently seeks reimbursement for claims paid. Accrued FECA liability represents amounts due to DOL for claims paid on behalf of the IRS. Actuarial FECA liability represents the liability for future workers' compensation benefits, which includes the expected liability for death, disability, medical, and miscellaneous costs for approved cases. DOL estimates the liability for future payments as a result of past events.

Employee Pension Benefits

The IRS employees participate in the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS). For employees covered by CSRS, the IRS contributes 7% of the employees' gross pay for regular and 7.5% for law enforcement officers' retirement. For employees covered by FERS, the IRS contributes 11.7% of employees' gross pay for regular and 25.7% for law enforcement officers' retirement.

Employees covered by CSRS and FERS are eligible to contribute to the Thrift Savings Plan (TSP), a defined contribution plan. For those employees participating in the FERS, a TSP account is automatically established, and IRS makes a mandatory contribution to this plan equal to one percent of the employees' compensation as well as matching contributions ranging from one to four percent of the employees' compensation for FERS-eligible employees who contribute to their TSP. No matching contributions are made to the TSP for employees participating in the CSRS.

13

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2011 and 2010

Employee Health and Life Insurance Benefits
Employees are eligible to participate in the Federal Employees Health Benefit Program (FEHB) and Federal Employees Group Life Insurance Program (FEGLI). The FEHB offers a wide variety of group plans and coverage. The coverage is available to employees, retirees, and their eligible family members. The cost for each plan varies and is shared between the IRS and the employee. Employees participating in the FEGLI program can obtain basic term life insurance, with the employee paying two-thirds of the cost and IRS paying one-third. Additional coverage is optional, to be paid fully by the employee. The basic life coverage may be continued into retirement if certain requirements are met. The IRS recognizes the full cost of providing these benefits.

P. Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions related to the reporting of assets, liabilities, revenues, and expenses and the disclosure of contingent liabilities. Actual results could differ from those estimates.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2011 and 2010

Note 2. Fund Balance with Treasury

(In Millions)	2011	2010
General Funds	$ 2,258	$ 2,248
Special Funds	343	310
Revolving Funds	7	6
Other Funds	-	(2)
Fund Balance with Treasury	**$ 2,608**	**$ 2,562**

(In Millions)	2011	2010
Unobligated balances:		
Available	$ 292	$ 241
Unavailable	598	575
Obligated balance not yet disbursed	1,724	1,752
Non-budgetary FBWT	(6)	(6)
Status of Fund Balance with Treasury	**$ 2,608**	**$ 2,562**

Note 3. Other Assets

(In Millions)	2011		2010	
	Intra-governmental	With the Public	Intra-governmental	With the Public
Advances	$ 78	$ 6	$ 83	$ 8
Accounts receivable, net	45	11	49	2
Forfeited property held for sale	-	2	-	2
Clearing accounts	3	-	4	-
Other Assets	**$ 126**	**$ 19**	**$ 136**	**$ 12**

Note 4. Cash and Other Monetary Assets

(In Millions)	2011	2010
Imprest Fund	$ 4	$ 4
Other monetary assets	317	291
Cash and Other Monetary Assets	**$ 321**	**$ 295**

15

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2011 and 2010

Note 5. Federal Taxes Receivable, Net and Due to Treasury

(In Billions)	2011	2010
Federal taxes receivable	$ 147	$ 138
Allowance for uncollectible taxes receivable	(112)	(103)
Federal taxes receivable, net and Due to Treasury	**$ 35**	**$ 35**

Federal taxes receivable consists of tax assessments, penalties and interest not paid or abated which were agreed to by the taxpayer and the IRS or upheld by the courts. Federal taxes receivable, net is the portion of gross Federal taxes receivable estimated to be collectible. It is based on projections of collectibility from a statistical sample of taxes receivable. The allowance for uncollectible taxes receivable was established for the difference between the gross Federal taxes receivable and the portion estimated to be collectible. Due to Treasury is the offsetting liability to Federal taxes receivable, net, and represents amounts to be transferred to Treasury when collected.

Note 6. Non-entity Assets

(In Millions)	2011		2010	
	Intra-governmental	With the Public	Intra-governmental	With the Public
Due from Treasury	$ 3,981	$ -	$ 4,133	$ -
Federal taxes receivable, net	-	35,000	-	35,000
Other monetary assets	-	317	-	291
Non-entity Assets	**$ 3,981**	**$ 35,317**	**$ 4,133**	**$ 35,291**

Non-entity assets are not available for use by the IRS. Federal taxes receivable are collected for the U.S. Government, but the IRS does not have the authority to spend them.

16

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2011 and 2010

Note 7. Property and Equipment

(In Millions)	Useful Life (Years)	Cost	Accumulated Depreciation	2011 Net Book Value	2010 Net Book Value
ADP assets	3 to 7	$ 1,517	$ (1,020)	$ 497	$ 432
Internal use software	2 to 15	1,098	(867)	231	367
Leasehold improvements	10	389	(227)	162	163
Major systems	7	422	(422)	-	-
Internal use software – work in process		247	-	247	60
Vehicles	5	59	(43)	16	20
Furniture and non-ADP equipment	8 to 10	86	(32)	54	16
Assets under capital lease	3 to 7	7	(1)	6	2
Investigative equipment	10	6	(6)	-	-
Property and Equipment		**$ 3,831**	**$ (2,618)**	**$ 1,213**	**$ 1,060**

The Cost column represents the historical cost of property and equipment, net of disposals. The cost basis for FY 2011 and FY 2010 is $3,831 million and $3,622 million, respectively. Accumulated depreciation for FY 2011 and FY 2010 is $2,618 million and $2,562 million, respectively.

The IRS has 16 internal use software projects, including deployed and work in process:

- Account Management Services (AMS) is a project which establishes the foundation for major compliance programs by providing the applications to monitor and interface with taxpayers, issue enhanced notices and deliver improved customer support and functionality.
- Current Customer Account Data Engine (CADE) is a project to replace the master files for individual taxpayer accounts.
- Customer Account Data Engine 2 (CADE 2) is leveraging existing systems and new development to implement a single, data-centric solution which provides daily processing of individual taxpayer accounts and establishes a solid data foundation for the future.
- Customer Communications is a customer service telephone system.
- Custodial Detail Database (CDDB) is the subsidiary ledger for Redesign Revenue and Accounting System (RRACS) which provides the functionality needed for custodial financial management and reporting.
- E-Services is a system of web-based products and services for tax practitioners and the public.
- Enterprise Systems Management (ESM) is an infrastructure system allowing remote monitoring and network management.
- Information Reporting and Document Matching (IRDM) is a business document matching program designed to increase voluntary compliance and accurate reporting of income through the use of third party information reporting data.
- Integrated Financial System (IFS) is the IRS administrative financial system.
- Integrated Procurement System (IPS) is a project to re-engineer the existing procurement system, Web Requisition Tracking System/Integrated Procurement System, to meet current enterprise architecture and security standards.
- Internet Refund Fact of Filing allows taxpayers to review the status of their refund.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2011 and 2010

The IRS has 16 internal use software projects, continued:

- Knowledge Incident/Problem Service Asset Management (KISAM) project replaced the IRS' asset and problem management system, Information Technology Asset Management System.
- Modernized E-File is an electronic filing system for tax returns.
- RRACS adds enhancements to financial reporting of taxpayer receipts and adds traceability between summary records and the detailed subsidiary ledger (CDDB).
- Return Review Program (RRP) is an automated system designed to maximize fraud detection at the time tax returns are filed.
- Security and Technology Infrastructure Release (STIR) is the infrastructure for information technology security.

Deployed Internal Use Software

(In Millions)	Cost	Accumulated Depreciation	2011 Net Book Value	2010 Net Book Value
Current CADE	$ 303	$ (257)	$ 46	$ 137
Modernized E-File	269	(175)	94	106
Integrated Financial System	147	(137)	10	32
E-Services	141	(141)	-	10
AMS	78	(13)	65	70
STIR	76	(76)	-	-
Customer Communications	25	(25)	-	-
Enterprise Systems Management	16	(16)	-	-
Internet Refund Fact of Filing	15	(15)	-	-
CDDB	8	(4)	4	6
RRACS	7	(1)	6	5
KISAM	6	-	6	-
Other	7	(7)	-	1
Deployed Internal Use Software	**$ 1,098**	**$ (867)**	**$ 231**	**$ 367**

Work in Process Internal Use Software

(In Millions)	2011	2010
CADE2	$ 175	$ 40
Modernized E File	32	11
IRDM	25	-
IPS	8	4
RRP	7	-
KISAM	-	5
Work in Process Internal Use Software	**$ 247**	**$ 60**

18

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2011 and 2010

Note 8. Liabilities

Other Liabilities

(In Millions)	2011 Current	2011 Non-Current	2011 Total
Intragovernmental:			
Accrued payroll and benefits	$ 101	$ -	$ 101
Accrued FECA liability	42	56	98
Accrued expense	32	-	32
Other Liabilities	**$ 175**	**$ 56**	**$ 231**
With the Public:			
Accrued annual leave	$ 537	$ -	$ 537
Actuarial FECA liability	-	448	448
Accrued payroll and benefits	396	-	396
Accrued expenses	231	-	231
Liability for Deposit Funds, Clearing Accounts and Custodial Liabilities	323	-	323
Accounts payable	112	-	112
Net Capital Lease Liability	1	-	1
Other Liabilities	**$ 1,600**	**$ 448**	**$ 2,048**

(In Millions)	2010 Current	2010 Non-Current	2010 Total
Intragovernmental:			
Accrued payroll and benefits	$ 89	$ -	$ 89
Accrued FECA liability	43	55	98
Accrued expenses	48	-	48
Other Liabilities	**$ 180**	**$ 55**	**$ 235**
With the Public:			
Accrued annual leave	$ 549	$ -	$ 549
Actuarial FECA liability	-	441	441
Accrued payroll and benefits	375	-	375
Accrued expenses	235	-	235
Liability for Deposit Funds, Clearing Accounts and Custodial Liabilities	300	-	300
Accounts payable	103	-	103
Other Liabilities	**$ 1,562**	**$ 441**	**$ 2,003**

19

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2011 and 2010

Liabilities Not Covered by Budgetary Resources

(In Millions)	2011		2010	
	Intra-governmental	With the Public	Intra-governmental	With the Public
Accrued annual leave	$ -	$ 537	$ -	$ 549
Actuarial FECA liability	-	448	-	441
Accrued FECA liability	98	-	98	-
Liabilities Not Covered by Budgetary Resources	**$ 98**	**$ 985**	**$ 98**	**$ 990**

Liabilities not covered by budgetary resources include liabilities for which congressional action is needed before budgetary resources can be provided. Although future appropriations to fund these liabilities are likely, it is not certain appropriations will be enacted to fund these liabilities.

Note 9. Leases

Capital Leases

The net capital lease liability is $1 million as of September 30, 2011. The IRS leases ADP telecommunications equipment for toll free call centers. These consist of a two-year lease and two seven-year leases.

The future payments due for the equipment under the two-year lease are $1 million and will be paid in FY 2012. The payments for the leased equipment under the seven-year leases are made at the beginning of the leases. There are no future payments due for the equipment under the seven-year leases.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2011 and 2010

Operating Leases

(In Millions)

Fiscal Year	Lease Payment
2012	$ 13
2013	11
2014	7
2015	6
2016	6
After 2016	8
Total Future Lease Payments	**$ 51**

The IRS leases office space from commercial entities under five year non-cancelable operating leases. Future lease payments under non-cancelable leases of office spaces are presented above.

Additionally, the IRS has annual operating leases with the General Services Administration for office space and vehicles and with commercial entities for equipment. These leases may be canceled or renewed on an annual basis at the option of the IRS. They do not impose binding commitments on the IRS for future rental payments on leases with terms longer than one year.

Note 10. Commitments and Contingencies

The IRS is a party to legal actions whose outcome, if unfavorable, could materially affect the financial statements. For some of these actions, management and legal counsel have determined the likelihood of an unfavorable outcome is remote. As of September 30, 2011 and 2010, there were no estimated contingent liabilities arising from these actions.

For some of the legal actions to which the IRS is a party, management and legal counsel cannot determine the likelihood of an unfavorable outcome nor can any related loss be reasonably estimated. The IRS does not accrue for possible losses related to cases where the potential loss cannot be estimated or the likelihood of an unfavorable outcome is less than probable. As of September 30, 2011 and 2010, there were four cases and three cases, respectively, for which management and legal counsel are unable to determine the likelihood of an unfavorable outcome or establish a range of potential losses.

As of September 30, 2011 and 2010, the IRS does not have contractual commitments for payments on obligations related to canceled appropriations.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2011 and 2010

Note 11. Cost and Earned Revenue by Programs

2011 (In Millions)	Taxpayer Assistance and Education	Filing and Account Services	Compliance	Administration of Tax Credit Programs	Total
Intragovernmental Gross Cost	$ 367	$ 1,379	$ 2,614	$ 46	$ 4,406
Gross Costs with the Public	765	1,987	6,150	163	9,065
Program Costs	1,132	3,366	8,764	209	13,471
Intragovernmental Earned Revenue	(9)	(11)	(52)	-	(72)
Earned Revenue from the Public	(3)	(67)	(336)	-	(406)
Program Revenues	(12)	(78)	(388)	-	(478)
Net Cost of Operations	**$ 1,120**	**$ 3,288**	**$ 8,376**	**$ 209**	**$ 12,993**

2010 (In Millions)	Taxpayer Assistance and Education	Filing and Account Services	Compliance	Administration of Tax Credit Programs	Total
Intragovernmental Gross Cost	$ 201	$ 1,499	$ 2,834	$ 45	$ 4,579
Gross Costs with the Public	592	2,029	6,497	205	9,323
Program Costs	793	3,528	9,331	250	13,902
Intragovernmental Earned Revenue	(4)	(6)	(59)	-	(69)
Earned Revenue from the Public	(3)	(64)	(319)	-	(386)
Program Revenues	(7)	(70)	(378)	-	(455)
Net Cost of Operations	**$ 786**	**$ 3,458**	**$ 8,953**	**$ 250**	**$ 13,447**

22

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2011 and 2010

Note 12. Statement of Budgetary Resources

Obligations Incurred

(In Millions)	2011	2010
Direct - Category B	$ 12,432	$ 12,467
Reimbursable - Category B	139	136
Obligations Incurred	**$ 12,571**	**$ 12,603**

Category B apportionments distribute budgetary resources by activities or programs and are restricted by purpose for which obligations can be incurred.

Explanation of Differences Between the FY 2010 Statement of Budgetary Resources and the FY 2012 President's Budget

(In Millions)	Budgetary Resources	Obligations Incurred	Distributed Offsetting Receipts	Net Outlays
Statement of Budgetary Resources (SBR)	$ 13,419	$ 12,603	$ 283	$ 11,914
Included on SBR, not in President's Budget				
Expired Funds	(300)	-	-	-
Distributed Offsetting Receipts	-	-	(283)	283
Allocation Transfer from Treasury	(95)	(86)	-	(88)
Other	2	7	-	2
Included in President's Budget, not on SBR				
Tax credits and interest refunds to taxpayers	112,446	112,446	-	112,446
Payments to informants	19	11	-	11
Budget of the United States Government	**$ 125,491**	**$ 124,981**	**$ -**	**$ 124,568**

The *FY 2013 Budget of the United States Government* (President's Budget) presenting the actual amounts for the year ended September 30, 2011 has not been published as of the issue date of these financial statements. The FY 2013 President's Budget is scheduled for publication in February 2012. A reconciliation of the FY 2010 column on the Statement of Budgetary Resources (SBR) to the actual amounts for FY 2010 in the FY 2012 President's Budget for budgetary resources, obligations incurred, distributed offsetting receipts, and net outlays is presented above.

The President's Budget includes appropriations for EITC, Child Tax Credit, HCTC, interest relating to taxpayer refunds, informant payments and additional refundable tax credits relating to the Recovery Act totaling $112.4 billion. The majority of the appropriations represent budgetary resources and outlays of payments to taxpayers for credits that exceed the taxpayer's income tax liability and interest paid on refunds of collections.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2011 and 2010

Undelivered Orders at the End of Period

Undelivered orders are the value of goods and services ordered and obligated which have not been received. This amount includes any orders which may have been prepaid or advanced but for which delivery or performance has not yet occurred. Undelivered orders were $983 million and $1,043 million for the periods ended September 30, 2011 and 2010, respectively.

Note 13. Collections of Federal Tax Revenue

(In Billions)	Tax Year 2011		Tax Year 2010	Tax Year 2009	Tax Year Prior Years	Collections Received FY 2011	Collections Received FY 2010
Individual income, FICA/SECA, and other	$ 1,357	*	$ 704	$ 19	$ 22	$ 2,102	$ 1,989
Corporate income	166	**	63	2	12	243	278
Excise	36		13	-	-	49	47
Estate and gift	-		6	1	2	9	20
Railroad retirement	4		1	-	-	5	5
Federal unemployment	5		2	-	-	7	6
Collections of Federal Tax Revenue	**$ 1,568**		**$ 789**	**$ 22**	**$ 36**	**$ 2,415**	**$ 2,345**

* Includes other collections of $72 million.
** Includes tax year 2012 corporate income tax receipts of $9 billion.

Note 14. Federal Tax Refund Activity

(In Billions)	Tax Year 2011	Tax Year 2010	Tax Year 2009	Tax Year Prior Years	Refunds Disbursed FY 2011	Refunds Disbursed FY 2010
Individual income, FICA/SECA, and other	$ 1	$ 303	$ 27	$ 14	$ 345	$ 366
Corporate income	6	17	7	38	68	98
Excise	1	1	-	-	2	2
Estate and gift	-	-	-	1	1	1
Federal Tax Refund Activity	**$ 8**	**$ 321**	**$ 34**	**$ 53**	**$ 416**	**$ 467**

Refund disbursements include EITC, child tax credit and those enacted under the ARRA. The *Economic Stimulus Act of 2008* included provisions to help stimulate the economy through recovery rebates. (See Other Accompanying Information - unaudited for discussion of refundable tax credits.)

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2011 and 2010

Note 15. Fiduciary Activities

(In Millions)	2011 20X6737	20X6738	20X6740	20X6741	Total
Fiduciary net assets, beginning of year	$ -	$ 19	$ -	$ -	$ 19
Contributions	17	48	28	9	102
Disbursements to and on behalf of beneficiaries	(17)	(29)	(28)	(9)	(83)
Increase (Decrease) in fiduciary net Assets	-	19	-	-	19
Fiduciary Net Assets, end of year	**$ -**	**$ 38**	**$ -**	**$ -**	**$ 38**

(In Millions)	2010 20X6737	20X6738	20X6740	20X6741	Total
Fiduciary net assets, beginning of year	$ -	$ 18	$ -	$ -	$ 18
Contributions	17	27	772	20	836
Disbursements to and on behalf of beneficiaries	(17)	(26)	(772)	(20)	(835)
Increase (Decrease) in fiduciary net Assets	-	1	-	-	1
Fiduciary Net Assets, end of year	**$ -**	**$ 19**	**$ -**	**$ -**	**$ 19**

In fiduciary fund 20X6738, the fiduciary net assets, end of the year balances are pending a tax matter resolution.

In accordance with Statement of Federal Financial Accounting Standards No. 31, *Accounting for Fiduciary Activities*, fiduciary cash and other assets are not assets of the Federal government. The IRS has four fiduciary funds not reported on the balance sheet:

- Internal Revenue Collections for Northern Mariana Islands 20X6737
- Coverover Withholdings – U.S. Virgin Islands 20X6738
- Coverover Withholdings – Guam 20X6740
- Coverover Withholdings – American Samoa 20X6741

Internal Revenue Code (26 USC) Section 7654 governs the tax coordination between the governments of the United States and the U.S. territories of the Northern Mariana Islands, the U.S. Virgin Islands, Guam and American Samoa.

The collections of Federal income taxes withheld from United States military and Federal employees who are working in these U.S. territories are maintained in fiduciary funds of the IRS. The disbursements of these collections to these U.S. territory governments represent the transfer of the individual tax liability for a taxable year.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2011 and 2010

Note 16. Reconciliation of Net Cost of Operations to Budget

(In Millions)	2011	2010
Resources used to finance activities:		
Obligations incurred	$ 12,571	$ 12,603
Spending authority from offsetting collections and recoveries	(306)	(241)
Distributed offsetting receipts	(285)	(283)
Transfers to General Fund	(52)	(64)
Imputed financing	1,182	1,390
Transfers in/out without reimbursement	30	35
	13,140	**13,440**
Resources that do not fund net cost of operations:		
Changes in goods, services and benefits ordered but not yet received or provided	60	(56)
Costs capitalized on the balance sheet	(308)	(249)
Budgetary offsetting collections and receipts	2	(1)
	(246)	**(306)**
Costs that do not require resources in current period:		
Depreciation and amortization	352	361
Increase (Decrease) in unfunded liabilities	(5)	33
Revaluation of assets and liabilities	15	16
Other	(263)	(97)
	99	**313**
Net Cost of Operations	**$ 12,993**	**$ 13,447**

In accordance with Statement of Federal Financial Accounting Standards No. 7 (SFFAS No. 7), *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, a reconciliation is required for the relationship between the budgetary resources obligated during the period for the programs and operations of the IRS to the net cost of operations. The budgetary accounting reports the obligations and outlays of financial resources to acquire or provide goods and services. The accrual basis of accounting reports the net cost of resources used.

Required Supplementary Information

INTERNAL REVENUE SERVICE

Required Supplementary Information - Unaudited

For the Years Ended September 30, 2011 and 2010

Schedule of Budgetary Resources by Major Budget Accounts

(In Millions)	Taxpayer Service (2011)	Enforcement (2011)	Operations Support (2011)	Other Appropriations (2011)	Total (2011)
Budgetary Resources					
Unobligated Balance, Brought Forward, October 1	$ 93	$ 91	$ 210	$ 422	$ 816
Recoveries of Prior Year Unpaid Obligations	13	23	75	10	121
Budget Authority					
Appropriations	2,279	5,504	4,083	609	12,475
Spending Authority from Offsetting Collections	35	101	47	2	185
Nonexpenditure Transfers, Net	148	14	35	(197)	-
Permanently Not Available	(46)	(39)	(41)	(10)	(136)
Total Budgetary Resources	**$ 2,522**	**$ 5,694**	**$ 4,409**	**$ 836**	**$ 13,461**
Status of Budgetary Resources					
Obligations Incurred	$ 2,453	$ 5,614	$ 4,137	$ 367	$ 12,571
Unobligated Balance – Available	25	19	121	127	292
Unobligated Balance – Not Available	44	61	151	342	598
Total Status of Budgetary Resources	**$ 2,522**	**$ 5,694**	**$ 4,409**	**$ 836**	**$ 13,461**
Change in Obligated Balance:					
Obligated Balance, Net, Brought Forward, October 1	$ 200	$ 411	$ 961	$ 180	$ 1,752
Obligations Incurred	2,453	5,614	4,137	367	12,571
Gross Outlays	(2,449)	(5,569)	(4,082)	(381)	(12,481)
Recoveries of Prior Year Unpaid Obligations, Actual	(13)	(23)	(75)	(10)	(121)
Change in Uncollected Customer Payments from Federal Sources	-	5	(1)	(1)	3
Obligated Balances, Net, End of Period	**$ 191**	**$ 438**	**$ 940**	**$ 155**	**$ 1,724**
Net Outlays					
Gross Outlays	$ 2,449	$ 5,569	$ 4,082	$ 381	$ 12,481
Offsetting Collections	(35)	(106)	(46)	(2)	(189)
Distributed Offsetting Receipts	-	-	-	(285)	(285)
Net Outlays	**$ 2,414**	**$ 5,463**	**$ 4,036**	**$ 94**	**$ 12,007**

27

INTERNAL REVENUE SERVICE

Required Supplementary Information - Unaudited

For the Years Ended September 30, 2011 and 2010

Schedule of Budgetary Resources by Major Budget Accounts

	2010				
(In Millions)	Taxpayer Service	Enforcement	Operations Support	Other Appropriations	Total
Budgetary Resources					
Unobligated Balance, Brought Forward, October 1	$ 156	$ 90	$ 217	$ 424	$ 887
Recoveries of Prior Year Unpaid Obligations	12	26	46	6	90
Budget Authority					
Appropriations	2,279	5,504	4,084	577	12,444
Spending Authority from Offsetting Collections	27	79	42	3	151
Nonexpenditure Transfers, Net	133	(10)	22	(145)	-
Permanently Not Available	(76)	(24)	(34)	(19)	(153)
Total Budgetary Resources	**$ 2,531**	**$ 5,665**	**$ 4,377**	**$ 846**	**$ 13,419**
Status of Budgetary Resources					
Obligations Incurred	$ 2,437	$ 5,574	$ 4,168	$ 424	$ 12,603
Unobligated Balance – Available	22	23	77	119	241
Unobligated Balance – Not Available	72	68	132	303	575
Total Status of Budgetary Resources	**$ 2,531**	**$ 5,665**	**$ 4,377**	**$ 846**	**$ 13,419**
Change in Obligated Balance:					
Obligated Balance, Net, Brought Forward, October 1	$ 205	$ 410	$ 826	$ 146	$ 1,587
Obligations Incurred	2,437	5,574	4,168	424	12,603
Gross Outlays	(2,430)	(5,524)	(3,986)	(384)	(12,324)
Recoveries of Prior Year Unpaid Obligations, Actual	(12)	(26)	(46)	(6)	(90)
Change in Uncollected Customer Payments from Federal Sources	-	(23)	(1)	-	(24)
Obligated Balances, Net, End of Period	**$ 200**	**$ 411**	**$ 961**	**$ 180**	**$ 1,752**
Net Outlays					
Gross Outlays	$ 2,430	$ 5,524	$ 3,986	$ 384	$ 12,324
Offsetting Collections	(27)	(56)	(41)	(3)	(127)
Distributed Offsetting Receipts	-	-	-	(283)	(283)
Net Outlays	**$ 2,403**	**$ 5,468**	**$ 3,945**	**$ 98**	**$ 11,914**

INTERNAL REVENUE SERVICE

Required Supplementary Information - Unaudited

For the Years Ended September 30, 2011 and 2010

Other Claims for Refunds

Management has estimated amounts which may be paid out as other claims for tax refunds. This estimate represents an amount (principal and interest) which may be paid for claims pending judicial review by the Federal courts or, internally, by Appeals. In FY 2011, the total estimated payout (including principal and interest) for claims pending judicial review by the Federal courts is $8.1 billion and by Appeals is $7.5 billion. In FY 2010, the total estimated payout (including principal and interest) for claims pending judicial review by the Federal courts was $8.8 billion and by Appeals was $8.0 billion. To the extent judgments against the government in these cases prompt other similarly situated taxpayers to file similar refund claims, these amounts could become significantly greater.

The Treasury Department made an administrative determination to accept the position that certain medical residents who received stipends be exempted from FICA taxes for periods before April 1, 2005. As of September 30, 2011, the IRS has estimated unpaid refund claims of approximately $3.7 billion. In accordance with Federal accounting standards, these claims have not been recorded in the financial statements because certain administrative processes had not yet been completed by the end of FY 2011.

Federal Taxes Receivable, Net

In accordance with SFFAS No. 7, some unpaid assessments do not meet the criteria for financial statement recognition as discussed in Note 1.F., Federal Taxes Receivable, Net and Due to Treasury. Although compliance assessments and write-offs are not considered receivables under Federal accounting standards, they represent legally enforceable claims of the IRS acting on behalf of the Federal government. There is, however, a significant difference in the collection potential of these categories.

The components of the total unpaid assessments and derivation of net Federal taxes receivable were as follows:

(In Billions)	2011	2010
Total unpaid assessments	$ 356	$ 330
Compliance assessments	(103)	(93)
Write-offs	(106)	(99)
Gross Federal taxes receivables	147	138
Allowance for uncollectible taxes receivable	(112)	(103)
Federal taxes receivable, net	**$ 35**	**$ 35**

The IRS cannot reasonably estimate the allowance for uncollectible amounts pertaining to its compliance assessments, and thus cannot determine their net realizable value or the value of the pre-assessment work-in-process.

To eliminate double-counting, the compliance assessments reported above exclude trust fund recovery penalties, totaling $2 billion and $3 billion as of September 30, 2011 and 2010, respectively, which

INTERNAL REVENUE SERVICE

Required Supplementary Information - Unaudited

For the Years Ended September 30, 2011 and 2010

were assessed against officers and directors of businesses who were involved in the non-remittance of Federal taxes withheld from their employees. The related unpaid assessments of those businesses are reported as taxes receivable or write-offs, but the IRS may also recover portions of those businesses' unpaid assessments from any and all individual officers and directors against whom a trust fund recovery penalty is assessed.

INTERNAL REVENUE SERVICE

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2011 and 2010

Refundable Tax Credits and Other Outlays

To provide tax relief to targeted individuals and businesses, Congress has provided assistance in the form of tax credits. For the majority of tax credits, the economic benefit is limited to the taxpayer's tax liability. Credits limited in this manner are termed nonrefundable credits. There exists a separate class of tax credits which is fully payable to the taxpayer, even if the credit exceeds the tax liability. These types of credits, designated as refundable, provide greater economic benefits because the taxpayer realizes the full benefit of the credit, regardless of the underlying tax liability.

The overview which follows summarizes the refundable credits which the IRS administers and pays. Included in the overview are descriptions of refundable credits in existence for many years as well as those enacted as part of the *American Recovery and Reinvestment Act of 2009* (ARRA) and the *Patient Protection and Affordable Care Act of 2010* (PPACA).

Stimulus Credit

In 2008, the Economic Stimulus Act provided taxpayers with a one-time rebate. These rebates were remitted to individuals who filed a 2007 tax return and met certain eligibility requirements. Although payments under this program were substantially completed by 2010, some earlier payments were returned to the IRS in 2011. These 2011 negative disbursements are reflected as such in the accompanying payment schedule.

Earned Income Tax Credit

The Earned Income Tax Credit (EITC) is a refundable tax credit for low to moderate income working individuals and families. Congress originally approved the tax credit legislation in 1975 in part to offset the burden of social security taxes and to provide an incentive to work. To qualify, taxpayers must meet certain requirements and file a tax return, even if they did not have sufficient income to meet regular tax return filing requirements.

Additional Child Tax Credit

The Additional Child Tax Credit is a special credit for taxpayers who work, have earnings below an established ceiling and have a qualifying child. The Child Tax Credit is limited to the taxpayer's tax liability and is a nonrefundable tax credit. However, certain individuals who receive less than the full amount of the Child Tax Credit may qualify for the "Additional" Child Tax Credit. Under this credit, subject to additional criteria, the taxpayer may receive the full credit amount even if such amount exceeds the taxpayer's tax liability. Consequently, the Additional Child Tax Credit is categorized as a refundable tax credit.

Health Care Tax Credit

The Health Care Tax Credit was established in 2002 to assist economically dislocated workers in acquiring or continuing critical health care coverage during periods of economic distress. Under this credit, participants can elect to take a portion of their premium as a credit on their tax return.

INTERNAL REVENUE SERVICE

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2011 and 2010

Alternatively, participants can elect to receive direct reimbursements should they have insufficient tax liability against which to apply the credit.

Individual Alternative Minimum Tax (AMT) Credit

In 2007, the Individual Alternative Minimum Tax (AMT) Credit was established. This refundable credit is calculated by referencing specific timing items which produced an AMT liability in earlier years. Timing items involve certain transactions such as incentive stock options and adjustments for accelerated depreciation. Non timing events, such as having a large number of exemptions or a large itemized deduction for state and local taxes, will not qualify for the credit.

First-Time Home Buyer Credit

In 2008, Congress provided taxpayers with a refundable tax credit equivalent to an interest-free loan equal to ten percent of the purchase of a home (up to $7,500) by a first-time home buyer. The provision applied to homes purchased on or after April 9, 2008 and before July 1, 2009. Taxpayers receiving this tax credit are required to repay any amount received under this provision back to the government over 15 years in equal installments, or earlier if the home is sold. The credit phases out for taxpayers with adjusted gross income in excess of $75,000 ($150,000 in the case of a joint return).

The ARRA bill eliminated the repayment obligation for taxpayers who purchase homes after January 1, 2009, increased the maximum value of the credit to $8,000, and removed the prohibition on financing by mortgage revenue bonds. Additionally, ARRA extended the availability of the credit for homes purchased before December 1, 2009. The ARRA provision retains the credit recapture if the house is sold within three years of purchase.

Corporate Alternative Minimum Tax (AMT) Credit

Section 168(k)(4) allows a taxpayer to elect to claim a refundable credit for certain unused research credits in lieu of the special depreciation allowance for eligible property.

American Opportunity Tax Credit

The American Opportunity Tax credit modifies the existing Hope Credit for tax years 2009 and 2010. This tax credit makes the Hope Credit available to a broader range of taxpayers including many with higher incomes and those who owe no tax. Additionally, it adds required course materials to the list of qualifying expenses and allows the credit to be claimed for four post-secondary education years instead of two. Many of those eligible will qualify for the maximum annual credit of $2,500 per student.

Making Work Pay Credit and Credit for Certain Government Retirees

The Making Work Pay Credit and Credit for Certain Government Retirees was established in 2009. This is a refundable tax credit calculated at a rate of 6.2 percent of earned income, phasing out for taxpayers with adjusted gross income in excess of $75,000 ($150,000 for married couples filing jointly). Taxpayers receive this benefit through a reduction in the amount of income tax withheld from their paychecks or through claiming the credit on their tax returns. The Making Work Pay Credit is reduced by a separate $250 credit (the Credit for Certain Government Retirees) for government retirees who are not eligible for Social Security benefits.

INTERNAL REVENUE SERVICE

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2011 and 2010

Build America and Recovery Zone Bonds (BAB)

BABs are a financing tool for state and local governments. The bonds, which allow a new direct Federal payment subsidy, are taxable bonds issued by state and local governments which will give them access to the conventional corporate debt markets. At the election of the state and local governments, the Treasury Department will make a direct payment to the state or local governmental issuer in an amount equal to 35 percent of the interest payment on the Build America Bonds. As a result of this Federal subsidy payment, state and local governments will have lower net borrowing costs and be able to reach more sources of borrowing than with more traditional tax-exempt or tax credit bonds.

Created by the ARRA, Recovery Zone Bonds are targeted to areas particularly affected by job losses and will help local governments obtain financing for much needed economic development projects, such as public infrastructure development.

Qualified Zone Academy Bonds (QZAB) and Qualified School Construction Bonds (QSCB)

Congress created QZABs and QSCBs to help schools raise funds to renovate and repair buildings, invest in equipment and current technology, develop more challenging curricula, and train teachers.

The tax credit portion of these bonds depends on the issuance date of the bonds, the number of bonds outstanding and their redemption. The total volume cap for these bonds is $4 billion for the QZABs while the QSCBs do not have a volume cap.

Qualified Energy Conservation and New Clean Renewable Energy Bonds

Qualified Energy Conservation Bonds (QECB) may be issued by state, local and tribal governments to finance qualified energy conservation projects. A minimum of 70 percent of a state's allocation must be used for governmental purposes, and the remainder may be used to finance private activity projects. QECBs were originally structured as tax credit bonds. However, the March 2010 HIRE Act (H.R. 2847 (Sec. 301)) changed QECB from tax credit bonds to direct subsidy bonds similar to BABs. The QECB issuer pays the investor a taxable coupon and receives a rebate from the U.S. Treasury.

New Clean Renewable Energy Bonds (CREBs) may be issued by public power utilities, electric cooperatives, government entities (states, cities, counties, territories, Indian tribal governments), and certain lenders to finance renewable energy projects. CREBs were originally structured as tax credit bonds. However, the March 2010 HIRE Act (H.R. 2847 (Sec. 301)) changed CREBs from tax credit bonds to direct subsidy bonds similar to BABs. The issuer pays the investor a taxable coupon and receives a rebate from the U.S. Treasury.

COBRA Continuation Coverage for Unemployed Workers

To assist persons in maintaining health coverage for themselves and their families, ARRA provides a 65 percent subsidy for COBRA continuation premiums for up to nine months for workers who have been involuntarily terminated. Additionally, this subsidy applies to health care continuation coverage if required by states for small employers.

33

INTERNAL REVENUE SERVICE

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2011 and 2010

To qualify for premium assistance, a worker must be involuntarily terminated between September 1, 2008 and December 31, 2009. The subsidy would terminate upon an offer of any new employer-sponsored health care coverage or Medicare eligibility. Workers who were involuntarily terminated between September 1, 2008 and enactment, but failed to initially elect COBRA because it was unaffordable, would be given an additional 60 days to elect COBRA and receive the subsidy. To ensure this assistance is targeted at workers who are most in need, participants must attest their same year income will not exceed $125,000 for individuals and $250,000 for families.

COBRA continuation coverage payments to workers are initially paid by the employer. The employer receives reimbursement either as a direct refund or through their payroll tax return where payments are taken as a credit against existing withholdings and payroll taxes.

Adoption Tax Credit

Individuals qualify for the adoption tax credit if they have adopted a child and paid out-of-pocket expenses relating to the adoption. They may claim an adoption credit of up to $13,170 (for tax year 2010) per eligible child. The credit is phased out based on the individual's modified adjusted gross income.

Small Business Insurance Tax Credit

Certain small employers will be eligible for a tax credit, provided they contribute a uniform percentage of at least 50 percent toward their employees' health insurance. For nonprofit (tax-exempt) organizations, the credit will be in the form of a reduction in income and Medicare tax the employer is required to withhold from employees' wages and the employer share of Medicare tax on employees' wages.

Therapeutic Discovery Grants

The Qualifying Therapeutic Discovery Project tax credit is provided under new Section 48D of the Internal Revenue Code (26 USC), enacted as part of the PPACA. The credit is a tax benefit targeted to certain therapeutic discovery projects. Such projects must show a reasonable potential to (1) achieve new therapies to treat unmet medical needs, (2) detect or treat chronic or acute diseases and conditions, (3) reduce the long-term growth of health care costs, or (4) significantly advance the goal of curing cancer.

INTERNAL REVENUE SERVICE

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2011 and 2010

The following table summarizes refundable tax credits in excess of tax liabilities and outlays paid in FY 2011 and FY 2010.

(In Millions)	2011	2010
Stimulus Credit *	$ (269)	$ 81
Earned Income Tax Credit	55,652	54,712
Additional Child Tax Credit	22,691	22,659
Health Care Tax Credit	185	205
Individual Alternative Minimum Tax (AMT) Credit	458	1,034
First-Time Homebuyer Credit	2,185	8,668
Corporate Alternative Minimum Tax (AMT) Credit	65	86
American Opportunity Tax Credit	5,604	3,851
Making Work Pay Credit	13,905	13,694
Build America and Recovery Zone Bonds	3,597	1,376
COBRA Credit	2,191	3,857
Credit for Certain Government Retirees	1	46
Qualified Zone Academy Bonds	19	-
Qualified School Construction Bonds	349	-
Clean Renewable Energy Bonds	11	-
Energy Conservation Bonds	9	-
Adoption Credit	719	-
Small Business Health Insurance Tax Credit	30	-
Therapeutic Discovery Grants	960	-
Refundable Tax Credits	**$ 108,362**	**$ 110,269**

* Reflects net return of payments.

INTERNAL REVENUE SERVICE

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2011 and 2010

Social Security and Medicare Taxes

The Federal Insurance Contributions Act (FICA) provides for a Federal system of old-age, survivors, disability, and hospital insurance benefits. Payments to trust funds established for these programs are financed by payroll taxes on employee wages and tips, employers' matching payments, and a tax on self-employment income.

A portion of FICA benefits involves old-age, survivors, and disability payments. These benefits are funded by the social security tax, which is currently 4.2 percent of wages and tips up to $106,800 and an employer matching amount of 6.2 percent bringing the total rate to 10.4 percent for calendar year 2011. In calendar year 2010, the rate was 6.2 percent of wages and tips up to $106,800 and an employer matching amount of 6.2 percent bringing the total rate to 12.4 percent. These benefits are also funded by a self-employment tax of 10.4 and 12.4 percent on self employment income up to $106,800 for calendar years 2011 and 2010, respectively. Remaining benefits under FICA pertain to hospital benefits (referred to as "Medicare") and are funded by a separate 1.45 percent tax on all wages and tips (there is no wage limit) and the employer matching contribution of 1.45 percent bringing the total rate to 2.9 percent. Self-employed individuals pay a Medicare tax of 2.9 percent on all self-employment income. Social Security taxes collected by the IRS were estimated to be approximately $572 billion and $639 billion in FY 2011 and FY 2010, respectively. Medicare taxes collected by the IRS were estimated to be approximately $190 billion and $182 billion in FY 2011 and FY 2010, respectively. Social Security taxes and Medicare taxes are included in individual income, FICA/SECA and other on the Statement of Custodial Activity.

Tax Gap

The tax gap is the difference between the amount of tax imposed by law and what taxpayers actually pay on time. The tax gap arises from the three types of noncompliance: not filing required tax returns on time or at all (the nonfiling gap), underreporting the correct amount of tax on timely filed returns (the underreporting gap), and not paying on time the full amount reported on timely filed returns (the underpayment gap). Of these three components, only the underpayment gap is observed; the nonfiling gap and the underreporting gap must be estimated. The tax gap, estimated to be about $345 billion for tax year 2001 (the most recent estimate made), represents the net amount of noncompliance with the tax laws. Underreporting of tax liability accounts for 82 percent of the gap, with the remainder almost evenly divided between nonfiling (eight percent) and underpaying (ten percent). Part of the estimate is based on data from a study of individual returns filed for tax year 2001. It does not include any taxes that should have been paid on income from illegal activities. Each instance of noncompliance by a taxpayer contributes to the tax gap, whether or not the IRS detects it, and whether or not the taxpayer is even aware of the noncompliance. Some of the tax gap arises from intentional (willful) noncompliance, and some of it arises from unintentional mistakes.

The collection gap is the cumulative amount of tax, penalties, and interest that has been assessed over many years, but has not been paid by a certain point in time, and which the IRS expects to remain uncollectible. In essence, it represents the difference between the total balance of unpaid assessments and the net taxes receivable reported on the balance sheet of the IRS. The tax gap and the collection gap are related and overlapping concepts, but they have significant differences. The collection gap is a cumulative balance sheet concept for a particular point in time, while the tax gap is like an income statement item for a single year. Moreover, the tax gap estimates include all noncompliance, while the

INTERNAL REVENUE SERVICE

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2011 and 2010

collection gap includes only amounts that have been assessed (a small portion of all noncompliance) and have not yet reached their statutory collection expiration date. Also, the tax gap includes only tax, while the collection gap includes tax, penalties, and interest.

Tax Burden and Tax Expenditures

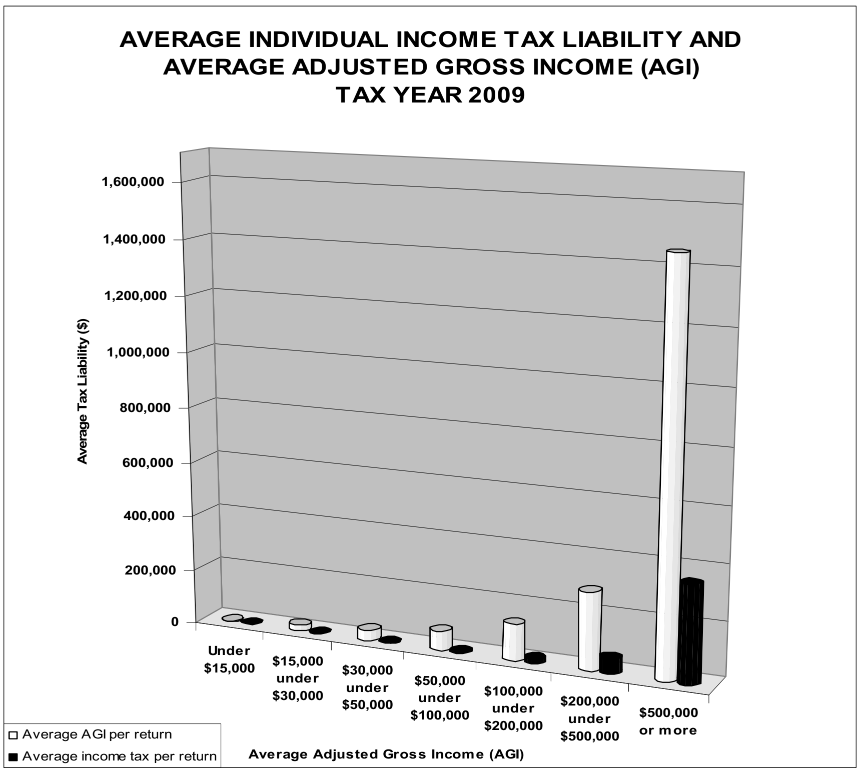
The Internal Revenue Code provides for progressive rates of tax, whereby higher incomes are generally subject to higher rates of tax. The following graphs and charts present the latest available information on income tax and adjusted gross income (AGI) for individuals by AGI level and for corporations by size of assets. For individuals, the information illustrates, in percentage terms, the tax burden borne by varying AGI levels. For corporations, the information illustrates, in percentage terms, the tax burden borne by these entities by various sizes of their total assets. The graphs are representative of more detailed data and analysis available from the Statistics of Income (SOI) office.

Total tax expenditures are the foregone Federal revenue resulting from deductions and credits provided in the Internal Revenue Code. Since tax expenditures directly affect funds available for government operations, decisions to forego Federal revenue are as important as decisions to spend Federal revenue.

INTERNAL REVENUE SERVICE

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2011 and 2010



Adjusted gross income (AGI)	Number of taxable returns (in thousands)	AGI (in millions)	Total income tax (in millions)	Average AGI per return (in whole dollars)	Average income tax per return (in whole dollars)	Income tax as a percentage of AGI
Under $15,000	37,624	76,133	1,354	2,024	36	1.8%
$15,000 under $30,000	30,097	662,180	14,013	22,002	466	2.1%
$30,000 under $50,000	25,168	982,969	45,556	39,056	1,810	4.6%
$50,000 under $100,000	30,159	2,139,407	158,455	70,938	5,254	7.4%
$100,000 under $200,000	13,522	1,801,447	212,291	133,223	15,700	11.8%
$200,000 under $500,000	3,195	905,347	176,322	283,364	55,187	19.5%
$500,000 or more	729	1,058,948	257,958	1,452,604	353,852	24.4%
Totals	**140,494**	**7,626,431**	**865,949**	**-**	**-**	**-**

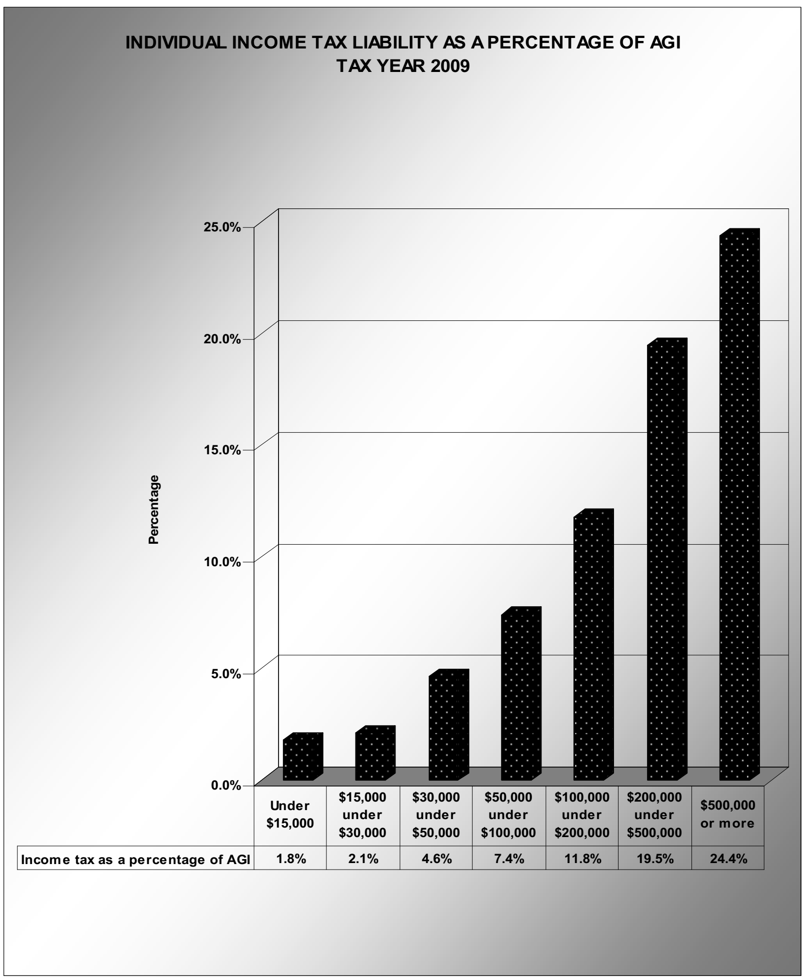
(All figures are estimates and based on samples provided by the Statistics of Income (SOI) Office)

38

INTERNAL REVENUE SERVICE

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2011 and 2010



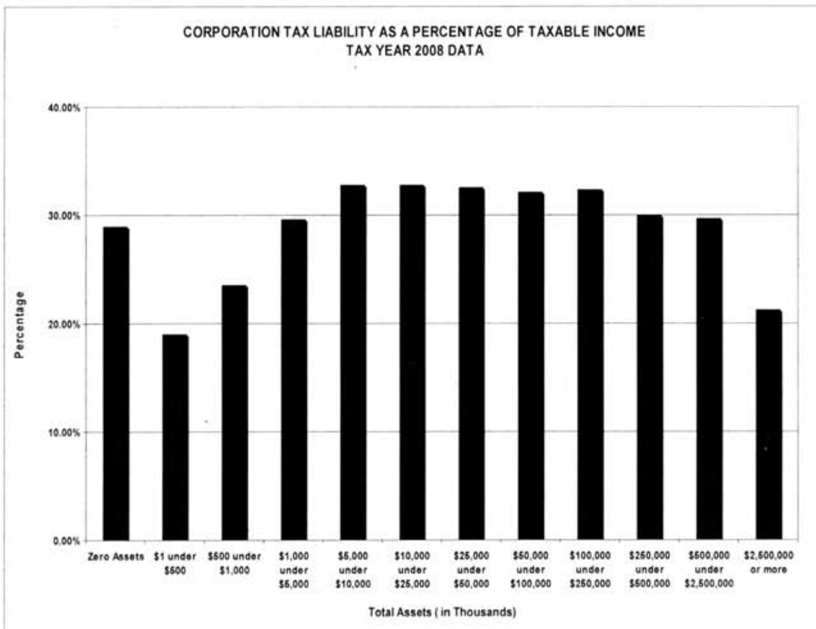
(All figures are estimates and based on samples provided by the Statistics of Income (SOI) Office)

39

INTERNAL REVENUE SERVICE

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2011 and 2010



Total Assets (in thousands)	Income subject to tax (in millions)	Total income tax after credits (in millions)	Percentage of income tax after credits to taxable income
Zero Assets	13,373	3,870	28.9%
$1 under $500	7,414	1,406	19.0%
$500 under $1,000	3,778	889	23.5%
$1,000 under $5,000	12,785	3,783	29.6%
$5,000 under $10,000	7,846	2,569	32.7%
$10,000 under $25,000	11,898	3,893	32.7%
$25,000 under $50,000	10,343	3,366	32.5%
$50,000 under $100,000	12,766	4,100	32.1%
$100,000 under $250,000	23,043	7,445	32.3%
$250,000 under $500,000	30,685	9,180	29.9%
$500,000 under $2,500,000	107,715	31,935	29.6%
$2,500,000 or more	736,507	156,087	21.2%
Total	**978,153**	**228,523**	**23.4%**

(All figures are estimates and based on samples provided by the Statistics of Income (SOI) Office)

40

Material Weaknesses, Significant Deficiency, and Compliance Issues

During our audit of the Internal Revenue Service's (IRS) fiscal years 2011 and 2010 financial statements, we identified material weaknesses[1] in internal control over unpaid tax assessments[2] and information security, a significant deficiency[3] in internal control over the processing of tax refunds, and a noncompliance with legal provisions in IRS's management of the release of federal tax liens.

In evaluating the materiality of identified deficiencies in internal control to determine whether they represent a material weakness or significant deficiency, the auditor assesses the risk and magnitude of potential misstatements that may not be prevented or be timely detected and corrected by the entity's internal control due to the existence of the identified deficiency or combination of deficiencies. Because the judgments of financial statement users encompass not only the amounts and disclosures contained in the financial statements but are also made in light of surrounding circumstances, materiality judgments necessarily involve both quantitative and qualitative considerations. Quantitative considerations refer to the dollar magnitude of actual or potential misstatements. Qualitative considerations include the sensitivity of the circumstances and perceived importance surrounding the actual or potential misstatement and the significance of the financial statement element(s) affected by the actual or potential misstatement. After considering both quantitative and qualitative factors, we concluded, as discussed below, that deficiencies we identified in IRS's internal control over unpaid tax assessments and information security constitute material weaknesses.

[1]A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. Materiality represents the magnitude of an omission or misstatement of an item in a financial report that, when considered in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the inclusion or correction of the item.

[2]An unpaid tax assessment is a legally enforceable claim against a taxpayer and consists of taxes, penalties, and interest that have not been collected or abated (a reduction in a tax assessment).

[3]A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Material Weaknesses

During our audits of IRS's fiscal years 2011 and 2010 financial statements, we identified material weaknesses in IRS's internal control over unpaid tax assessments and information security. These material weaknesses, which we also reported on last year, represent significant management challenges and have (1) impaired management's ability to prepare its balance sheet without extensive compensating procedures, (2) limited the availability of reliable information to assist management in making well-informed decisions concerning its unpaid tax assessments on an ongoing basis, (3) resulted in errors in taxpayer accounts that increased taxpayer burden, and (4) reduced assurance that data processed by IRS's information systems are reliable and that sensitive taxpayer information is appropriately protected. We reported on each of these deficiencies last year[4] and in prior audits.

Unpaid Tax Assessments

During fiscal year 2011, we continued to find serious deficiencies in IRS's internal control over unpaid tax assessments. Specifically, we continued to find (1) IRS's reported balances for taxes receivable and other unpaid tax assessments[5] were not traceable from its general ledger system for tax administration–related transactions (the Redesign Revenue Accounting Control System, or RRACS),[6] to individual transactions in underlying source records, (2) IRS lacked a subsidiary ledger for unpaid tax assessments that would allow it to produce reliable, useful, and timely information with which to manage and report externally on its unpaid tax

[4]GAO, *Financial Audit: IRS's Fiscal Years 2010 and 2009 Financial Statements*, GAO-11-142 (Washington, D.C.: Nov. 10, 2010).

[5]Federal accounting standards classify unpaid tax assessments into one of the following three categories for reporting purposes: federal taxes receivable, compliance assessments, and write-offs. Federal taxes receivable are taxes due from taxpayers for which IRS can support the existence of a receivable through taxpayer agreement or a favorable court ruling. Compliance assessments are tax assessments where neither the taxpayer nor the court has affirmed that the amounts are owed. Write-offs represent unpaid tax assessments for which IRS does not expect further collections because of factors such as the taxpayer's death, bankruptcy, or insolvency. Of these three classifications of unpaid tax assessments, only federal taxes receivable, net of an allowance for uncollectible amounts, are reported on the financial statements.

[6]In January 2010, IRS implemented RRACS to account for custodial tax activities including tax revenue, tax refunds, and taxes receivable. RRACS is an enhancement to the previous general ledger system known as the Interim Revenue Accounting Control System (IRACS) and RRACS is designed to conform to the governmentwide United States Standard General Ledger (USSGL) at the transaction level.

assessments, and (3) IRS experienced errors and delays in recording taxpayer information, payments, and other tax assessment–related activities.

Similar to our findings in prior years,[7] IRS's balance for federal taxes receivable, which comprised over 80 percent of IRS's total assets as reported on its fiscal year 2011 balance sheet, is a product of a compensating statistical estimation process rather than the summation of individual account balances. IRS's financial management systems could not reliably classify and report the transaction-by-transaction unpaid tax assessments balances in accordance with federal accounting standards due to material inaccuracies. To compensate for this deficiency, IRS applied a statistical sampling and estimation process to data from its master files[8] to estimate the year-end balances of (1) taxes receivable in its financial statements and required supplementary information and (2) compliance assessments and write-offs in its required supplementary information.

While IRS adjusts the gross taxes receivable balance in its general ledger based on the results of this estimation process, IRS could not trace adjusted account balances to its detailed supporting records. This process leaves IRS unable to identify which taxpayers owe the tax debts summarized in the gross taxes receivable balance or how much each one owes, and unable to trace transactions from the taxes receivable amount, through its general ledger system, and back to underlying transaction-level source documents. Such traceability is necessary to enable IRS to ensure that recorded transactions are complete, accurate, and supported by underlying records.

Over the years, IRS has taken a number of actions intended to improve its accounting and reporting of unpaid tax assessments. IRS began phasing in the use of the Custodial Detail Data Base (CDDB) in 2006. One key objective of CDDB was to serve as a transaction-level subsidiary ledger for unpaid tax assessments by linking and classifying taxpayer account information from IRS's master files to its general ledger for tax-related transactions and activity, thus providing transactional traceability. In fiscal

[7] GAO-11-142.

[8] IRS's master files contain detailed records of taxpayer accounts. However, the master files do not contain all the details necessary to properly classify or estimate collectibility for unpaid tax assessment accounts.

year 2008, IRS enhanced CDDB to analyze and record unpaid tax assessments balances from its master file on a weekly basis, including related interest and penalty accruals, to its general ledger by the various financial reporting categories (taxes receivable, compliance assessments, and write-offs). These enhancements established CDDB's capability to function as a transaction-level subsidiary ledger for unpaid tax assessments.

However, IRS cannot yet use CDDB as its subsidiary ledger for recording transaction-based tax debt information to its RRACS general ledger in a manner that ensures reliable internal and external reporting on the status of unpaid tax assessments. While CDDB analyzes and classifies master file tax debt transactions into the various financial reporting categories, IRS found that the analysis and classification continues to contain material inaccuracies. Specifically, through the use of its statistical sampling and estimation process, IRS identified errors necessitating almost $9 billion in adjustments to the 2011 fiscal year-end gross taxes receivable balance produced by CDDB. Accordingly, IRS must continue to use a resource-intensive statistical sampling and estimation process to adjust the amounts for taxes receivable and other unpaid tax assessments produced by its systems in order to derive reliable amounts for internal and external reporting. This process took IRS several months to complete and required a multibillion-dollar adjustment to the fiscal year 2011 year-end taxes receivable balance in its general ledger. Once adjusted, the taxes receivable balance in the general ledger could no longer be traced back to underlying transaction-level source documents. Consequently, the lack of an effective transaction-level subsidiary ledger continued to inhibit IRS's ability to timely develop reliable financial and management reports useful for ongoing management decisions and external reporting of unpaid tax assessments in accordance with federal accounting standards.

During our fiscal year 2011 audit, we continued to identify systemic deficiencies in the programs used by CDDB that resulted in it misclassifying tax debt accounts among the three financial reporting categories—taxes receivable, compliance assessments, and write-offs. Such systemic deficiencies involve CDDB not correctly classifying account modules[9] because IRS had not written sufficient details into the CDDB classification program to allow it to sort through, identify, and analyze all the relevant transaction-level information required for proper classification, recording, and reporting. For example, when IRS records multiple tax assessments on a single account module, CDDB is currently unable to distinguish among and separately classify the various balances. In a number of the cases we reviewed, a taxpayer filed a tax return but did not pay the entire amount of the self-reported tax liability, which results in the amount owed, including related penalties and interest, being classified as taxes receivable.[10] IRS later assessed additional taxes against the taxpayer through its Automated Underreporter (AUR) program for the same tax period.[11] However, these taxpayers did not agree to the additional AUR tax assessment. Consequently, the additional AUR tax assessment, along with any related penalties and interest, should have been classified as a compliance assessment.[12] Instead, CDDB classified the total outstanding balance in the account module as taxes receivable because CDDB programming did not provide for separate classification of different tax assessments recorded on the same account module into separate accounting categories. Consequently, IRS had to manually reclassify a portion of the balance from these account modules to compliance assessments.

[9]A taxpayer may have multiple account modules within IRS's master files under a unique taxpayer identification number, that is, Social Security number or an employer identification number. Each unique account module is identified by the taxpayer identification number, specific tax period (e.g., year, quarter), and tax type (e.g., excise tax, individual tax, payroll tax, etc.).

[10]According to federal accounting standards, the self-reporting of an outstanding tax liability establishes the outstanding balance as a tax receivable for financial reporting purposes.

[11]AUR is designed to identify underreported income by matching taxpayer-reported information against information submitted to IRS by third parties, such as interest or dividend information submitted by financial institutions.

[12]According to federal accounting standards, outstanding tax liabilities are to be classified as compliance assessments when there is no evidence that the taxpayer agreed with the tax assessment, and there is no court order in favor of IRS's tax assessment, unless IRS determines the assessment has no future collection potential, in which case it is to be classified as a write-off.

In another example, CDDB was unable to process and properly classify related account modules associated with unpaid payroll taxes when IRS had (1) designated a business as defunct,[13] (2) assessed a trust fund recovery penalty (TFRP)[14] against an officer of the business for a specific tax period,[15] and (3) assessed the same individual a TFRP from a different business for the same tax period. In a number of cases we reviewed, a business filed a Form 941 tax return reporting payroll taxes for a particular tax period, but did not pay the full amount of the self-reported tax. IRS assessed a TFRP against an officer of the business in relation to the unpaid payroll taxes for the particular tax period. However, because the business became defunct, IRS's only recourse was to pursue collection on the TFRP from the officer. In this situation, CDDB should have (1) classified the outstanding TFRP against the officer as taxes receivable, (2) classified a like amount of the business's outstanding payroll tax as a duplicate tax assessment that is not counted for financial reporting purposes, and (3) classified any remaining balance from the business's unpaid payroll tax account module that is above the TFRP amount as a write-off. However, in these cases, IRS had also assessed the same corporate officer a TFRP related to another business for the same tax period. Because there were two separate TFRP tax assessments recorded on the officer's master file account module for the same tax period, CDDB was unable to process and correctly classify the related account modules. As a result of the programming deficiency, CDDB defaulted to classifying the business's outstanding payroll tax account as taxes receivable and classifying the individual's TFRP accounts as duplicate tax assessments. Since the business was defunct and the

[13]A defunct business is one that is no longer operating and does not have any assets IRS can levy to pay off some or all of the business's outstanding tax debt.

[14]When a business willfully fails to collect, account for, or pay the taxes it is legally required to withhold from its employees' wages, such as Social Security or individual income tax withholdings (what is commonly referred to as "trust fund taxes"), IRS assesses underpayment penalties against the business and may impose an additional trust fund recovery penalty (TFRP) against the responsible officers. Although IRS has the authority to assess the TFRP individually against all responsible officers, the full amount of the TFRP need only be paid once. Thus, IRS may record tax assessments against each of several individuals for the employee-withholding component of the payroll tax liability of a given business in an effort to collect the total tax liability of the company. See 26 U.S.C. § 6672 and implementing IRS guidance for IRS policy in the *Internal Revenue Manual* at § 4.23.9.13, Trust Fund Recovery Penalty (May 14, 2008).

[15]The tax period for reporting payroll taxes is a 3-month period referred to as a "quarter." For example, the quarter ended March 31 includes the months of January, February, and March.

amount of the payroll tax owed by the business was more than the amount of the TFRP assessed against the individual, the taxes receivable balance was overstated by the amount assessed against the defunct business that was in excess of the TFRP assessment. Consequently, IRS had to make adjustments to reduce the balance on the business account in order to report the correct balance of taxes receivable.

In addition to CDDB's systemic limitations, IRS's management and reporting of unpaid tax assessments also continued to be hindered by inaccurate tax records. During our fiscal year 2011 audit, we again found errors in taxpayer records resulting from IRS not recording information accurately and timely. Such errors directly affect the accuracy of CDDB's tax debt classification and reporting. Additionally, such errors can cause frustration and place additional burden on taxpayers who either have already paid taxes owed or who owe significantly lower amounts than IRS's records indicate.

In a number of cases we reviewed, IRS erroneously recorded information in its master files that indicated the taxpayer had agreed with an unpaid tax assessment. Such errors included IRS (1) recording that the taxpayer agreed with an examination tax assessment when, in fact, the taxpayer had not agreed, (2) recording that a taxpayer had entered into an installment agreement to pay off the outstanding balance when, in fact, the taxpayer had not entered into such an agreement with IRS, and (3) recording payments in the wrong account module of taxpayers.[16] Erroneous entry of information indicating taxpayer agreement resulted in CDDB misclassifying these account modules as taxes receivable. Because there was no actual agreement by the taxpayer to the outstanding tax assessment in these cases, IRS had to reclassify these account modules as compliance assessments. In another example, we found that IRS made a data entry error when recording information from a taxpayer's partnership tax return that resulted in a tax assessment against the taxpayer for approximately $10.5 million when the taxpayer had reported a tax liability of $1 million. IRS's error created a balance due

[16]According to federal accounting standards, taxpayer agreement to an outstanding tax liability establishes the outstanding balance as a tax receivable for financial reporting purposes. When there is no other evidence of taxpayer agreement, such as the filing of a tax return, IRS programmed CDDB to interpret a series of payments on an account module to indicate agreement by the taxpayer. When a taxpayer has unpaid tax assessments for multiple tax periods, criteria in the Internal Revenue Manual establishes the order in which IRS should apply these payments.

within the account and led to IRS erroneously issuing a notice to the taxpayer requesting payment for over $10 million. When the taxpayer received the notice, the taxpayer researched the issue, determined that it was the result of an IRS error, and contacted IRS to report IRS's error. Although IRS subsequently corrected the information in the taxpayer's account module, the identification and resolution of the error placed a significant burden on the taxpayer.

Not properly recording payments to all related taxpayer accounts associated with unpaid payroll taxes continued to adversely affect the accuracy of IRS's records. As we previously reported,[17] IRS's systems were unable to automatically link the account information between a business and the responsible officers, as well as account information between related officers assessed a TFRP for the same business.[18] Consequently, transactions recorded in one account that should have been reflected in other related accounts were not automatically recorded. If the business or one of its officers paid some or all of the outstanding payroll tax or related TFRP, IRS's systems were unable to automatically reflect the payment as a reduction to the outstanding liability in the related accounts. IRS has taken a number of corrective actions in response to this deficiency. For example, in April 2010, IRS began conducting its own periodic testing of TFRP payment processing to identify and address the root cause of errors and delays. In addition, in 2008, IRS completed the implementation of the Automated Trust Fund Recovery (ATFR) system, which interfaces with the business and individual master files[19] to facilitate the linking of payment information to related parties. One of the key objectives of ATFR is to automatically record a reduction to the outstanding liability of related taxpayer accounts when either the business or any one of the responsible officers makes a payment. However, as of February 2011, IRS reported that ATFR can automatically credit the outstanding tax liability of related taxpayer accounts for only about

[17]GAO, *Management Report: Improvements Are Needed in IRS's Internal Controls and Compliance with Laws and Regulations*, GAO-10-565R (Washington, D.C.: June 28, 2010).

[18]See footnote 14 for explanation of the relationship between a business and responsible officers assessed a TFRP for that business.

[19]IRS records the payroll tax assessments against businesses on its business master file, which contains tax records of corporations and other businesses. IRS records the TFRP assessments against officers on the individual master file, which contains tax records of individual taxpayers.

57 percent of TFRP payments IRS processes through ATFR.[20] The remaining 43 percent of TFRP payments require some form of manual intervention in order to credit the outstanding tax liability on related taxpayer accounts because these payment transactions are too complex for ATFR to automatically credit related accounts without human verification.

While IRS's actions have improved the accuracy and timeliness of recording trust fund recovery penalty payments to related parties, our work in fiscal year 2011 continued to find deficiencies in this process, leading to errors in taxpayers' accounts. In our testing of 93 statistically selected payments received in the first 6 months of fiscal year 2011 that were recorded on TFRP accounts, we found four instances in which IRS did not properly record payments received on all related taxpayer accounts due to ineffective controls. Based on our testing, we are 95 percent confident that up to 9.6 percent of TFRP payment transactions in the first 6 months of fiscal year 2011 that were posted on TFRP accounts could contain inaccuracies.[21] On the basis of these results, we concluded that IRS's controls for ensuring the accuracy and timeliness of recording TFRP payments to all related parties remain ineffective.

Furthermore, the processing delays and errors we continued to find contributed to IRS's inability to timely release federal tax liens against taxpayers who fully satisfied or were otherwise relieved of their tax liability. Such delays and errors resulted not only in inaccurate tax records but also delayed IRS's release of federal tax liens and may cause undue burden on any taxpayers attempting to sell property or apply for commercial credit.[22]

Current systemic limitations and processing errors that caused inaccurate tax records resulted in IRS having to make numerous adjustments as part

[20]According to IRS, about 18 percent of total TFRP payment transactions are not processed through ATFR at all but are instead manually processed. Such payments relate to TFRP assessments that IRS recorded prior to August 2001 using procedures that prevent ATFR from recognizing related accounts in IRS's master files.

[21]When evaluating statistical results, GAO compares the projected upper error limit to the acceptable error rate set for the test. For this test, we set the acceptable error rate at 5 percent. While the projected most likely error is 4.3 percent, we are 95 percent confident that the upper error limit does not exceed 9.6 percent. Because the error rate in the tested population could be as high as 9.6 percent, we concluded that the errors in the tested population exceed the amount we designated as acceptable.

[22]This issue is discussed further in the Compliance Issues section of this report.

of its process for reporting net taxes receivable and other unpaid tax assessment balances in its financial statements and required supplementary information. IRS identified misclassified tax assessment records when reviewing a sample of unpaid tax assessment cases during fiscal year 2011. To address these errors, it recorded adjustments to affected accounts to reflect the correct account values at the point in time that IRS sampled the account information. On the basis of a statistical projection of these individual adjustments, IRS had to make a multibillion dollar adjustment to the year-end balance of gross taxes receivable generated by CDDB in order to produce a reliable taxes receivable balance for external reporting on its balance sheet for fiscal year 2011. Absent the use of this statistical estimation process, the various fiscal year 2011 unpaid tax assessment balances produced by CDDB would have been materially inaccurate.

The progress IRS has made to date with using CDDB is an important step in moving toward a fully functioning subsidiary ledger that could provide for full traceability of detailed taxes receivable transaction information from taxpayer accounts to the general ledger. However, IRS has not yet fully addressed all the issues that cause material inaccuracies in the unpaid tax assessments information produced by CDDB. This will require further enhancements to CDDB to enable it to more accurately distinguish between the three categories of unpaid tax assessments, and improving controls over the recording of information in taxpayer accounts so that reliable transaction-based balances for taxes receivable can be ultimately recorded in the general ledger. We issued a report in 2010 discussing the existing deficiencies in internal control in this area and made recommendations to address those issues.[23]

Information Security

IRS relies extensively on computerized systems to process and report its financial transactions and to support its mission-related operations. Ensuring that financial transactions and related taxpayer and other sensitive information are adequately safeguarded to prevent inadvertent or deliberate alteration, improper disclosure, modification, or destruction requires effective information system controls. Ineffective information system controls over the automated aspects of financial transaction processing can jeopardize the accuracy, completeness, and timeliness of

[23] GAO-10-565R.

financial information used by management and increase the risk that sensitive agency and taxpayer information may be compromised. These deficiencies also increase the risk that errors or irregularities may affect IRS's financial information and not be detected and corrected in time to prevent material misstatement of IRS's financial statements or other internal and external reports.[24]

During fiscal year 2011, IRS management devoted attention and resources to addressing the agency's information security controls. The agency developed enterprise-wide security initiatives that are designed to improve its controls and provide management with the ability to measure the state of IRS's controls. For example, IRS formed cross-functional working groups with knowledge of the IRS internal systems to address identified areas considered at risk.

Nevertheless, the agency made limited progress in correcting information security weaknesses we identified in previous audits. IRS addressed approximately 15 percent of the 105 open recommendations that we had previously reported. For example, IRS took action to address recommendations related to (1) encrypted data transfers for its Integrated Financial System (IFS),[25] thereby decreasing the risk that malicious users could capture sensitive information; (2) upgraded domain name system servers, thereby decreasing the risk that known vulnerabilities may not be mitigated; and (3) improved the infrastructure supporting RRACS, thereby decreasing the risk of exposure to unauthorized access or manipulation through the exploitation of known vulnerabilities.

[24]As discussed above, measurements of materiality encompass both quantitative and qualitative considerations. Quantitative considerations refer to the dollar magnitude of actual or potential misstatements, while qualitative considerations encompass surrounding circumstances which, in the judgment of the auditors, may significantly elevate financial statements users' perceptions of the importance of actual or potential misstatements and deficiencies in internal control. The deficiencies in internal control over information security discussed in this report increase the risk that errors or omissions may occur and not be timely detected and corrected, which even if not quantitatively material, may nevertheless be considered qualitatively material due to the sensitive nature of the underlying information and its importance to financial statement users.

[25]IFS is IRS's administrative accounting system, which the agency uses to account for core financial management activities, including general ledger, budget formulation, accounts payable, accounts receivable, funds management, cost management, and financial reporting. IFS does not process or report IRS's tax-related transactions, including tax revenues, tax refunds, and taxes receivable.

Despite these actions, most of the previously identified weaknesses in internal control over information security remain unresolved and continue to place IRS systems at risk. For example, significant risks remain in the procurement system. Specifically, access control weaknesses persist, and database software maintenance has not yet been performed. The agency's strategy to address these weaknesses is to replace the existing system. However, implementation of the replacement system has been repeatedly delayed and is not expected until the third quarter of fiscal year 2012. In addition, IRS continued to use unencrypted protocols for network devices and transfer of sensitive data. Also, certain database security controls were not yet in place for systems such as IFS, and the Electronic Federal Payment Posting System (EFPPS).[26] Further, several physical security–related issues remain unresolved, including issues concerning management validation of access to restricted areas, proximity cards allowing inappropriate access, and unlocked cabinets containing network devices.

IRS has acknowledged that maintaining effective information security controls, at the individual system or component level in its large internal network, presents significant challenges. During fiscal year 2011, the agency cited actions taken to implement additional controls designed to partially compensate for and mitigate the risks associated with previously identified information security weaknesses, including issues related to its internal network, database, and mainframe security; procurement and administrative accounting applications; and internal control monitoring.

However, our tests of these additional controls during our fiscal year 2011 audit revealed that they were not always operating as intended or were not effective in compensating for the associated weaknesses. For example:

- *Enterprise Security Audit Trails (ESAT).* IRS initiated a program, ESAT, to centrally collect and analyze user activity recorded in audit logs from application programs. However, this program was not yet implemented for many of the agency's key financial applications, including the procurement system, during fiscal year 2011. In addition, although ESAT was partially implemented for IFS, financial staff did not receive

[26]EFPPS processes electronic tax payment information transmitted from Treasury Financial Agents contracted through Treasury's Financial Management Service and then processes those payments for posting to the taxpayers' accounts.

timely information on system activity for at least 4 months during fiscal year 2011.

- *Automated tools used to test compliance with agency policy.* The agency uses automated tools to test compliance with IRS's security policies for its three major computing environments—Windows, UNIX, and mainframes. However, the UNIX tool does not test whether appropriate security patches have been applied, and the mainframe tool only tests compliance with a limited subset of the agency's policies. Thus, results from IRS's use of these tools do not provide management the information necessary to allow it to arrive at appropriate conclusions about the security status of these systems.

- *Host-based intrusion detection systems.* IRS deployed host-based intrusion detection systems (HIDS) for monitoring servers supporting financial applications. However, during our fiscal year 2011 audit, we found that while the HIDS are configured to detect patterns of activity consistent with network security incidents, the current configurations do not provide controls specific to the applications.

- *Enterprise continuous monitoring (eCM).* IRS established the eCM program to augment the agency's 3-year cycle of system testing required as part of the security assessment and authorization (SA&A) process with an annual test of a subset of the SA&A controls for each system.[27] Although the systems we reviewed had undergone either SA&A or eCM testing, we concluded that the tests IRS performed for eCM were too limited to provide appropriate compensating controls for specific areas. For example, the most recent eCM review of IFS did not include tests of access controls, and other tests relied heavily on reviews of plans and policies rather than actual system tests. In one case, testers concluded that encryption was in place by reviewing a diagram and interviewing staff rather than performing system testing.

[27]Security authorization is the official management decision given by a senior organizational official to authorize operation of an information system and to explicitly accept the risk to organizational operations and assets, individuals, other organizations, and the nation based on the implementation of an agreed-upon set of security controls. Authorization decisions are based on the results of security assessments. At IRS, the SA&A process occurs once every 3 years unless there is a significant change to the system.

- *Business process controls.* Although the agency employs controls in its business processes to help ensure the accuracy of financial information, these controls did not always compensate for certain information security weaknesses as intended. For example, reconciliations, if they are to be effective in compensating for deficiencies in information security controls, must rely on data from independent automated systems. However, we found that some of the reconciliations IRS referred us to as compensating for such control deficiencies, such as the comparison of tax payments and tax refunds against IRS's accounting systems, relied on data derived from, and the information security controls associated with, a single computer system. Consequently, weaknesses in the information security controls for this system reduce the reliability of these reconciliations to serve as an effective compensating control.

- *System used to authorize access.* IRS identified its automated system for authorization of system access as a mitigating control for known information security weaknesses. However, control weaknesses in this automated system limit its effectiveness as an additional control. In addition, the process for system authorization was not always working as intended. For example, the agency's monthly review of access for the procurement system revealed that users had been granted access without using the authorization system.

Without effective mitigating or compensating controls for the associated weaknesses, IRS lacks reasonable assurance as to the accuracy of financial information or the adequate protection of sensitive taxpayer information.

During our fiscal year 2011 audit, we identified additional deficiencies in internal control over information security that, along with previously identified deficiencies that remain unresolved, jeopardize the confidentiality, integrity, and availability of information processed by IRS's key systems. Our testing performed during this audit identified additional weaknesses of approximately the same significance as those we identified in prior audits. For example, we found

- a key application used for processing tax payment information employs a system design that exposes the configuration used to control logon to alterations by its users, allowing circumvention of the application's controls; additionally, insecurely configured software used to support this application exposed it to unauthorized users;

- servers supporting important financial management applications were not patched in a timely manner;

- a major system used to facilitate user access to IFS relied upon operating system software that was no longer supported by its vendor and was not receiving security updates, leaving these servers and systems exposed to known vulnerabilities; and

- a system used to process tax accounts had database and server weaknesses similar to weaknesses identified in previous audits for other systems that exposed the system and data to unauthorized access.

Although management has demonstrated a commitment to addressing unresolved weaknesses and has created layers of compensating and mitigating controls, an underlying reason for the identified deficiencies is that the agency has not yet fully implemented key components of its comprehensive information security program. IRS has provided a comprehensive framework for its information security program and has initiatives underway to further enhance its security posture. For example, during fiscal year 2011, IRS continued to implement a Security Compliance and Posture Monitoring and Reporting program to measure, monitor, and report compliance with security controls. However, key components of its information security program, such as system testing and remediation, have not yet been fully or effectively implemented. For example, we identified significant, but readily detectable, weaknesses in the design and implementation of access controls for a key financial system of which IRS was unaware, despite this system having undergone IRS's SA&A testing process. In addition, IRS continues to face challenges in carrying out its policies requiring validation that its corrective actions have effectively addressed previously reported recommendations for correcting identified weaknesses. We continued to identify weaknesses that IRS informed us it had addressed. For example, IRS informed us that it had addressed 29 of the 105 previously reported information systems security–related recommendations we made. However, we determined that 13 (about 45 percent) of the 29 recommendations had not yet been fully resolved. This was due in part to the fact that while 6 of the 29 recommendations related to multiple systems, IRS had not yet implemented corrective actions for all of the affected systems. Until IRS takes additional steps to implement more-comprehensive testing and effective validation processes and to implement effective corrective actions to address the identified vulnerabilities, its facilities, computing resources, and information will remain vulnerable to inappropriate use, modification, or disclosure, and agency management will have limited assurance of the integrity and reliability of its financial and taxpayer information.

Considered collectively, the unresolved deficiencies from prior audits, combined with less-than-fully effective compensating and mitigating controls and the additional control deficiencies identified in fiscal year 2011, impair IRS's ability to ensure that its financial and taxpayer information is secure from internal threats and increase the potential that (1) errors or irregularities in IRS's financial transactions may not be prevented or detected and corrected in time to prevent material misstatement to IRS's financial statements and other internal and external financial reports and (2) the confidentiality of taxpayer information may not be adequately safeguarded. We plan to issue a separate report to IRS on the information security control deficiencies we identified during fiscal year 2011 and the status of actions to address previous recommendations. We will also issue a limited distribution report to IRS that addresses certain details that have been omitted from this report due to the sensitivity of the information.

Significant Deficiency

In addition to the material weaknesses, we identified a significant deficiency in IRS's internal control over tax refund disbursements during our fiscal year 2011 audit.

Tax Refund Disbursements

Each year, IRS disburses hundreds of billions of dollars of tax refunds. In fiscal years 2011 and 2010, IRS disbursed refunds totaling $416 billion and $467 billion, respectively. In recent years, we have reported[28] a number of deficiencies in IRS's internal control over the processing of tax refunds. In our fiscal year 2010 audit, we concluded that several of these deficiencies collectively represented a significant deficiency in the design

[28]GAO, *Management Report: Improvements Needed to Enhance the Internal Revenue Service's Internal Controls and Operating Effectiveness,* GAO-11-494R (Washington, D.C.: June 21, 2011); GAO-10-565R; *Management Report: Improvements Needed in IRS's Internal Controls,* GAO-09-513R (Washington, D.C.: May 24, 2009); *Management Report: Improvements Needed in IRS's Internal Controls,* GAO-07-689R (Washington, D.C.: May 11, 2007); and *Management Report: Improvements Needed in IRS's Internal Controls*, GAO-05-247R (Washington, D.C.: Apr. 27, 2005).

or operation of internal control. In fiscal year 2011, we continued to identify similar deficiencies in internal control over manual tax refunds[29] as well as additional related issues not previously identified. We also continued to find deficiencies in IRS's internal control over processing First-time Homebuyer Credit (FTHBC) claims.[30] The persistence of the internal control deficiencies, coupled with the material magnitude of tax refunds disbursed, have led us to conclude that, collectively, these deficiencies in internal control continue to constitute a significant deficiency in IRS's internal control over tax refund disbursements. This significant deficiency increases the risk that IRS may pay duplicate or otherwise erroneous tax refunds to which individuals or businesses are not entitled and which IRS must devote additional resources attempting to recover, with no assurance of success.

The deficiencies in IRS's controls over manual tax refunds that we have reported in previous years and that continued to exist in fiscal year 2011 are as follows:

[29]The preponderance of tax refunds is disbursed to taxpayers automatically by IRS's automated systems once a tax return is posted to the taxpayer's account and an overpayment to IRS is identified and calculated. However, tax refunds meeting certain defined criteria, such as those exceeding $10 million in dollar amount, are subject to manual review before disbursement and are known as manual tax refunds. IRS policy requires that employees processing manual tax refunds monitor the taxpayers' account during tax refund processing to compensate for flaws in IRS's process that might otherwise allow these taxpayers to be paid two tax refunds; one manual and one automatically generated.

[30]See FTHBC, 26 U.S.C. § 36. The FTHBC was originally authorized by section 3011 of the Housing and Economic Recovery Act of 2008. The new credit was originally available for a limited time only, applying to taxpayers who purchased a principal residence after April 8, 2008, and before July 1, 2009. Taxpayers were permitted to claim a fully refundable credit equal to 10 percent of the purchase price of the home, with a maximum available credit of $7,500. This credit was to be repaid within 15 years with payments beginning 2 years after the credit was claimed. The American Recovery and Reinvestment Act of 2009 extended the FTHBC to include purchases made on or after January 1, 2009, and before December 1, 2009; increased the maximum credit to $8,000; and eliminated the repayment requirement as long as the taxpayer retains the residence for 36 months. Further, section 11 of the Worker, Homeownership, and Business Assistance Act of 2009 extended the FTHBC for purchases made from December 1, 2009, to April 30, 2010, and expanded eligibility for the credit (with a maximum available credit of $6,500) to qualifying long-time resident homebuyers. The law allowed taxpayers to claim the credit if they entered into a binding contract for the purchase of a home prior to May 1, 2010, and closed on the home prior to July 1, 2010. Section 2 of the Homebuyer Assistance and Improvement Act of 2010 extended the closing deadline to September 30, 2010, for taxpayers who entered into a binding contract prior to May 1, 2010.

- Employees at the IRS locations we visited were not effectively monitoring taxpayer accounts during manual refund processing to identify duplicate tax refunds in process and prevent their disbursement. Effective monitoring is critical because IRS's automated systems are not adequately coordinated to prevent the issuance of a duplicate automated tax refund if a corresponding manual tax refund has already been generated.

- Employees at the IRS locations we visited were not effectively documenting actions to monitor tax refund processing. Appropriate documentation is necessary to provide verifiable evidence that appropriate tax refund monitoring is conducted.

- Training for employees responsible for processing manual tax refunds was not effective at the IRS locations we visited. We found that many of the staff we spoke to who were responsible for initiating manual refunds or performing related centralized monitoring had not received appropriate related training. In addition, Unit Security Representatives, who perform important security duties for IRS's Integrated Data Retrieval System,[31] did not complete either the required initial training prior to assuming their responsibilities nor the required annual refresher training at the IRS locations we visited. Effective training is critical to ensure that employees responsible for these important functions are proficient in their responsibilities.

Over the years, we have made numerous recommendations for corrective actions to address these deficiencies.[32] IRS has devoted significant resources to its efforts to resolve them, and has successfully implemented a number of our recommendations. Nevertheless, many of the underlying deficiencies have continued to persist. In addition to these deficiencies, we identified new deficiencies in internal control over manual tax refunds during our fiscal year 2011 audit. Specifically, we found instances in which manual refund initiators initiated manual refunds without supervisory

[31]The Integrated Data Retrieval System is one of the key systems IRS uses to process taxpayer data; the training Unit Security Representatives receive covers how they should carry out their duties in order to properly fulfill their security obligations.

[32]GAO, *Internal Revenue Service: Status of GAO Financial Audit and Related Financial Management Report Recommendations*, GAO-11-536 (Washington, D.C.: June 22, 2011).

approval. In addition, the Internal Revenue Manual[33] requires manual refund initiators to perform research on taxpayers' accounts to verify that there are no outstanding balances or pending automated refunds in process on the account before issuing a manual refund. However, we found instances where employees were not effectively performing this research; during our testing, we observed cases in which erroneous refunds were recorded in taxpayers' accounts but were not detected and corrected in time to prevent the disbursement of an erroneous refund because the manual refunds initiators did not carry out the required research.

In fiscal year 2011, IRS continued its implementation of a service-wide corrective action plan (CAP) to address the deficiencies in internal control over refunds that we and the Treasury Inspector General for Tax Administration (TIGTA) reported,[34] and to strengthen existing internal controls designed to eliminate or reduce duplicate tax refunds. The specific actions detailed in the CAP, if effectively implemented, have the potential to significantly improve IRS's internal control over refunds. In this regard, effectively communicating CAP corrective actions to the staff responsible for executing them is critical to effective implementation. However, we reviewed the CAP IRS provided to us in January 2011 and found that it did not always clearly identify the specific IRS units that were expected to perform the tasks specified in the plan. Specifically, the CAP did not specify which IRS units were responsible for implementing the corrective action related to the manual refunds process improvements contained in the plan. Such lack of clarity can contribute to confusion as to the roles and responsibilities for implementing the plan, and lead to

[33]The Internal Revenue Manual is the official source for IRS policies, directives, guidelines, procedures, and delegations of authority which direct the agency's operation.

[34]TIGTA is a component of the Department of the Treasury responsible for audits and investigations of the IRS. In fiscal year 2011, TIGTA issued a number of audit reports citing deficiencies in various aspects of IRS's refund processing, including refundable credits such as FTHBC, refunds paid to prisoners, and refunds paid to individuals not authorized to work in the United States. See TIGTA, *Administration of the First-time Homebuyer Credit Indicates a Need for Improved Controls Over Refundable Credits*, Reference Number 2011-41-035 (Mar. 31, 2011); *Control Weaknesses Over Amended Returns Allowed Some Inappropriate Claims for First Time Home Buyer Credit to be Allowed*, Reference Number 2011-41-057 (June 24, 2011); *Significant Problems Still Exist With Internal Revenue Service Efforts to Identify Prisoner Tax Refund Fraud*, Reference Number 2011-40-009 (Dec. 29, 2010); and *Individuals Who Are Not Authorized to Work In the United States Were Paid $4.2 Billion in Refundable Credits*, Reference Number 2011-41-061 (July 7, 2011).

inaction on the part of those IRS staff members whom the CAP authors expected to complete the tasks described in the plan. In addition, as part of our testing of the internal controls over manual refunds in June 2011, we reviewed the implementation of many of the corrective actions contained in the CAP that, according to the version of the CAP we reviewed, had either been completed or were scheduled to have been completed by that time.[35] In doing so, we interviewed manual refund initiators at the four service center campuses we visited who had key roles in implementing some of the CAP's corrective actions we reviewed. We found that the initiators were not aware of these corrective actions; consequently, they were not yet in place at these IRS locations. For example, the individuals we interviewed were not aware of the

- significance of an account indicator designed to prevent duplicate manual refunds by alerting manual refund initiators that a manual refund had been processed previously; and
- Accept/Reject Criteria Job Aid guidance or the Treasury Check Information System tool, or both, which were designed to reduce duplicate refunds by providing enhanced research capabilities to those staff that initiate and process manual refunds.

In addition, the CAP specifies that all manual refunds initiated by the Submission Processing (SP) unit are to be centrally monitored,[36] in addition to being monitored by individual manual refund initiators. As we discussed in our report on our audit of IRS's fiscal year 2010 financial statements, this approach, coupled with other planned corrective actions, has the potential to improve internal control over manual refunds if effectively implemented.[37] However, at one service center we visited, we found that the SP unit did not maintain a list of the manual refund initiators that were initiating manual refunds in the SP unit and would therefore be subject to the centralized monitoring. This increases the risk that the centralized monitoring process may not consider all of the manual refunds initiated by the SP unit. As a result of these issues we found relating to the

[35]Some CAP corrective actions involved tasks which, by their nature, did yield independently verifiable evidence.

[36]When a unit performs central monitoring, an employee is responsible for monitoring all of the manual refunds initiated in that unit.

[37]GAO-11-142.

CAP, we concluded that the corrective actions IRS had identified as completed or scheduled to be completed by June 2011 in the version of the CAP we were provided were not always effectively implemented by that date.[38]

In addition to the persistent internal control issues affecting manual tax refunds, we continued to find deficiencies in IRS's internal controls over processing FTHBC claims, which resulted in instances of erroneous tax refund disbursements. In 2010, the FTHBC expired for the majority of taxpayers, which resulted in a significant reduction in the volume and amount of FTHBCs filed in fiscal year 2011.[39] During fiscal year 2011, taxpayers filed about 635,000 FTHBC claims totaling about $4.3 billion, while in fiscal year 2010, taxpayers had filed over 2.2 million FTHBC claims totaling about $16 billion. While the volume of FTHBCs has significantly decreased, we continued to find deficiencies in IRS's internal control over FTHBC claims processing. From the over 626,000 FTHBCs that IRS allowed between October 1, 2010, and June 30, 2011, we statistically selected a random sample of 45. For each case we selected, we reviewed supporting documentation to determine whether the credit, and ultimately the resultant tax refund paid, if any, was valid to the extent this was determinable based on the limited documentary support made available to IRS. On the basis of our testing, we found 13 cases in which the IRS allowed erroneous FTHBCs. Specifically, we found

[38]Subsequent to our testing, IRS revised the CAP to (1) be more clearly communicated to the employees responsible for performing the procedures; (2) develop service-wide training for monitoring manual refunds; and (3) be monitored by management to measure its effectiveness. We will follow up during our fiscal year 2012 audit to assess the effectiveness of the revised CAP.

[39]In order to claim the credit, taxpayers had until April 30, 2010, to purchase a home and claim the FTHBC or they had to have entered into a binding contract prior to May 1, 2010, to close on a home by September 30, 2010. These taxpayers had the option of claiming the FTHBC on their 2009 or 2010 return. In addition, members of the uniformed services, Foreign Service, or intelligence community meeting certain criteria have an additional year to purchase a home and qualify for the credit. These taxpayers may claim the credit on their 2010 or 2011 tax return.

- five cases in which a taxpayer was allowed to claim long-time resident status[40] although the taxpayer did not provide the required documentation[41] to support the claim,
- six cases in which IRS allowed FTHBCs for purchases made after April 30, 2010, although the taxpayer did not submit a copy of the required binding contract,
- one case in which IRS allowed a taxpayer to claim long-time resident status for a purchase made after April 30, 2010, although the taxpayer did not submit a copy of the required binding contract, and
- one case in which IRS allowed a FTHBC to a taxpayer claiming long-time resident status even though the taxpayer purchased the home prior to the date IRS should have allowed the credit on this basis.

In each of the cases described above, an erroneous tax refund was disbursed to the taxpayer.

On the basis of our work, we estimated that as much as 39.3 percent[42] of FTHBCs IRS allowed between October 1, 2010, and June 30, 2011, may have been in error. Therefore, we concluded that IRS's internal control over FTHBC claims was not effective in ensuring that the claims and any resultant tax refunds paid were valid. These errors in FTHBC processing occurred primarily because procedures developed to process the FTHBCs were not consistently followed.

Although the volume of FTHBC claims filed by taxpayers during fiscal year 2011 was significantly smaller than in fiscal year 2010, the results of our

[40]To claim the FTHBC, a taxpayer must be either a first-time home buyer or meet the requirements of "long-time resident" status. A long-time resident is defined as a taxpayer who has owned and used the same residence as a principal residence for any 5-consecutive-year period during the 8-year period ending on the date of the purchase of a subsequent principal residence. See 26 U.S.C. § 36(c)(6).

[41]In order to claim long-time resident status, the taxpayer must submit copies with his/her tax return of one of the following for 5 consecutive years of the 8-year period ending on the purchase date of the new main home: (1) prior year mortgage interest payments, (2) property tax records, (3) Form 1098 issued by a mortgage company, or (4) homeowner's insurance records.

[42]We are 90 percent confident that as much as 39.3 percent of these credits may have been in error.

review indicate that in fiscal year 2011, erroneous FTHBCs were still being allowed by IRS, potentially resulting in erroneous refunds being disbursed.

In a September 2009 report,[43] we suggested to Congress that it consider providing IRS authority to use prior years' tax return information to ensure taxpayers do not improperly claim the credit in multiple years because it did not have the authority to implement a mechanism to check for such improper claims. The next month, we testified about significant implementation and compliance challenges IRS faces related to the FTHBC.[44] Congress subsequently passed the Worker, Homeownership, and Business Assistance Act of 2009,[45] which granted IRS authority to check for obvious noncompliance with certain FTHBC provisions, including whether a taxpayer claimed the credit in a prior year. We calculated that use of this authority resulted in IRS saving approximately $93 million in fiscal year 2010.[46]

Nonetheless, the deficiencies in internal control over tax refund disbursements discussed above resulted in IRS disbursing erroneous tax refunds and increased the risk of erroneous tax refund payments beyond those we identified.

Compliance Issues

Our tests of IRS's compliance with selected provisions of legal provisions disclosed one instance of noncompliance that is reportable under U.S. generally accepted government auditing standards. This instance relates to the release of federal tax liens against taxpayers' property. We also found that IRS's financial management systems do not substantially comply with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA).

[43]GAO, *Tax Administration: Opportunities Exist for IRS to Enhance Taxpayer Service and Enforcement for the 2010 Filing Season,* GAO-09-1026 (Washington, D.C.: Sept. 23, 2009).

[44]GAO, *First-time Homebuyer Tax Credit: Taxpayers' Use of the Credit and Implementation and Compliance Challenges*, GAO-10-166T (Washington, D.C.: Oct. 22, 2009).

[45]Pub. L. No. 111-92, 123 Stat. 2984 (Nov. 6, 2009).

[46]These dollar savings could be understated because they do not include all returns claiming the FTHBC.

Release of Federal Tax Liens

The Internal Revenue Code grants IRS the authority to obtain a statutory lien against the property of any taxpayer who neglects or refuses to pay all assessed federal taxes.[47] The lien serves to protect the interest of the federal government and as a public notice to current and potential creditors of the government's interest in the taxpayer's property. For example, federal tax liens are disclosed in individuals' credit reports. Under section 6325 of the Internal Revenue Code, IRS is required to release federal tax liens within 30 days after the date the tax liability is satisfied or has become legally unenforceable or the Secretary of the Treasury has accepted a bond for the assessed tax.

In our prior audits, we found that IRS did not always release the applicable federal tax lien within 30 days after a tax liability is satisfied, either through payment or abatement, as required by the Internal Revenue Code.[48] In response, IRS has taken a number of actions over the years to improve its lien release processing, including the creation of a comprehensive action plan to address the various causes for lien release delays we identified, as well as those identified through its own reviews. Over the past several years, IRS has steadily completed actions on this plan and identified additional actions to improve lien release timeliness. For example, it completed various system enhancements to improve the timeliness of recognizing when a taxpayer has fully satisfied the outstanding tax liability. IRS also continues to perform targeted reviews of areas where processing delays were identified in the past.

While IRS's actions have improved the timeliness of its lien releases, our work in fiscal year 2011 and IRS's own testing continued to find that it did not always release all tax liens within 30 days after taxpayers paid or were otherwise relieved of a tax liability. During our annual audits prior to fiscal year 2006, we tested a statistical sample of tax cases with liens in which the taxpayers' total outstanding tax liabilities were either paid off or abated during the fiscal year. Beginning in fiscal year 2006, IRS began performing its own test of the effectiveness of its lien release process as part of its implementation of requirements in the revised Office of Management and

[47] 26 U.S.C. §§ 6321, 6322. The lien becomes effective when it is "perfected," (i.e., obtains priority and validity) in relation to creditors, future purchasers, and other persons who might have interests in the same property when it is filed with a designated office, such as a courthouse in the county where the taxpayer's property is located. See 26 U.S.C. § 6323.

[48] GAO-11-142.

Budget (OMB) Circular No. A-123[49] and we began reviewing these test results. In our review and validation of IRS's testing of 59 statistically selected tax cases with liens in which the taxpayers' total outstanding tax liabilities were either paid off or abated during fiscal year 2011, we noted that IRS's testing identified two instances in which it did not release the applicable federal tax lien within the statutorily mandated 30 days.[50] On the basis of this sample of unpaid tax assessment cases resolved in the first 6 months of fiscal year 2011 for which it had filed a tax lien, IRS estimated that it did not release liens within 30 days for 3.4 percent of the cases. IRS is 95 percent confident that the percentage of cases in which it did not release the lien within 30 days does not exceed 10.3 percent. On the basis of these results, we concluded that the potential noncompliance in the tested population exceeded the amount IRS designated as acceptable for its test.[51]

As identified by IRS, the delay in lien releases was caused by processing delays and errors. In one case, IRS did not timely update the taxpayer's account to reflect that the taxpayer had been discharged of the taxes in bankruptcy court. In the other case, IRS needed more than one attempt to correctly post the taxpayer's satisfying payment onto the taxpayer's master file account module. In fiscal year 2000, we issued a report discussing the delays IRS was experiencing in releasing tax liens and recommended that IRS analyze the cause of delays in releasing liens and

[49]OMB's revised Circular No. A-123, Management's Responsibility for Internal Control, became effective on October 1, 2005. App. A to OMB Circular No. A-123 provides internal control guidance and requirements for executive branch agencies to follow in conducting management's assessment of the effectiveness of internal control over financial reporting. On the basis of this assessment, agency management is required to prepare an assurance statement on the effectiveness of internal control over financial reporting to be included in its performance and accountability report. These requirements are applicable to the 24 Chief Financial Officers Act agencies, including the Department of the Treasury, of which IRS is a significant component.

[50]The time between satisfaction of the liability and release of the lien in these two cases was 36 and 41 days.

[51]When evaluating statistical results, GAO and IRS compare the projected upper error limit to the acceptable error rate set for the test. In this case, the acceptable noncompliance rate is 5 percent while the projected upper error limit is 10.3 percent. Consequently, IRS and we concluded that IRS continued to be noncompliant with the lien release provisions of the Internal Revenue Code.

implement procedures to ensure their timely release.[52] While the actions IRS has taken to improve lien release timeliness has improved the noncompliance rate over prior years, IRS has not yet completed all actions to fully address this recommendation. Until IRS addresses the remaining deficiencies that result in lien release delays, IRS will not be able to ensure that it releases liens in accordance with the 30-day limit mandated by the Internal Revenue Code. Further, the continued failure to promptly release tax liens could cause undue hardship and burden to taxpayers who are attempting to sell property or apply for commercial credit.

Financial Management Systems' Noncompliance with FFMIA

In fiscal year 2011, we found that IRS's financial management systems did not substantially comply with the requirements of FFMIA. Specifically, IRS's systems did not substantially comply with *Federal Financial Management Systems Requirements* (FFMSR) or federal accounting standards (U.S. generally accepted accounting principles). However, we did find that IRS's systems substantially complied with the *United States Standard General Ledger* (USSGL) at the transaction level. In its fiscal year 2011 Federal Managers' Financial Integrity Act of 1982 assurance statement to the Department of the Treasury, IRS reported the same conclusion.

In fiscal year 2011, IRS's systems did not substantially comply with FFMSR because of the existence of material weaknesses in IRS's internal control over unpaid tax assessments and information security, as discussed earlier in this report. As a result of these material weaknesses, IRS's internal control over financial reporting was not effective as of September 30, 2011.

IRS's financial management systems also did not substantially comply with federal accounting standards, specifically Statement of Federal Financial Accounting Standards No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*.[53] IRS's automated systems for tax-related transactions did not

[52]GAO, *Internal Revenue Service: Recommendations to Improve Financial and Operational Management*, GAO-01-42 (Washington, D.C.: Nov. 17, 2000).

[53]FASAB Statement of Federal Financial Accounting Standards 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, as codified in FASAB *Statements of Federal Financial Concepts and Standards, Pronouncements as Amended* (Washington, D.C.: June 30, 2010).

support the net federal taxes receivable amount on IRS's balance sheet and other required supplementary information related to uncollected taxes—compliance assessments, and write-offs—as required by the standard.

As discussed previously, in fiscal year 2010, IRS implemented RRACS, which brought IRS's system into conformance with the requirements of the USSGL. During our 2011 audit, we determined that the posting model utilized by RRACS substantially conformed with the USSGL requirements and we verified that IRS's tax-related transactions were recorded in accordance with the USSGL at the transaction level. During 2011, IRS continued to materially adjust its gross federal taxes receivable balance based on the results of a statistical estimation process, as it had done in prior years, and those adjustments were posted to RRACS in substantial conformance with the USSGL. However, these statistically derived adjustments, and consequently the resultant adjusted gross federal taxes receivable balance, were not traceable to individual underlying transactions and, consequently, continued to constitute a deficiency in internal control that contributed to the material weakness in unpaid tax assessments discussed earlier in this report. However, we concluded that IRS recorded federal taxes receivable in substantial conformance with the USSGL because these adjustments were themselves recorded in accordance with the USSGL, and the reported gross federal taxes receivable balance could be traced through the adjustments to the unadjusted federal taxes receivable balance, and from there to underlying transaction detail, which had also been recorded in accordance with the USSGL. As discussed above, the essential purpose of this estimation process is to compensate for the existence of a continued material weakness in internal control over unpaid tax assessments that results in a material misstatement of the unadjusted balance for taxes receivable.

IRS has established a remediation plan to address the conditions that lead to its systems' substantial noncompliance with the FFMIA requirements. This plan outlines the actions to be taken to resolve these issues and defines related resources and responsible organizational units. Many of the actions detailed in the plan are long-term in nature and are tied to IRS's systems modernization efforts.[54]

[54]Section 803(c)(4) of FFMIA requires that the Department of the Treasury, with the concurrence of the Director of OMB, specify the most feasible date for bringing its systems into substantial compliance with the three FFMIA systems requirements and designate a Department of the Treasury official who shall be responsible for bringing its systems into substantial compliance by that date.

Management's Report on Internal Control over Financial Reporting

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

COMMISSIONER

November 4, 2011

Mr. Steven J. Sebastian
Director, Financial Management and Assurance
U.S. Government Accountability Office
441 G Street, N.W.
Room 5474
Washington, DC 20548

Dear Mr. Sebastian:

The Internal Revenue Service (IRS) internal control over financial reporting is a process affected by those charged with governance, management, and other personnel, the objectives of which are to provide reasonable assurance that (1) transactions are properly recorded, processed and summarized to permit the preparation of financial statements in accordance with U.S. generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition; and (2) transactions are executed in accordance with the laws governing the use of budget authority and other laws and regulations that could have a direct and material effect on the financial statements.

IRS management is responsible for establishing and maintaining effective internal control over financial reporting. IRS management evaluated the effectiveness of IRS internal control over financial reporting as of September 30, 2011, based on the criteria established under 31 U.S.C. 3512, commonly known as the Federal Managers' Financial Integrity Act (FMFIA).

Based on our evaluation, IRS has two material weaknesses in its internal control over financial reporting, specifically (1) unpaid tax assessments and (2) information security. IRS financial management systems do not substantially comply with the requirements of the Federal Financial Management Improvement Act (FFMIA). On this basis, management provides qualified assurance that as of September 30, 2011, IRS internal control over financial reporting was effective.

Douglas H. Shulman
Commissioner

November 4, 2011
Date

Pamela J. LaRue
Chief Financial Officer

November 4, 2011
Date

Comments from the Internal Revenue Service

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

COMMISSIONER

November 7, 2011

Mr. Steven J. Sebastian
Director
Financial Management and Assurance
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Sebastian:

Thank you for the opportunity to comment on the draft report titled, *Financial Audit: IRS's Fiscal Years 2011 and 2010 Financial Statements.* We are pleased that the Internal Revenue Service (IRS) received an unqualified opinion on the combined financial statements for the twelfth consecutive year. The unqualified opinion demonstrates that the IRS accurately accounts for approximately $2.4 trillion in tax revenue receipts, $416 billion in tax refunds, and $12 billion in IRS appropriated funds.

We are pleased the Government Accountability Office (GAO) recognized our progress in strengthening information security controls, through the establishment of enterprise-wide security initiatives improving management's ability to measure the state of controls. The GAO also noted our efforts in developing cross-functional working groups with knowledge of internal systems and the ability to assess risk areas. We look forward to working with the GAO in our efforts to continue to improve these controls.

We are also pleased that the GAO recognized the improvements made in performance measures and the timely release of tax liens. In addition, the IRS continues to make improvements in the areas of cash management, cost allocations, upward and downward adjustments to prior year obligations, and undelivered orders. The IRS is dedicated to continuing to improve financial management and internal controls as evidenced by our A-123 activities that incorporated testing transaction processes material to the Department of the Treasury's consolidated financial statements, including the testing of 10 administrative processes related to $12.6 billion in administrative transactions and three custodial tax processes related to $2.4 trillion in tax revenues.

2

I want to recognize the GAO's support throughout the audit. While challenges remain, the IRS has established its ability to consistently produce accurate and reliable financial statements. We have a solid management team dedicated to promoting the highest standard of financial management, and we continue to increase the focus on information security and internal controls while improving financial reporting.

Sincerely,

Douglas H. Shulman

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