Why GAO Did This Study

Because of the significance of Internal Revenue Service (IRS) collections to overall federal receipts and, in turn, to the consolidated financial statements of the U.S. government, which GAO is required to audit, and Congress’s interest in financial management at IRS, GAO audits IRS’s financial statements annually to determine whether (1) the financial statements are fairly stated, 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).

What GAO Found

In GAO’s opinion, IRS’s fiscal years 2009 and 2008 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 deficiencies, IRS did not, in GAO’s opinion, maintain effective internal control over financial reporting as of September 30, 2009, and thus did not provide reasonable assurance that losses and misstatements material to the financial statements would be prevented, or detected and corrected timely.

During fiscal year 2009, IRS continued to make significant strides in addressing its internal control deficiencies. Specifically, IRS sufficiently addressed several issues constituting its material weakness over financial reporting and its significant deficiency over tax revenue collection and refund issuance such that we do not consider the remaining unresolved issues in those areas to constitute reportable deficiencies in internal control. However, continued management commitment and sustained efforts are necessary to build on the progress made to date and to fully address IRS’s remaining internal control, compliance, and system deficiencies. These remaining deficiencies pertain to IRS’s (1) material weaknesses in internal control over unpaid tax assessments and over information security, (2) noncompliance with the law concerning the timely release of tax liens, and (3) financial management systems’ nonconformance with FFMIA requirements.

The serious challenges IRS faces as a result of these remaining deficiencies adversely affect IRS’s ability to (1) produce reliable financial statements without significant compensating procedures and (2) obtain current, complete, and accurate information it needs to make well-informed decisions. As IRS continues to progress toward increasingly automated financial management processes, the continued material weakness in internal control over information security that jeopardizes the reliability of the financial information IRS processes could have serious implications for our future ability to determine whether IRS’s financial statements are fairly stated. This weakness also continues to significantly increase the risk that sensitive taxpayer information may be compromised.

During fiscal year 2009, IRS also continued to face significant financial management challenges in developing and institutionalizing the use of financial management information to assist it in making operational decisions and measuring the effectiveness of its programs. IRS has not fully integrated the use of cost- and revenue-based performance information into its routine management and decision-making processes or in its externally reported performance metrics.

What GAO Recommends

Based on prior audits, GAO made numerous recommendations to IRS to address the internal control and compliance issues that continued to persist during fiscal year 2009. GAO will continue to monitor IRS’s progress in implementing the 136 recommendations that remain open as of the date of this report, of which 74 relate to the material weakness in information security.

IRS stated that it is dedicated to improving financial management and cited several recent achievements. It noted that it has a solid management team in place to address remaining financial management challenges and is committed to improving information security as an ongoing priority.

View GAO-10-176 or key components.
For more information, contact Steven J. Sebastian at (202) 512-3406 or sebastians@gao.gov.
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<td>Custodial Detail Data Base</td>
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<tr>
<td>CFO</td>
<td>Chief Financial Officer</td>
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<td>FFMIA</td>
<td>Federal Financial Management Improvement Act of 1996</td>
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<td>FFMSR</td>
<td>Federal Financial Management System Requirements</td>
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<td>FMFIA</td>
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<td>IRACS</td>
<td>Interim Revenue Accounting Control System</td>
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November 10, 2009

The Honorable Timothy F. Geithner
The 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, 2009, and 2008. We performed our audits in accordance with the Chief Financial Officers Act of 1990. 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, 2009, (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, as of September 30, 2009, with the requirements of the Federal Financial Management Improvement Act of 1996. 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 and users of IRS’s financial statements.

During fiscal year 2009, IRS continued to make progress in addressing its financial management challenges. IRS sufficiently addressed the internal control deficiencies constituting its material weakness over financial reporting such that we do not consider the remaining unresolved issues to constitute a reportable deficiency in internal control. IRS substantially completed developing traceability of its revenue and refund transactions from its general ledger to supporting detailed transaction information. However, IRS continues to experience challenges in developing an adequate general ledger system and transaction traceability for taxes receivable, and we have included this deficiency as a component of the material weakness in internal control over unpaid assessments.

Additionally, during fiscal year 2009, IRS continued to enhance its ability to develop managerial cost accounting information such that we no longer

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1A 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.
consider IRS to have a reportable significant deficiency\(^2\) in internal control over tax revenue and refunds. However, IRS continues to experience significant financial management challenges with respect to (1) developing full cost information on the full range of its programs and activities, (2) institutionalizing the use of cost accounting agencywide, and (3) developing and routinely using cost-based (and where appropriate enforcement revenue–based\(^3\)) performance metrics to measure the results of its efforts and to assist in making resource allocation decisions. It is important that IRS continue to aggressively pursue and expand the financial management initiatives it has underway in order to achieve comprehensive and lasting financial management reform.

In fiscal year 2009, as in past years, IRS continued to have material weaknesses in its internal control over Unpaid Assessments and Information Security. We continued to find that IRS lacked a subsidiary ledger for unpaid tax assessments that would allow it to support a reliable balance for 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 relies on resource-intensive statistical sampling techniques to estimate these amounts. In addition, these amounts are not recorded in IRS’s general ledger system for tax-related transactions because they are the product of this statistical estimation process rather than an accumulation of individual underlying transactions. As a result, IRS does not have transaction traceability from these amounts as reported in its financial statements and required supplementary information through its general ledger system back to underlying source documents.

Also in fiscal year 2009, IRS's internal control over its information systems’ security continued to be ineffective, particularly as it relates to controls over access to mission-critical applications and the often sensitive information they process. As a result, IRS cannot rely on the internal controls contained in its automated financial management systems to provide reasonable assurance that, in the absence of effective

\(^2\)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 attention by those charged with governance.

\(^3\)The term enforcement revenue refers to the tax revenue received as a result of IRS's tax collection actions—enforcement—taken against taxpayers who do not voluntarily pay their taxes when due.
compensating procedures, (1) its financial statements, taken as a whole, are fairly stated, (2) the information IRS relies on to make decisions on a daily basis is accurate, complete, and timely, and (3) proprietary financial and taxpayer information is appropriately safeguarded.

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 Web site 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
To the Commissioner of Internal Revenue

In accordance with the Chief Financial Officers (CFO) Act of 1990, we are responsible for conducting audits of the financial statements of the Internal Revenue Service (IRS). The financial statements report the assets, liabilities, net position, net costs, changes in net position, budgetary resources, and custodial activity related to IRS's administration of its responsibilities for implementing federal tax legislation. The financial statements do not include an estimate of the amount of taxes that are owed the federal government but have not been paid by taxpayers, often referred to as the tax gap, nor do they include information on tax expenditures.

In our audits of IRS's fiscal years 2009 and 2008 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, 2009;
- 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) as of September 30, 2009.

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2IRS 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.

3Tax expenditures are revenue losses—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. Under U.S. generally accepted accounting principles, tax expenditure amounts are not required to be disclosed as part of federal agencies' financial statements, but certain information on tax expenditures can be included as other accompanying information to the financial statements.

In its role as the nation’s tax collector, IRS has a demanding responsibility in collecting taxes, processing 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 states and territories and some U.S. embassies and consulates. In fiscal years 2009 and 2008, IRS collected about $2.3 trillion and $2.7 trillion, respectively, in tax payments, processed hundreds of millions of tax and information returns, and paid about $438 billion and $426 billion, respectively, in refunds to taxpayers.

In fiscal year 2009, for the 10th consecutive year, IRS was able to produce financial statements covering its tax administration and nontax administrative activities that are fairly stated in all material respects. IRS also continued to make progress in modernizing its financial management capabilities and in addressing its financial management challenges.

In our November 2008 report on the results of our audit of IRS’s fiscal years 2008 and 2007 financial statements, we reported a material weakness in IRS’s internal control over financial reporting. Specifically, we reported that IRS (1) did not have an adequate general ledger system for tax-related transactions and (2) was unable to readily determine the costs of its discrete activities and programs. In fiscal year 2008, we also reported a significant deficiency in IRS’s internal control over tax revenue and refunds. In particular, we reported that IRS did not have cost-benefit (return-on-investment) information on its programs and activities or the structures and processes to provide such key financial management data to IRS managers. During fiscal year 2009, IRS (1) substantially completed developing traceability of its revenue and refund transactions from its general ledger to supporting detailed transaction information and (2)

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6A 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, detected and corrected on a timely basis.

7A 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.

8IRS continues to face difficulty with the traceability of certain transactions related to unpaid tax assessments, which we discuss in the section of this report on the material weakness in internal control over unpaid assessments.
continued to develop its cost accounting capabilities. IRS also developed (1) full cost information on numerous additional IRS programs and activities, (2) measures of the cost-benefit on the enforcement programs for which it developed full cost information, and (3) a plan to standardize the use of cost information agencywide. IRS made sufficient progress during fiscal year 2009 in addressing the outstanding internal control deficiencies over financial reporting and over tax revenue and refunds such that we no longer consider the remaining issues in those areas to be reportable deficiencies in internal control.

However, during fiscal year 2009, IRS continued to have a material weakness in its internal control over unpaid assessments. This material weakness results from IRS control deficiencies concerning its (1) inability to rely on its core financial system and underlying subsidiary records to report taxes receivable, compliance assessments, and write-offs in accordance with federal accounting standards without significant compensating procedures, (2) lack of transaction traceability for the reported balance in taxes receivable that comprises nearly 80 percent of IRS’s total assets as of September 30, 2009, 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 weaknesses are caused primarily by IRS’s continued reliance on software applications that were not designed to provide the accurate, complete, and timely transaction-level financial information that management needs to make well-informed decisions, or 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. Successfully addressing these issues is vital and is one of the goals of IRS’s ongoing systems modernization effort.

An unpaid 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).

Federal accounting standards classify unpaid 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 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 net federal taxes receivable are reported on the financial statements.
In addition, we consider the internal control deficiencies that IRS experienced in fiscal year 2009 and in previous years in its management of information systems security to continue to be a material weakness in internal control. IRS made progress during fiscal year 2009 in addressing several of the information security weaknesses identified in our previous audits. Specifically, IRS (1) documented approved access privileges for its mainframe user groups, (2) implemented role-based access controls to reduce the number of users with special privileged access on the system supporting its administrative accounting system, and (3) changed vendor-supplied database accounts and passwords to avoid potential use by malicious users. Nevertheless, persistent, serious deficiencies in IRS’s controls over information security remain uncorrected. Those deficiencies (1) render IRS unable to rely upon these controls to provide reasonable assurance that its financial statements are fairly stated in the absence of effective compensating procedures, (2) have serious adverse implications related to the reliability of other financial management information produced by IRS’s systems, and (3) increase the risk that confidential IRS and taxpayer information will be compromised.

As IRS continues to increase the automation of accounting and reporting processes, the need for effective security over the data these systems process becomes increasingly more critical. Absent effective information security, confidential taxpayer records will remain at risk and both IRS’s management and we, as IRS’s auditors, will continue to be unable to rely on the automated controls built into these systems to assist in obtaining reasonable assurance that the reported balances generated by them are reliable. Opportunities for us to use the types of alternate audit procedures we have applied in the past to compensate for this condition, such as reviewing comparisons between automated systems and utilizing remaining hard-copy records, continue to diminish as IRS’s modernization efforts progress. If IRS does not resolve its information security material weakness before these options disappear, it could have serious adverse implications for our ability to determine whether IRS’s financial statements are fairly stated. In addition, as IRS continues to modernize its computer-based administrative processes, it will be important for IRS management to ensure that paperless transactions using electronic signatures are appropriately implemented. As part of the Office of Management and Budget’s (OMB) implementation of the Government Paperwork Elimination Act, OMB procedures and guidance caution
agencies to carefully control access to electronic data associated with paperless transactions.\textsuperscript{11}

During fiscal year 2009, IRS continued to face significant financial management challenges in developing and institutionalizing the use of financial information to assist it in making operational decisions and measuring the effectiveness of its programs. The Federal Accounting Standards Advisory Board’s (FASAB) Statement of Federal Financial Accounting Concepts No. 1, \textit{Objectives of Federal Financial Reporting},\textsuperscript{12} in its discussion of financial reporting concepts, notes that federal financial data should provide accountability and decision-useful information on the costs of various programs and the outputs and outcomes achieved, and it should provide data for evaluating service efforts, costs, and accomplishments. A key objective of the CFO Act is for 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.

In fiscal year 2009, the financial information available to IRS’s program managers and reported externally in its Management Discussion and Analysis (MD&A) did not fully meet these objectives. IRS had not yet fully integrated the use of cost-based (and when appropriate, revenue-based) performance information into its routine management and decision-making processes or in its externally reported performance metrics. Specifically, IRS had not (1) developed full cost\textsuperscript{13} information on the range of IRS programs and activities that could provide important resource allocation—related information; (2) completed the process of institutionalizing the use of its cost accounting policy; and (3) developed cost-based (and when appropriate, revenue-based) performance metrics for its programs and activities. These limitations inhibit IRS’s ability to more fully assess and monitor the relative merits of its various programs,


\textsuperscript{13}The “full cost” of a program or activity includes all the direct costs, including personnel time charges, and indirect costs, such as the allocation of overhead costs, that are applicable to the program or activity.
especially its enforcement programs and new initiatives, and to consider alternatives and adjust its strategies as needed.

We acknowledge that IRS may face significant challenges in developing such data, especially cost-benefit (return-on-investment) performance metrics. However, doing so would better position IRS to evaluate the effectiveness of its programs and work activities, optimize the allocation of resources among them, provide better information with which to defend its budgets, and evaluate alternative strategies. To date, IRS’s CFO officials have provided significant leadership in developing and promoting the awareness of these challenges throughout IRS. Continued visible support and leadership from those officials as well as the involvement of IRS’s business operating division executives and other officials remains essential.

Although levels of electronic filing of tax and information returns have been steadily increasing, IRS also faces 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 received. 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. Thus, 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.

**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, 2009 and 2008; 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 internal control deficiencies described in this report.
IRS's financial statements include tax revenues collected during the fiscal year as well as the total unpaid taxes for which IRS and the taxpayers or courts agree on the amounts owed. Cumulative unpaid tax assessments for which there is no future collection potential or for which there is no agreement on the amounts owed are not reported in the financial statements. Rather, they are reported as write-offs and compliance assessments, respectively, in required supplemental information to IRS’s financial statements. Also, in conformity with U.S. generally accepted accounting principles, 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, they are not reported in the financial statements nor in required supplemental information to the financial statements. Additionally, in conformity with U.S. generally accepted accounting principles, tax expenditures, which represent the amount of revenue 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, are not reported in the financial statements but rather are presented as other accompanying information.

Because of the two material weaknesses in internal control discussed below, IRS did not maintain, in all material respects, effective internal control over financial reporting as of September 30, 2009, and thus did not provide reasonable assurance that losses and misstatements 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 and its systems deficiencies, IRS was able to prepare financial statements that were fairly stated in all material respects for fiscal years 2009 and 2008. Nonetheless, IRS continues to face the following key issues that represent material weaknesses in internal control:

- Weaknesses in internal control over unpaid tax assessments, resulting in IRS’s inability to properly manage unpaid tax assessments and rendering IRS unable to rely on its core financial management system 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 also lead to increased taxpayer burden.
Weaknesses in internal control over information security, resulting in IRS's inability to rely on the controls embedded in its automated financial management systems to provide reasonable assurance that (1) the financial statements are fairly stated in accordance with U.S. generally accepted accounting principles, (2) financial information 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.

These material weaknesses in internal control may adversely affect any decision by IRS's management that is 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 reported by IRS in (1) its fiscal year 2009 FMFIA assurance statement to the Department of the Treasury, and (2) Management's Report on Internal Control over Financial Reporting. We considered the material weaknesses identified above in determining the nature, timing, and extent of our audit procedures on IRS's fiscal years 2009 and 2008 financial statements. We caution that misstatements may occur and not be detected by our tests and that such testing may not be sufficient for other purposes.

We have reported on these material weaknesses in prior audits and have provided IRS recommendations to address these and other less-significant issues. As of the date of this report, 136 recommendations were still open, of which 12 relate to the material weakness in internal control over unpaid assessments and 74 relate to the material weakness in internal control over information security. IRS continues to make strides in resolving these matters. We will follow up in future audits to monitor IRS's progress in implementing these recommendations. For more details on the material weaknesses, see appendix I.

We also identified other deficiencies in IRS's system of internal control that we do not consider to be material weaknesses or significant

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deficiencies. We have communicated these matters to management informally and, as appropriate, will be reporting them to IRS separately.

Compliance with Laws and Regulations

Our tests of IRS's compliance with selected provisions of laws and regulations for fiscal year 2009 disclosed one area of noncompliance that is reportable under U.S. generally accepted government auditing standards. This area relates to IRS not releasing federal tax liens against taxpayers’ property on time.\(^{15}\) (For more details on this issue, see app. I.) 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 three requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA) as of September 30, 2009.\(^{16}\) Specifically, IRS's financial management systems did not substantially comply with Federal Financial Management System Requirements (FFMSR), federal accounting standards (U.S. generally accepted accounting principles), and the U.S. Government Standard General Ledger (SGL) 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 SGL.

The issues resulting in IRS's systems' lack of substantial compliance with the FFMIA requirements relate to the material weaknesses discussed above, and were reflected in the material weaknesses reported by IRS in (1) its fiscal year 2009 FMFIA assurance statement to 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

\(^{15}\)Tax law requires IRS to release a federal tax lien 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. 26 U.S.C. § 6325(a).

noncompliant with the requirements of FFMIA. For more details on these issues, see appendix I.

Consistency of Other Information

IRS’s MD&A 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 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, and OMB Circular No. A-136, Financial Reporting Requirements.

Objectives, Scope, and Methodology

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. Management evaluated the effectiveness of IRS’s internal control over financial reporting as of September 30, 2009, based on the criteria established under FFMIA. IRS management provided an assertion concerning the effectiveness of its internal control over financial reporting (see app. II).

We are responsible for planning and performing the audit to obtain reasonable assurance and provide our opinion about whether (1) the 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, 2009, and (3) IRS’s financial management systems substantially comply with the three 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 assessments, revenue, refunds, payroll and nonpayroll expenses, property and equipment, and undelivered order transactions. 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;

- assessed the accounting principles used and significant estimates made by management;
- evaluated the overall presentation of the financial statements;
- obtained an understanding of IRS and its operations, including its internal control over financial reporting;
- 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 the financial statements and (2) material weakness in internal control over financial reporting;
- tested relevant internal control over financial reporting;
- evaluated the design and operating effectiveness of internal control over financial reporting based on the assessed risk;
- tested compliance with selected provisions of the following laws and regulations: Internal Revenue Code; Antideficiency 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; Continuing Appropriations Resolution, 2009, as amended; Department of the Treasury Appropriations Act, 2009; and American Recovery and Reinvestment Act of 2009;
- 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, 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.

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. 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 laws and regulations 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, 2009. 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 responding to this report, IRS stated that it is dedicated to continuing to improve its financial management and noted several recent significant accomplishments in addressing related challenges. IRS reported that in fiscal year 2009 it (1) conducted A-123 activities by testing transaction
processes material to the Department of the Treasury’s Consolidated Financial Statements, which included 16 administrative processes related to $12 billion in administrative transactions and 3 custodial tax processes related to $2.3 trillion in tax revenues; (2) established the CDDB as the subsidiary ledger to IRACS for revenue and refunds, which provided traceability for 98 percent of all revenue receipts to the detailed taxpayer transactions; (3) enhanced its financial management structure and processes to provide key management data on costs and enforcement tax revenue by publishing an IRS-wide Cost Accounting Manual and developing a plan to standardize the use of cost measures, and (4) ensured the continuity and resiliency of critical business processing systems by completing the development of disaster recovery plans for all general support systems.

IRS also stated that information security continues to be a priority, and noted that it had increased the security of IRACS, IFS, and the Treasury Information Executive Repository environment, by limiting access to a reduced number of authorized staff. Additionally, IRS stated it instituted role-based access in financial management systems and implemented controls to enforce the use of strong passwords in accordance with the Internal Revenue Manual. Finally, IRS recognized that challenges remain, but noted that it has a solid management team dedicated to promoting the highest standard of financial management and to continuing to increase the focus on information security and internal controls while improving financial reporting. The complete text of IRS's response is included in appendix III.

Sincerely yours,

Steven J. Sebastian
Director
Financial Management and Assurance

November 5, 2009
Management Discussion and Analysis

The Internal Revenue Service
FY 2009 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 $2.345 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, as well as oversight of tax-exempt organizations and the Earned Income Tax Credit program, the nation’s largest federally administered means-tested benefits program.

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 2009 Statistics

<table>
<thead>
<tr>
<th>IRS FY 2009 Statistics</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Revenue Collected</td>
<td>$2.345 trillion</td>
</tr>
<tr>
<td>Total Enforcement Revenue Collected</td>
<td>$48.9 billion</td>
</tr>
<tr>
<td>Total Refunds</td>
<td>$438 billion</td>
</tr>
<tr>
<td>Number of Hits on IRS.gov</td>
<td>1.7 billion</td>
</tr>
<tr>
<td>Number of Downloads from IRS.gov</td>
<td>191 million</td>
</tr>
<tr>
<td>Number of Returns Filed</td>
<td>236 million</td>
</tr>
<tr>
<td>Where’s My Refund? Usage</td>
<td>54 million</td>
</tr>
<tr>
<td>Number of Taxpayers Assisted</td>
<td>74 million</td>
</tr>
<tr>
<td>Number of Returns Filed Electronically</td>
<td>106 million</td>
</tr>
</tbody>
</table>

Financial Resources
The IRS FY 2009 budget was $11.52 billion in direct appropriations, supplemented by $175.7 million in user fee revenue and $152.5 million in reimbursable resources for a total operating level of $11.9 billion. The IRS also received $80 million in FY 2009 supplemental funding to execute the expanded Health Coverage Tax Credit (HCTC).

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
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.

GOALS AND OBJECTIVES

IMPROVE SERVICE TO MAKE VOLUNTARY COMPLIANCE EASIER

- 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

ENFORCE THE LAW TO ENSURE EVERYONE MEETS THEIR OBLIGATION TO PAY TAXES

- 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

STRATEGIC FOUNDATIONS: INVEST FOR HIGH PERFORMANCE

- 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
Management Discussion and Analysis

IRS RESOURCES

Funding by Appropriations ($ thousands)

In FY 2009, funding for the three core operating appropriations was allocated as follows:

- **Taxpayer Services** [$2,293,000] funds processing tax returns and related documents, and assistance for taxpayers in filing returns and paying taxes due.

- **Enforcement** [$5,117,267] 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** [$3,876,011] 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** [$229,914] funds capital asset acquisitions of information technology systems to modernize key tax administration systems.

- **Health Insurance Tax Credit Administration** [$15,406] funds the administration of the Health Coverage Tax Credit (HCTC). The IRS also received a one-time $80 million supplemental appropriation to expand the participants covered under this program as mandated by the American Recovery and Reinvestment Act (ARRA) of 2009.

- **Other: Mandatory Appropriation (Special Funds):** User Fees [$175,700] are receipts from payment for services provided and reimbursable agreements [$152,490].

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 2009 and 2008 data on the use of IRS resources by major programs:

<table>
<thead>
<tr>
<th>Use of Resources ($ thousands)</th>
<th>Program</th>
<th>FY 2009</th>
<th>FY 2008</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Taxpayer Assistance and Education</strong></td>
<td></td>
<td>$555,735</td>
<td>$622,852</td>
</tr>
<tr>
<td><strong>Filing and Account Services</strong></td>
<td></td>
<td>$3,350,070</td>
<td>$3,801,581</td>
</tr>
<tr>
<td><strong>Compliance</strong></td>
<td></td>
<td>$8,174,550</td>
<td>$8,136,464</td>
</tr>
<tr>
<td><strong>Administration of Health Insurance/Tax Credit Programs</strong></td>
<td></td>
<td>$189,685</td>
<td>$184,344</td>
</tr>
</tbody>
</table>

Page 19 GAO-10-176 IRS's Fiscal Years 2009 and 2008 Financial Statements
Strategic Plan Update

The 2009-2013 IRS Strategic Plan lays out the road map for the next four years. It will keep and build on strong and successful IRS programs while adapting to a new environment in which IRS interactions with taxpayers are more complicated.

The IRS must change with the complex and constantly changing environment in which it operates.

- Accelerating globalization and the development of new business models challenge IRS efforts to ensure that all businesses pay the taxes they owe.
- Tax laws are increasingly complex, and the role of tax practitioners and other third parties is expanding.
- The explosion in technology has raised expectations for new ways to interact with the IRS and increased security risks.

The Strategic Plan will guide the IRS to deliver a high level of performance both in how we serve taxpayers and in how we enforce the tax laws by emphasizing two overarching goals:

**Improve service to make voluntary compliance easier:**
- Incorporate taxpayer perspectives.
- Expedite resolution of taxpayer issues.
- Provide timely guidance to help all taxpayers pay their fair share.

**Enforce the law to ensure everyone meets their obligation to pay taxes:**
- Take timely enforcement actions.
- Expand approaches and tools used in compliance activities.
- Improve expertise and coordinating better with international organizations.

The IRS will support these goals by investing in two strategic foundations, its people and its technology. To succeed, it will:
- Strive to make the IRS the best place to work in government.
- Provide technology needed to improve efficiency, ensure privacy and security of data, and target the highest risk areas of tax abuse and fraud.

Fiscal Year (FY) 2009 Performance

For the second consecutive year, the IRS achieved an overall success rate of 69% in meeting or exceeding the targets for 22 of its 32 performance measures. Nine of the ten measures that fell below the target were within 95 percent 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 $48.9 billion, a 30% increase over FY 2003.

During FY 2009, the IRS continued its research studies of filing, payment and reporting compliance, including the National Research Program (NRP), to provide a comprehensive picture of overall taxpayer compliance levels. Research allows the IRS to target specific areas to improve voluntary compliance and to allocate resources more effectively to reduce the tax gap. In FY 2009, the NRP included analyzing individual income tax returns for Tax Years 2006 through 2008 as part of an ongoing reporting compliance study and studies of employment taxes and their contribution to the tax gap. The IRS also began a NRP study to address cases with the highest-compliance risk by providing an identification process for returns filed by U.S. persons living abroad.

The IRS is studying the effects of its taxpayer services (internet, walk-in sites, and toll-free hotline) on voluntary compliance including identifying why taxpayers make errors and exploring the relationships between errors made and unclear correspondence. Results will be used to develop new approaches to service.

As part of its continuing effort to measure the burden associated with meeting Federal tax obligations, the IRS surveyed 7,000 individual and self-employed taxpayers to measure time and expense in meeting filing requirements. Efforts are underway to develop models to measure time and expenses for small-business taxpayers who file income and employment tax returns. Estimates are scheduled to be released in FY 2010.
American Recovery and Reinvestment Act (ARRA) of 2009

The ARRA was signed into law on February 17, 2009. The bill was intended to create and save jobs, jumpstart the economy, and build the foundation for long term economic growth.

ARRA includes federal tax credits and expansion of unemployment benefits that are being implemented by the IRS.

Additionally, the President called on Federal agencies, including the IRS, to ensure that recovery funds are used for authorized purposes and every step is taken to prevent instances of fraud, waste, error and abuse. Therefore, every taxpayer dollar spent on the economic recovery is subject to unprecedented levels of transparency and accountability.

In FY 2009, to meet these stringent accountability requirements, the IRS developed a process to assess and mitigate risk to timely implement each provision. The process includes completion of a risk assessment for each provision that follows a systematic and disciplined approach to identify, assess and manage risks to avoid negative consequences as the provisions are implemented. Once risks have been identified, risk mitigation plans are established that include steps necessary to prevent erroneous payments from being made and also to identify any attempts to commit fraud. Some of the most common steps included in the IRS mitigation plan are:

- Developing controls to identify questionable claims for tax credits.
- Developing new forms for eligible taxpayers to calculate and claim tax credits that require proof of eligibility.
- Performing examinations of returns to ensure the credits are being claimed legitimately.
- Developing screening tools to be used during return processing that are designed to systemically reject claims for credits if all validation tests are not met.

American Recovery and Reinvestment Act of 2009 (ARRA)

Upon enactment of ARRA the IRS initiated work on the tax-related provisions to ensure timely implementation, including:

- Planning before and after passage of the Act to expedite implementation of immediate and retroactive provisions.
- Establishing comprehensive plans to ensure all Act provisions are timely implemented.
- Completion of several revised and new products released 3 days after the bill signing, including:
  - New Wage Withholding and Advanced Earned Income Credit Payment Tables and update to the withholding calculator available on IRS.gov
  - First-Time Homebuyer Claim Form
  - Employer’s Quarterly Federal Tax Return
  - Net Operating Loss publications
- Developing new publications to explain the tax provisions to individual and business filers.
- Informing taxpayers of the tax credits they may be entitled to through multiple communication channels including press releases, television commercials, and updated information on the IRS.gov website. For the first time, the IRS launched a YouTube video site and an iTunes podcast site to provide information on ARRA, tax tips, and how-to videos.
- Establishing new schedules for Tax Year 2009, Schedule M to calculate the Making Work Pay and Government Retiree credits, and Schedule L to help taxpayers complete their 2009 standard deduction based on certain state and local real estate taxes, net disaster losses, and qualified motor vehicle taxes.
- Developing updated information and educational materials, detailing changes to the Health Coverage Tax Credit to be distributed to taxpayers through IRS partners and stakeholders.
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 improved services through automation, outreach and education of taxpayers. In FY 2009, taxpayers continued to use the IRS website, IRS.gov, in record numbers to get current information. Passage of the First-Time Homebuyer Credit and provisions of the American Reinvestment and Recovery Act as well as questions on Economic Stimulus Payments meant the IRS needed to provide real time updated information to taxpayers as they filed their returns. Notable accomplishments include:

♦ Provided free tax assistance, including the preparation of over 3.0 million tax returns, at the more than 12,100 Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) sites.
♦ Established 320 additional VITA sites to provide face-to-face assistance to a larger population of taxpayers. In FY 2009, the IRS also served over 6.2 million taxpayers at its 401 TACs.
♦ Launched Spanish versions of the Free File Program, an interactive Spanish application for "How much was my Stimulus Payment?", and a Spanish Tax Practitioner Tool Kit.
♦ Developed a Recovery Rebate Credit Calculator to help taxpayers who did not receive a stimulus payment in 2008 determine if they were eligible for the credit, and if so, how much they could claim. Over 650,000 taxpayers used the calculator.

Improve Service to Make Voluntary Compliance Easier

Helping taxpayers understand their tax reporting and payment obligations is the foundation of taxpayer compliance. In FY 2009, the IRS met or exceeded 100% (12 of 12) of the Taxpayer Service performance targets.

In FY 2009, the IRS offered new and revised products including notices, forms, schedules and publications to improve return filing and to increase the number of taxpayers using electronic filing. The number and use of volunteers to assist taxpayers in meeting filing requirements increased as did the geographic locations. Communication with external stakeholder organizations including tax return preparers improved as more national and local events were held to share information on tax law changes and to solicit comments on tax issues affecting taxpayer groups.

Highlights of the 2009 Filing Season

The IRS delivered a successful 2009 filing season, rising to challenges posed by the residual effects of the 2008 Economic Stimulus Payment program and the implementation of the American Reinvestment and Recovery Act. Results of the 2009 filing season include:

♦ Processed 144.4 million individual returns and issued 111.4 million refunds totaling $339.6 billion.
♦ Achieved a 70% telephone level of service while answering 39 million calls.
♦ Answered 29 million automated calls.
♦ Correctly responded to 92.9% of tax law questions and 94.9% of account questions.
♦ Processed over 3.0 million Free File returns.
♦ Over 24 million people received approximately $49 billion in Earned Income Tax Credit.
♦ Processed over 385,000 First-Time Home Buyer Credit claims, including amended returns, for the credit totaling over $2.88 billion.

Increased electronic filing over 2008:

♦ Individual returns electronically filed surpassed 65.9% with the total number of individual returns filed electronically reaching 95 million, up from 57.6%.
♦ Business returns electronically filed reached 22.8%, an increase of 1.5 million.
♦ Home-computer filing increased to 32.2 million returns, a 19% increase over 2008.
♦ Tax professional use of e-file increased to 63.2 million returns.

In FY 2009, taxpayers used the IRS website, IRS.gov, to view current information. The expansion of on-line information, described in the Taxpayer Assistance Facts, also helped the IRS reach more...
Management Discussion and Analysis

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2009

Taxpayer Communications

Each year, the IRS sends more than 150 million notices to individual and business taxpayers. It is critical that correspondence provide clear and accurate information to help taxpayers understand and comply with the tax law. Notices and letters need to be easier for taxpayers to understand to help them navigate the tax system.

In FY 2009, the IRS Commissioner established a Taxpayer Communications Taskgroup (TACT) to study and improve the clarity, accuracy and effectiveness of written communications to taxpayers.

The TACT consists of five workgroups each focused on a key aspect of improving taxpayer communications:

♦ Collection Notices
♦ Correspondence Reduction
♦ E-Notices
♦ Error Reduction
♦ Exam Notices

Notable TACT accomplishments in FY 2009 included:

♦ Reduced the number of inserts included with a balance due notice from 13 to 2, reducing paper and improving clarity and readability. This streamlining effort will eliminate more than 16 million pieces of paper per year and also reduce annual postage costs by over $570,000.

♦ Eliminated inserts in practitioner copies of notices, reducing paper by approximately 15 million pieces per year and reducing annual postage costs by nearly $350,000.

♦ Developed new prototypes for 40 notices (these notices comprise 70% of the total volume of all notices sent out) that are clear, concise and provide better comprehension for taxpayers.

Taxpayer Education and Outreach

The IRS enhanced its outreach and educational services through partnerships with the public to increase understanding and compliance with the tax law. Free tax seminars were offered to groups of people sharing common tax interests on a variety of topics tailored to the members and included films, video tapes, and discussions of tax questions.

The IRS partners with organizations such as state taxing authorities and volunteer groups to serve taxpayer needs. Through its 6,468 VITA and 5,692 TCE sites, the IRS provided free tax assistance to the elderly, disabled, and limited English proficient individuals and families. Over 82,000 volunteers located at these sites filed over 3.0 million returns. VITA grants were awarded to 111 organizations, resulting in funding 2,700 sites across the nation preparing over 777,000 returns.

Based on last year’s demand and positive feedback, the IRS held the 2nd annual “Super Saturday” event resulting in the largest one-day outreach service event in IRS history. Successes from Super Saturday include:

♦ Assisted over 11,000 taxpayers with a variety of services including tax advice and return preparation.
♦ Answered over 33,000 calls and prepared over 53,000 returns for taxpayers needing assistance.
♦ Promoted and achieved approximately 200 media stories on Super Saturday.
♦ Used over 1,700 VITA sites across the country.

With many people facing additional financial difficulties, the IRS took several steps to work with taxpayers who owed delinquent taxes, especially those who have filed in the past and were facing unusual hardships. These included:

♦ Postponement of Collection Actions: The IRS suspended collection actions in certain hardship cases where taxpayers were unable to pay.

♦ Lien Relief for Homeowners trying to Refinance or Sell: In an effort to raise taxpayer awareness of the availability of the discharge and lien subordination process, IRS conducted various outreach efforts and sought feedback from the National Society of...
Seamless Taxpayer Experience

One of the IRS goals is to strengthen contacts with taxpayers and tax preparers so that every interaction is positive and seamless. In FY 2009, the IRS continued efforts to solicit feedback from taxpayers and practitioners regarding the products and services it provides. In addition, the IRS is conducting research to determine the types of services the taxpayers seek from various options (internet, walk-in, or toll-free) and their preferences among these options.

As a result of the Taxpayer Assistance Blueprint, the Seamless Taxpayer Experience Group (STEG) was created to serve as a catalyst between the IRS and taxpayers. Current efforts of the STEG include:

♦ Improving international access to IRS services by offering overseas taxpayers with the same or comparable access to services offered to taxpayers in the United States.

♦ Reducing amended return processing time to allow additional case types to be transferred to the Submission Processing function.

♦ Developing a new job aid to reduce delays in processing refund claims by reducing the number of cases erroneously referred to Examination.

♦ Coordinating creation of an international brochure that provides step-by-step navigation tips for using IRS.gov, contacting the IRS, and general tips on filing requirements for international taxpayers to all U.S. embassies and Consulate offices.

Accountants, the American Bar Association and the National Associations of Enrolled Agents and Tax Professionals resulting in a 20.8% increase in lien discharge applications and a 5.3% increase in lien subordination.

♦ Added Flexibility for Missed Payments: Previously compliant taxpayers in current Installment Agreements in certain cases were allowed to skip payments or pay a reduced monthly payment amount without automatic suspension of the Installment Agreement.

♦ Prevention of Offer in Compromise (OIC) Defaults: Taxpayers who were unable to meet the payment terms of an accepted OIC received a letter outlining options to avoid default.

♦ Expedited Levy Releases: The IRS released levies in an expedited manner for taxpayers suffering financial hardships.

♦ Offering Installment Agreements: The IRS offered installment agreements at the end of an audit to taxpayers having difficulty paying their tax liability.

The IRS continued to reach out to taxpayers eligible for the Earned Income Tax Credit (EITC) through a vigorous outreach strategy to increase participation that included:

♦ Creating EITC products and services designed to target underserved groups such as rural taxpayers, childless workers, and limited English proficient filers.

♦ Conducting a 3rd annual EITC Awareness Day to promote the EITC that may be a critical financial lifeline to many taxpayers. Community coalitions and IRS partners across the nation marked the day with a series of local news conferences and news releases promoting this refundable tax credit for low-wage taxpayers. The organizations operated free tax preparation sites for low and moderate-income individuals, seniors and other eligible taxpayers in every state.

♦ Increasing electronic filing of EITC returns by 8.2%.

In its second year, the IRS increased the number of Facilitated Self-Assistance workstations and phones to 50 sites, allowing nearly 12,500 taxpayers to access IRS.gov at Taxpayer Assistance Centers, a 420% increase from 2008.
Enforce the Law to Ensure Everyone Meets Their Obligation to Pay Taxes

Enforcement of the tax laws is an integral component of the IRS effort to enhance voluntary compliance. IRS enforcement activities, such as examination and collection, target elements of the tax gap and remained a high priority. In FY 2009, the IRS expanded its enforcement presence in the international field, continued to pursue high net-worth noncompliant taxpayers, and initiated action to better leverage the tax return preparer community.

Highlights of Enforcement Performance

The IRS met 50% (9 of 18) examination performance measures in FY 2009.

Total enforcement revenue was $48.9 billion in FY 2009. The IRS showed steady progress, building on its FY 2008 successes in key enforcement programs:

- Total individual audits increased 2.6%.
- Automated underreporter contact closures increased 2.6%.
- Number of high net-worth audits increased 11.2%.
- Large corporate audits increased 2.6%, a significant achievement given the size (more than $10 million) and complexity of these corporate entities.

The IRS also continued to vigorously investigate egregious tax, money laundering, and other financial crimes which adversely affect tax administration. Performance levels for the criminal investigation and exempt organization programs remained high in FY 2009 as the IRS:

- Completed 3,848 criminal investigations.
- Achieved a conviction rate of 87.2%.
- Maintained a Department of Justice acceptance rate of 91.7%, with a U.S. Attorney acceptance rate of 88.7%, which compares favorably with other federal law enforcement agencies.
- Obtained 2,105 convictions.
- Increased tax-exempt and government entities compliance contacts 10%.

In addition, the Questionable Refund Program (QRP), a nationwide multifunctional program designed to identify fraudulent returns and to stop payment of fraudulent refunds, continued to show positive results. Accomplishments include:

- Identified over 414,000 potentially fraudulent returns claiming over $2.7 billion in total refunds of which more than $2.3 billion in fraudulent refunds were stopped.
- Completed 418 QRP investigations and an 86.6% conviction rate, a 78.8% incarceration rate, and an 87.2% publicity rate on adjudicated cases.
Enforcement Accomplishments

In FY 2009, the IRS placed unprecedented focus on detecting and bringing to justice those who hide assets overseas to avoid paying tax. Two new initiatives were implemented as alternative methods of workload selection for offshore cases.

♦ Offshore Private Banking Initiative – the largest bank in Switzerland agreed to provide the names of 4,450 of their U.S. account holders and to pay a $780M fine, including $380 million to the IRS. Another bank entered into a deferred prosecution agreement to forfeit $340 million, the largest seizure in IRS history, in connection with violations of the International Emergency Economic Powers Act. The bank falsified outgoing U.S. wire transfers that involved countries/persons on the U.S. sanctions list.

♦ Over 7,500 people have filed “voluntary disclosure” applications since the IRS announced the partial amnesty in March. The deadline was extended through October 15 at the request of accountants and tax lawyers who were experiencing an influx of inquiries and needed more time to prepare formal applications under the program.

♦ Offshore Merchant Account Initiative – a summons was issued to a large processor of merchant accounts to identify U.S. businesses that deposit unreported business receipts from debit and credit card sales in accounts in banks domiciled in secrecy jurisdictions.

The IRS developed an approach to provide assistance to international taxpayers to improve voluntary compliance. Actions taken in FY 2009 include:

♦ Updated a “one-stop” tax page on IRS.gov for the more than 7 million non-military Americans living outside the U.S.

♦ Created an “International Tax Gap Series” on IRS.gov to educate the public on a variety of international issues.

♦ Released a new form for non-resident entertainers and athletes who plan to work in the U.S. The form provides the ability to calculate the correct amount of withholding based upon net income at graduated rates.

International Tax Administration

International compliance is a key challenge as reflected in the IRS strategic plan.

The IRS along with the Joint International Tax Shelter Information Centre identified new focus areas to curb cross-border abusive transactions to supplement the work being done on tax shelter transactions. They include:

♦ Tax administration issues arising from the global economic environment and financial crisis.

♦ Use of off-shore arrangements to avoid tax.

♦ Arrangements used by high net-worth taxpayers to minimize their tax liabilities.

♦ Tax administration approaches and activities to improve transfer pricing compliance.

The IRS established an Offshore Voluntary Disclosures/Penalty Framework for taxpayers to voluntarily disclose their offshore activities. The framework provides taxpayers the opportunity to:

♦ Calculate the total cost of resolving all offshore tax issues.

♦ Become compliant with United States tax laws.

♦ Make voluntary disclosures that will be used to further the IRS understanding of how foreign accounts and foreign entities are promoted to U.S. taxpayers as ways to avoid or evade tax.

♦ Provide data to be used in developing additional IRS strategies to inhibit promoters and facilitators from soliciting new clients.

The initiatives are part of an overall IRS strategy to improve offshore compliance. The publicity surrounding the IRS successes resulted in an increase in the number of taxpayers with offshore accounts voluntarily coming forward to disclose information. This strategy and the initiatives underway also identify banks, promoters and others that offer, facilitate and enable abusive offshore tax avoidance schemes and other questionable financial arrangements. They bring high-wealth individuals and on-line e-commerce merchants into tax compliance.

As part of the effort to detect and deter aggressive tax shelters, the IRS launched a settlement initiative for both Lease In/Lease Out (LILO) and
In FY 2009, thousands of taxpayers were victimized by dozens of fraudulent investment schemes including “Ponzi schemes” where the perpetrator of the fraud promises returns which turn out to be fictitious. In FY 2009, one such scheme affected a large and diverse pool of investors, some of whom are reported to have lost most of their life savings. These cases raise numerous tax and pension implications for the victims. To assist the affected taxpayers, the IRS issued guidance designed to provide “safe-harbor” procedures for taxpayers who sustained losses in investment arrangements that were determined to be criminally fraudulent. The guidance:

- Provides a uniform approach to calculate the timeframe and amount of the theft loss.
- Avoids difficult problem of proof in determining how much of the income the taxpayer reported was fictitious.
- Alleviates the compliance burden on taxpayers and the administrative burden on the IRS.

The Compliance Assurance Process (CAP) identifies and resolves tax issues through open and transparent interaction between the IRS and large corporations. CAP participation has grown from 17 corporations in 2005 to 102 in 2009. The CAP program benefits both the IRS and the taxpayer by fostering compliance, reducing the time to process a return, and improving customer and employee satisfaction while maintaining a high level of quality. CAP involves some of the largest U.S. corporations.

In FY 2009, the IRS developed a comprehensive set of potential recommendations to ensure consistent standards for tax preparer qualifications, ethics and service. The recommendations were developed using information obtained from a large and diverse constituent community that included those licensed by state and federal authorities, unlicensed tax preparers, software vendors, consumer groups and taxpayers. Over 450 taxpayers and tax professionals along with 600 IRS employees responded to the IRS request for comments to help better leverage the tax return preparer community with the twin goals of increasing taxpayer compliance and ensuring uniform and high ethical standards of conduct for tax preparers.

The IRS continues to help pension plans, exempt organizations, and government entities comply with tax laws. In FY 2009, the IRS:

- Released the results of its nonprofit hospital study. The research presented demographics of nonprofit hospitals and their community benefit and executive compensation reporting and practices that can be used by Congress and others to revise community benefit and reasonable compensation standards.
- Created a new category of practitioner, “Enrolled Retirement Plan Agent” (ERPA). This new category allows practitioners who have administrative/financial information about a plan to have a limited practice before the IRS under the safeguard of Circular 230. In addition, ERPAs provide valuable information to the IRS with respect to the administrative and financial issues affecting retirement plans.
Strategic Foundations: Invest For High Performance

Business Systems Modernization (BSM)

IRS modernization efforts continue to focus on core tax administration systems designed to provide more sophisticated tools to taxpayers and to IRS employees. Customer Account Data Engine (CADE), Modernized e-File (MeF), and Account Management Services (AMS) modernization projects delivered the required changes for the filing season, supported implementation of ARRA provisions, and provided audit trails addressing security vulnerabilities.

FY 2009 successes include:

♦ Customer Account Data Engine (CADE). The IRS successfully deployed CADE Release 4.2 in January 2009. With this release, CADE added capabilities to process prior-year and decedent returns, remittances, estimated tax payments, requests for extensions and surname changes. In FY 2009, CADE processed over 40.0 million returns issued more than 34.9 million refunds using a modernized account database, and processed over 7 million payments totaling $56.6 billion. In addition, the IRS developed a comprehensive Audit Trail Plan for CADE outlining the audit trail requirements necessary to account for assets and processes across the IRS.

♦ Modernized e-File (MeF). The IRS deployed MeF Release 5.5 that included the redesigned Form 990 (Return of Organization Exempt from Income Tax) in time for the filing season. MeF processed Form 1120 and 990 returns at much higher volumes than expected. The volume of Form 1120 returns increased 38% and Form 990 increased 307% from 2008. Returns submitted through MeF have an average 7% processing error rate, compared to 19% for transcription-based paper processing. MeF return receipts increased to about 4.5 million.

♦ Account Management Services (AMS). Completed the 2009 releases of AMS providing additional real-time address changes to CADE by the conversion of account transcripts from paper to electronic format. AMS processed over 2.3 million accounts since deployment and more than 2.2 million electronic transcript cases were distributed. In addition, AMS delivered the capability to update account address data on a daily cycle. AMS added a new component to its organization in FY 2009, the Integrated Automation Technologies (IAT) Branch. The IAT developed tools to support the implementation of ARRA including the First-Time Home Buyer Credit tool which systematically researches amended returns for specific criteria to identify unavailable or fraudulent claims.

Strategic Foundation Facts

♦ Refreshed over 8,200 laptops and 12,800 desktops.
♦ Deployed over 26,600 aircards, 820 Blackberries, 1,500 shredders, and 550 printers to employees across the country.
♦ Equipped laptops with more sophisticated disk encryption software to protect against unauthorized use of sensitive data.
♦ Repelled more than 35 million unauthorized access attempts, with about 1/3 of this malicious activity originating from outside the U.S. borders.
♦ Successfully delivered 243 filing season applications and planned modernization projects.
♦ Allowed 3,730 employees to take courses in accounting and information technology or pursue other IRS-related opportunities through the Tuition Assistance Program.
Workforce of Tomorrow

The IRS Commissioner established a Workforce of Tomorrow (WOT) task force to address recruitment and retention issues so that the IRS has the necessary leadership and workforce to address future challenges.

The IRS conducted research, developed solutions, and tested recommendations to produce a roadmap of initiatives to address the most significant workforce challenges.

Highlights of the recommendations by the WOT task force included:

♦ Streaming the hiring process.
♦ Revising all communications used in the hiring process.
♦ Streamlining leadership competencies.
♦ Launching a “One IRS” Community Events pilot across the nation.
♦ Signing a Memorandum of Understanding with NTEU to pilot the Ambassador Program pairing new hires with current employees.
♦ Implementing a single-sign-on initiative reducing the number of passwords required for IRS systems.
♦ Establishing a new centralized IRS Recruitment Office within the Human Capital Office.
♦ Developing an attrition model to project attrition probabilities through 2020. The model estimates attrition by various organizational, demographic and work-related factors.
♦ Developing consistent equipment profiles for each IRS occupation.
♦ Enhancing the focus on recognition and career development for employees.

Implementation of the recommendations is underway with periodic tracking and reporting of milestones. An Annual Workforce Summit is planned for February 2010 to evaluate progress and continue the focus on work-force issues.

IT Security

The IRS collects a tremendous amount of sensitive information, and protecting this information is vital to maintaining the public trust. Public trust encourages voluntary compliance with the tax law and enables the IRS to conduct business effectively.

The IRS takes the issue of Identity Theft very seriously. In FY 2009, to preserve and enhance public confidence, the IRS advocated the protection and proper use of identity information by completing the following:

♦ Opened Identity Protection Specialized Units (IPSUs) and established a dedicated toll-free number to provide guidance and assistance to taxpayers affected by identity theft. These units assist taxpayers who have experienced tax administration issues or problems as a result of identity theft. In the first year, the IRS responded to 120,000 calls and opened nearly 34,000 cases for further action.

♦ Placed markers on more than 231,300 taxpayer accounts to alert employees the account belongs to a substantiated identity theft victim. The IRS also provided a portfolio of identity protection services for taxpayers, including letters to individuals triggered by the account marker informing taxpayers that their personal information was used by another individual to file a return or may have been compromised through phishing scams. In FY 2009, the IRS sent nearly 79,600 letters.

♦ Eliminated the use of Social Security Numbers (SSNs) on more than 8 million forms, notices, and letters. This is the first large-scale effort to eliminate and reduce the use of SSNs on taxpayer correspondence. Over the next 2 to 5 years IRS will eliminate the use of SSNs on more than 90 million notices and forms.

The Office of Online Fraud Detection and Prevention (OFDP) protects the IRS and taxpayers from increasing and evolving online threats. Through the OFDP, the IRS shut down 3,444 phishing Web sites in FY 2009 (1,578 domestic sites and 1,866 international sites), compared to 2,926 sites in 2008. The median shut down time was 2.35 hours for domestic phishing sites and 6.85 hours for international. By monitoring, identifying, and mitigating fraudulent sites and phishing scams, OFDP helps to reduce the number of taxpayers who fall victim to online fraud schemes.

Human Capital

In FY 2009, the IRS focused on workforce retention and replenishment, leadership succession planning, and competency gap assessment and resolution.

The level of employee engagement affects the ability to meet goals,
Enforcement Hiring

In FY 2009, the IRS engaged in one of the most extensive enforcement hiring efforts in years resulting in an enforcement staffing increase of over 3,000 employees.

To ensure coordination at all levels, the IRS established a governance structure to provide oversight for the hiring initiatives and created a centralized office to coordinate all recruiting efforts and piloted a consolidated approach to Revenue Agent hiring and training. For the first time, candidates who applied for multiple jobs in different locations were ranked and interviewed once, and competing organizations collaborated on selections to ensure the best-skilled individual was hired for each vacant position.

Veteran Hiring

The IRS promotes partnering with government and state agencies in an effort to recruit and employ qualified veterans.

- The IRS launched a six-month pilot of an Army-sponsored intern program to develop career skills and address the unique issues of veterans in the workplace.
- Veteran hiring increased 85% from 902 in FY 2006 to 1,669 in FY 2009.
- FY 2009 targeted recruitment efforts resulted in an increase in veteran hires from 1 in every 17 new hires in FY 2006 to 1 in every 11 new hires in FY 2009.

minimize attrition, and increase productivity. The IRS conducts an annual survey to assess the level of engagement of employees – 72% of employees participated in FY 2009 (a 7 percentage point increase). Overall employee satisfaction increased from 69% in FY 2007 to 74% in FY 2009 and employee engagement showed steady improvement from a score of 3.66 in 2007 to a score of 3.74 in 2009, on a scale of 1 to 5, with 5 being the most satisfied. The IRS uses these results to improve the workplace.

The IRS uses its Leadership Succession Review (LSR) process to identify the leaders of tomorrow with 80% of managers participating. Leadership competency, proficiency, and knowledge gaps for participating managers address individual developmental strategies using a web-based Career Learning Plan (webCLP) linked to LSR. The webCLP is an automated individual career learning plan used to develop a plan for growth in the current job or to prepare for advancement and to identify employees for developmental opportunities through acting assignments, details, and work on task forces.

In FY 2009, the IRS piloted the Succession Planning program that was recently recognized by The Best Practice Institute as a “best practice.” As a result, the IRS program will be included in the upcoming Best Practices in Talent Management Handbook in January 2010. Succession planning ensures employees possess the competencies necessary to meet future IRS needs at every level.

IRS continued the process of distributing new identification badges to employees, as mandated by Homeland Security Presidential Directive-12 (HSPD-12). To facilitate the delivery of badges to over 5,000 employees in remote locations, IRS established mobile credentialing circuits. A primary hurdle in reaching remote employees was the high cost and often unavailability of networking options to connect credentialing stations to the Internet. IRS leveraged the use of a Common Communication Gateway to not only provide the necessary connection, but also to phase out costly network connections at existing credentialing station locations.

In an effort to reduce the number of travel systems throughout the government, GSA required agencies to use an e-Travel service. The IRS migration to the new Gov-Trip entailed rolling it out to all IRS travelers. In FY 2009, the IRS delivered Gov-Trip to 60,446 travelers in all business units, successfully enrolling 100% of IRS travelers.
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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)

During FY 2009, the IRS complied with the internal control requirements of FMFIA, the Office of Management and Budget (OMB) Circular A-123, and the Reports Consolidation Act of 2000.

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

- Programs achieve their intended results
- Resources are consistent with the overall mission
- Programs and resources are protected from waste, fraud, abuse, mismanagement, and misappropriation of funds
- Laws and regulations are followed
- Controls are sufficient to minimize improper and erroneous payment
- 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 standards are in compliance with Federal financial systems standards, i.e., FMFIA Section 4 and Federal Financial Management Improvement Act (FFMIA).

Because the IRS has open material weaknesses and the financial management systems do not substantially comply with the FFMIA, the IRS provides qualified assurance that the above-listed systems of management control objectives were achieved by the IRS during FY 2009. This assurance is provided relative to Sections 2 and 4 of FMFIA. The FFMIA material weaknesses are:

- Improve Modernization Management and Processes
- Computer Security
- Financial Accounting of Revenue – Custodial

Federal Financial Management Improvement Act (FFMIA)

The IRS made significant progress in FY 2009 toward resolving the Financial Reporting material weakness to bring the tax revenue financial management systems in compliance with FFMIA. In FY 2009, the IRS completed the Custodial Detailed Database (CDDB) that serves as the subsidiary ledger for the Interim Revenue Accounting and Control System. In addition, IRS developed the Redesign Revenue Accounting and Control System (RRACS) that will be implemented in January 2010 allowing the IRS to comply with the U.S. standard general ledger and create traceability from the summary records to the detailed records in...

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 2009, the IRS conducted the following A-123 activities:

- Tested 19 transaction processes material to Treasury’s Consolidated Financial Statements.
  - 16 administrative processes related to $12 billion in administrative transactions.
  - 3 custodial revenue processes related to $2.345 trillion in tax revenues.
- Conducted supplemental testing of the FY 2009 transactions in the fourth quarter to verify that controls remained effective throughout the year.
- Reviewed controls over financial reporting, including Treasury Information Executive Repository (TIER) reporting.
- 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 upon the results of the evaluation, the IRS provided qualified assurance that its internal controls were operating effectively.

The qualified assurance is based on the fact that the IRS has open material weaknesses currently being addressed in corrective action plans. The IRS has 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 has issued an unqualified opinion in FY 2009 and 2008.

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In accordance with the requirements of FISMA, the IRS continued to take actions to establish a stronger agency-wide information security program.

<table>
<thead>
<tr>
<th>Actions</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Certification and testing of Systems</td>
<td>100%</td>
</tr>
<tr>
<td>Systems Accreditation</td>
<td>98%</td>
</tr>
<tr>
<td>Specialized Training</td>
<td>99.9%</td>
</tr>
<tr>
<td>Annual Awareness Training</td>
<td>99%</td>
</tr>
<tr>
<td>Contractor Systems Reviews</td>
<td>100%</td>
</tr>
<tr>
<td>Annual Security Controls Testing</td>
<td>100%</td>
</tr>
<tr>
<td>Annual IT Contingency Plan Testing</td>
<td>100%</td>
</tr>
<tr>
<td>Privacy Impact Assessment</td>
<td>100%</td>
</tr>
<tr>
<td>System of Record Notice</td>
<td>100%</td>
</tr>
</tbody>
</table>

In addition to the sustained performance from last year:

IRS received agreement with TIGTA to close the Security Training and the Certification and Accreditation components of the IRS Computer Security Material Weakness. The closing memorandum stated, "The actions taken by the IRS have yielded significant progress toward implementing effective, repeatable processes in these areas."

The Disaster Recovery Program made major enhancements to ensure the continuity and resiliency of IRS critical business processing systems by completing the development of disaster recovery plans for all General Support Systems; updating all IT contingency plans; performing over 400 tests and exercises; and performing an in-depth assessment and gap analysis of business processes and enterprise disaster recovery capabilities.

IRS continues to implement a risk management approach that cost-effectively focuses resources on major systems and assets supporting tax administration.

Lien Release Non-Compliance Issue

As of September 30, 2009, 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

The IRS continues to provide assurance that its critical performance measures are reliable. Internal Revenue Manual 1.5, "Managing Statistics in a Balanced Measurement System," provides a detailed template that documents each measure’s definition, formula, reliability, and reporting frequency. These controls are in place to ensure that the data are consistently and accurately collected over time.

Continuity of Operations (COOP)

The IRS Disaster Response Plan established a comprehensive partnership approach and response to Presidential-declared disasters. This partnership combines the strengths from both Governmental Liaison/Stakeholder Liaison that helps mobilize field personnel to assist taxpayers in areas affected by the declared disaster.

The IRS uses a combination of four integrated plans called the Business Continuity "Suite of Plans" to prepare for, respond to, and recover from an incident. The Suite of Plans are integrated through the use of the Incident Command System, that allows for a consistent, efficient, and effective response and recovery. These four plans include:

- The Occupant Emergency Plan/Shelter in Place Plan provides a set of response procedures and actions taken during the onset of an emergency to minimize the impact of the incident.
- The Incident Management Plan allows for management of the incident.
- The Business Resumption Plan is the business/functional unit plan that includes the advance planning and preparations necessary to minimize loss and ensure continuity of the critical business processes.
- The Disaster Recovery Plan is the Information Technology Plan that includes recovery of the IT infrastructure, network, hardware, systems, applications and operating systems.
Progress Made in Revenue Accounting and Cost Accounting

In FY 2009, GAO determined that the IRS had made sufficient progress in revenue accounting and cost accounting that it eliminated the material weakness in internal control over financial reporting and the significant deficiency in internal control over tax revenue and refunds.

To eliminate the material weakness, IRS established the Custodial Detail Database (CDDB) as the subsidiary ledger to the Interim Revenue Accounting and Control System (IRACS) for revenue and refunds. Through IRACS and CDDB, IRS established traceability of 98% of all revenue receipts, almost $2.3 trillion in FY 2009, to the detailed taxpayer transactions. In addition, prior-year frozen credit transactions systemically frozen from refunding or offsetting pending future action on the taxpayer’s account were loaded into CDDB. Audit plans were developed by GAO to use CDDB to test revenue receipts and refunds during the FY 2009 financial audit for the first time.

To eliminate the significant deficiency, IRS enhanced its financial management structure and processes to provide key management data on costs and enforcement tax revenue. The IRS demonstrated increased use of cost information by publishing an IRS-wide Cost Accounting Manual, establishing an IRS-wide cost accounting users group, and developed a plan to standardize the use of cost based measures approved by the Examination Enforcement Governance Council. The IRS continued to expand its ability to calculate standardized cost data and metrics for a wide variety of its products and services across all business units through the development of policies and methodologies adopted throughout the agency.

Major Management Challenges and High-Risk Areas

The Government Accountability Office (GAO) and the Treasury Inspector General for Tax Administration (TIGTA) identified several Management Challenges and High-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 on its July 2009 High-Risk List and by TIGTA in the October 15, 2008 memorandum titled Management and Performance Challenges Facing the Internal Revenue Service for Fiscal Year 2009.

♦ GAO High Risk Areas for IRS
  o IRS Business Systems Modernization
  o Enforcement of Tax Laws

♦ TIGTA Management Challenges
  o Modernization of the Internal Revenue Service (Computerized Systems and Business Structure) and IRS Business Systems
  o Security of the Internal Revenue Service
  o Enforcement of Tax Laws (GAO) and Tax Compliance Initiatives
  o Providing Quality Taxpayer Service Operations
  o Human Capital
  o Erroneous and Improper Payments
  o Complexity of the Tax Law
  o Taxpayer Protection and Rights
  o Processing Returns and Implementing Tax Law Changes
  o Improving Performance and Financial Data for Program and Budget Decisions

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.
**Overview of Revenue and Administrative Accounts**

The IRS FY 2009 financial statements received an unqualified audit opinion for the tenth consecutive year.

The Balance Sheet reflects total assets of $37 billion of which $29 billion (78%) are Federal Taxes Receivable, which represents amounts expected to be collected from past due accounts. The $1 billion increase in total assets is primarily attributable to the increase in Due from Treasury for refunds payable to the taxpayer. 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 $2.345 trillion in federal tax receipts.

**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).

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**Financial Highlights**

**Revenue and Refund Trend Information**

FY 2009 revenue receipts collected by IRS, $2.345 trillion, decreased by approximately 15% from FY 2008. 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 2009 tax refund activity, $438 billion, increased by approximately 3% from FY 2008. Federal tax refunds include payments for tax, interest, and Earned Income Tax Credit and Child Care Tax Credit in excess of the tax liability. In FY 2009, the IRS issued payments of $46 million for Advanced Earned Income 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 2006 through September 2008. The Department of the Treasury prepares the warrants and allocations to the trust funds.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Airport &amp; Airway Trust Fund</td>
<td>$11,531,893,000</td>
<td>$11,734,723,000</td>
</tr>
<tr>
<td>Black Lung Disability Trust Fund</td>
<td>651,394,000</td>
<td>644,590,000</td>
</tr>
<tr>
<td>Highway Trust Fund</td>
<td>39,891,934,000</td>
<td>38,052,198,000</td>
</tr>
<tr>
<td>Total</td>
<td>$52,075,221,000</td>
<td>$50,431,511,000</td>
</tr>
</tbody>
</table>

**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 2009 Financial Statements, the unpaid assessment balance was $308 billion as of September 30, 2009, and $171 billion (56%) 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 assessments and write-offs. Under federal accounting
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Custodial Detail Data Base (CDDB)
CDDB was developed by the IRS to comply with the Federal Financial Management Improvement Act and to resolve a material weakness in financial systems relating to accounting for duplicate Trust Fund Recovery Penalty (TFRP) assessments and the lack of a subsidiary ledger. Noteworthy FY 2009 accomplishments for include:

♦ IRS demonstrated traceability for 98% of the revenue receipts to GAO using Trace ID for the FY 2009 financial audit and all refunds. For the FY 2008 financial audit, IRS demonstrated the traceability for 78% of the revenue receipts.
♦ Implemented Release 4 to load frozen credit transactions into CDDB.

Redesign Revenue Accounting Control System (RRACS)
RRACS will allow the IRS to comply with the U.S. standard general ledger and create traceability from the summary records to the detailed records in the subsidiary ledger CDDB. In FY 2009, the IRS completed RRACS development.

Integrated Financial System (IFS)
FY 2009 accomplishments include:

♦ Completed IFS interface with GovTrip – implemented eGov.
♦ Significantly reduced user access to the mainframe by migrating legacy system reports to the business warehouse, retired legacy processes, and trained users on reporting capabilities.
♦ Implemented automated tax withholding for employee tuition assistance, created employee invoices, and automatically posted all payments received via pay.gov.
♦ Updated contingency plans, completed penetration and disaster recovery testing.
♦ Exceeded the average system uptime target of 97%.

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 $128 billion (42%) of unpaid assessments and increased $16 billion (14%) from $112 billion as of September 30, 2009. About $99 billion (77%) of this balance is estimated to be uncollectible due primarily because of the economic situation of the taxpayers. Except for bankruptcy situations, the IRS may continue collection actions for 10 years after the assessment. About $29 billion (23%) of taxes receivable is estimated is to be collectible.

♦ Compliance assessments of $75 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 $105 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)
IFS is the financial management system for the administrative activities in IRS and provides the accounting for $11.5 billion in funding. 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 Care Tax Credit Payments (HCTC), Budget Formulation, Labor Forecasting and Budget Execution decision support. Detailed financial, cost accounting, property accounting and procurement data are available for authorized users.
### Appendix B: Performance Measurement Data

<table>
<thead>
<tr>
<th>Measure</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>Target</th>
<th>Actual</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customer Service Representative (CSR) Level of Service</td>
<td>82.0%</td>
<td>82.1%</td>
<td>52.8%</td>
<td>70%</td>
<td>70.0%</td>
<td></td>
</tr>
<tr>
<td>Customer Contacts Resolved per Staff Year</td>
<td>7,414</td>
<td>7,648</td>
<td>12,634</td>
<td>10,386</td>
<td>12,918</td>
<td></td>
</tr>
<tr>
<td>Percent of Eligible Taxpayers Who File for EITC (CY) * * *</td>
<td>75%-80%</td>
<td>NA</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Customer Accuracy – Tax Law Phones</td>
<td>90.9%</td>
<td>91.2%</td>
<td>91.2%</td>
<td>91.0%</td>
<td>92.9%</td>
<td></td>
</tr>
<tr>
<td>Customer Accuracy – Customer Accounts (Phones)</td>
<td>93.2%</td>
<td>93.4%</td>
<td>93.7%</td>
<td>93.5%</td>
<td>94.9%</td>
<td></td>
</tr>
<tr>
<td>Timeliness of Critical Individual Filing Season Tax Products to the Public</td>
<td>83.0%</td>
<td>83.5%</td>
<td>92.4%</td>
<td>92.0%</td>
<td>96.8%</td>
<td></td>
</tr>
<tr>
<td>Timeliness of Critical TE/GE and Business Tax Products to the Public</td>
<td>61.2%</td>
<td>84.0%</td>
<td>89.5%</td>
<td>89.0%</td>
<td>95.2%</td>
<td></td>
</tr>
<tr>
<td>Percent Individual Returns Processed Electronically</td>
<td>54.1%</td>
<td>57.1%</td>
<td>57.6%</td>
<td>64.0%</td>
<td>65.9%</td>
<td></td>
</tr>
<tr>
<td>Cost per Taxpayer Served ($) (HCTC)</td>
<td>$13.71</td>
<td>$14.90</td>
<td>$16.94</td>
<td>$17.00</td>
<td>$13.79</td>
<td></td>
</tr>
<tr>
<td>Sign-Up Time (Days) – Customer Engagement (HCTC)</td>
<td>98.7</td>
<td>93.3</td>
<td>94.0</td>
<td>97.0</td>
<td>97.3</td>
<td></td>
</tr>
<tr>
<td>Percent Business Returns Processed Electronically</td>
<td>16.6%</td>
<td>19.1%</td>
<td>19.4%</td>
<td>21.6%</td>
<td>22.8%</td>
<td></td>
</tr>
<tr>
<td>Refund Timeliness – Individual (Paper)</td>
<td>99.3%</td>
<td>98.9%</td>
<td>99.1%</td>
<td>98.4%</td>
<td>99.2%</td>
<td></td>
</tr>
<tr>
<td>Taxpayer Self Assistance Rate</td>
<td>46.8%</td>
<td>49.5%</td>
<td>66.8%</td>
<td>64.7%</td>
<td>69.3%</td>
<td></td>
</tr>
<tr>
<td>Examination Coverage – Individual</td>
<td>1.0%</td>
<td>1.0%</td>
<td>1.0%</td>
<td>1.0%</td>
<td>1.0%</td>
<td></td>
</tr>
<tr>
<td>Field Examination National Quality Review Score</td>
<td>85.9%</td>
<td>85.9%</td>
<td>86.0%</td>
<td>87.0%</td>
<td>86.1%</td>
<td></td>
</tr>
<tr>
<td>Office Examination National Quality Review Score</td>
<td>88.2%</td>
<td>89.4%</td>
<td>90.0%</td>
<td>90.0%</td>
<td>92.1%</td>
<td></td>
</tr>
<tr>
<td>Examination Quality – Industry</td>
<td>85.0%</td>
<td>87.0%</td>
<td>88.0%</td>
<td>88.0%</td>
<td>88.0%</td>
<td></td>
</tr>
<tr>
<td>Examination Quality – Coordinated Industry</td>
<td>96.0%</td>
<td>96.0%</td>
<td>97.0%</td>
<td>96.0%</td>
<td>95.0%</td>
<td></td>
</tr>
<tr>
<td>Examination Coverage – Business (Corps. &gt;$10M)</td>
<td>7.3%</td>
<td>6.8%</td>
<td>6.1%</td>
<td>5.8%</td>
<td>5.6%</td>
<td></td>
</tr>
<tr>
<td>Examination Efficiency – Individual (1040)</td>
<td>128</td>
<td>137</td>
<td>138</td>
<td>132</td>
<td>138</td>
<td></td>
</tr>
<tr>
<td>Automated Underreporter (AUR) Efficiency</td>
<td>1.832</td>
<td>1.956</td>
<td>1.962</td>
<td>1.855</td>
<td>1.905</td>
<td></td>
</tr>
<tr>
<td>Automated Underreporter (AUR) Coverage</td>
<td>2.4%</td>
<td>2.5%</td>
<td>2.6%</td>
<td>2.5%</td>
<td>2.6%</td>
<td></td>
</tr>
<tr>
<td>Collection Coverage – Units</td>
<td>54.0%</td>
<td>54.0%</td>
<td>55.2%</td>
<td>54.4%</td>
<td>54.2%</td>
<td></td>
</tr>
<tr>
<td>Collection Efficiency – Units</td>
<td>1,677</td>
<td>1,828</td>
<td>1,926</td>
<td>1,872</td>
<td>1,845</td>
<td></td>
</tr>
<tr>
<td>Field Collection Embedded Quality</td>
<td>84.2%</td>
<td>84.0%</td>
<td>79.0%</td>
<td>80.0%</td>
<td>80.5%</td>
<td></td>
</tr>
<tr>
<td>Automated Collection System (ACS) Accuracy</td>
<td>91.0%</td>
<td>92.9%</td>
<td>95.3%</td>
<td>92.0%</td>
<td>94.3%</td>
<td></td>
</tr>
<tr>
<td>Criminal Investigations Completed</td>
<td>4,157</td>
<td>4,269</td>
<td>4,044</td>
<td>3,900</td>
<td>3,848</td>
<td></td>
</tr>
<tr>
<td>Number of Convictions</td>
<td>2,019</td>
<td>2,155</td>
<td>2,144</td>
<td>2,135</td>
<td>2,105</td>
<td></td>
</tr>
<tr>
<td>Conviction Rate</td>
<td>91.5%</td>
<td>90.2%</td>
<td>92.3%</td>
<td>92.0%</td>
<td>87.2%</td>
<td></td>
</tr>
<tr>
<td>Conviction Efficiency Rate ($)</td>
<td>$328,750</td>
<td>$301,788</td>
<td>$315,751</td>
<td>$317,100</td>
<td>$327,328</td>
<td></td>
</tr>
<tr>
<td>TE/GE Determination Case Closures</td>
<td>108,462</td>
<td>109,408</td>
<td>100,050</td>
<td>100,050</td>
<td>100,050</td>
<td></td>
</tr>
</tbody>
</table>

* *The methodology for estimating the eligibility rate is being revised.
**Cost and Schedule variance is based on +/- 10% and was reported separately for each project release/sub-release. In FY 2008, these measures were changed to reflect an overall percentage of all projects that were within the +/- 10% threshold for cost and schedule variance.
**Explanation of Shortfalls**

**Field Examination National Quality Review Score:** Actions underway to address quality weaknesses include: the National Quality Review Staff issued Quality Alerts to the Field to address the decline in the Solicit Payment attribute; Income Toolkit training began in the final quarter of FY 2009; area case quality improvement teams continue to work to address area specific quality deficiencies; area level quality targets will be reestablished in FY 2010, with specific emphasis on improvement within the weakest attributes.

**Exam Quality – Coordinated Industry:** Workpapers did not adequately document audit techniques used and conclusions reached, and the Examination reports did not adequately document the issue, fact, law, arguments and conclusions. In addition, Administrative Procedures Documents were missing or not signed by the Team Coordinator and/or the Team Manager. Improvements will focus on the importance of meeting the Auditing Standards through direct feedback to field teams, partnering with the industries in Quality Improvement Efforts, Quality Quotes, Quarterly Reports and outreach efforts.

**Exam Coverage – Business:** Although Large Business Closures (13,582) fell short of plan, results exceeded FY 2008 closures of 13,366. Actual return filings were 242,037, surpassing estimates of 237,315 used to compute the coverage percentage, causing the drop in coverage. The increased return filings were primarily in the 1120 and 1120S categories.

**Collection Coverage – Units:** A delay in the full implementation of Business Master File Case Creation Nonfiler Identification Process caused a delay in processing notices. Collection organizations have worked together throughout the year to identify and assign inventory to the campuses to mitigate the notice disposition shortfall.

**Collection Efficiency:** The large number of new employees in FY 2009 were not as productive as experienced caseworkers. Notice dispositions were also down 1.0 million (6.5%) over last year. Factors in the notice decrease included: delays in return delinquency notice processing earlier in the year resulted in a corresponding delay in notice closures, and a programming change in January 2009 accelerated notice accounts directly to revenue officers with related cases.

**Criminal Investigations Completed:** Legal source investigations were 13.3% above last fiscal year (1,734 vs. 1,531) and tax-related investigations increased 14.4% (2,612 to 2,283). The increased focus on legal and tax cases (which are more complex and have a higher cycle time) coupled with additional time spent on reducing cases in the pipeline resulted in a lower number of investigations completed. For FY 2010, the increase in the number of investigations initiated in FY 2009 will contribute to achievement of planned Investigations.

**Number of Convictions:** Convictions from legal sourced investigations, an area of increased focus, rose 2% over FY 2008. Dismissals lowered the conviction rates and contributed to an 11% drop in illegal tax case convictions and a 5% drop in narcotics case convictions. Monitoring of performance and ensuring appropriate and consistent contact with Department of Justice and the U.S. Attorney’s Office regarding prosecutorial priorities and quality investigations is planned.

**Conviction Rate:** Tax-based and legal sourced cases were the focus in FY 2009. While the number of convictions has not changed much over the last three years, the number of dismissals increased. Reasons for dismissal include fugitive subjects, uncooperative subjects, and unavailability of witnesses. Monitoring of performance and ensuring appropriate and consistent contact with Department of Justice and the U.S. Attorney’s Office regarding prosecutorial priorities and quality investigations is planned.
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Conviction Efficiency Rate ($): Higher than expected reimbursable amounts from asset forfeitures increased the overall CI financial plan thereby attributing to the increase.

Percent of BSM Projects within +/- 10% Cost Variance: Development costs for several Account Management Services (AMS) releases exceeded initial estimates.
### Goal 1: Improve Service to Make Voluntary Compliance Easier

<table>
<thead>
<tr>
<th>Performance Measure Description</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customer Service Representative (CSR) Level of Service</td>
<td>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.</td>
</tr>
<tr>
<td>Customer Contacts Resolved per Staff Year</td>
<td>The number of Customer Contacts resolved in relation to time expended.</td>
</tr>
<tr>
<td>Percent of Eligible Taxpayers Who File for EITC</td>
<td>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.</td>
</tr>
<tr>
<td>Customer Accuracy – Tax Law Phones</td>
<td>The percentage of correct tax law answers given by a live assistor on Toll-free tax law inquiries.</td>
</tr>
<tr>
<td>Customer Accuracy – Customer Accounts (Phones)</td>
<td>The percentage of correct account answers given by a live assistor on Toll-free account inquiries.</td>
</tr>
<tr>
<td>Timeliness of Critical Individual Filing Season Tax Products to the Public</td>
<td>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.</td>
</tr>
<tr>
<td>Percent of Eligible Taxpayers Who File for EITC</td>
<td>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.</td>
</tr>
<tr>
<td>Customer Accuracy – Customer Accounts (Phones)</td>
<td>The percentage of correct account answers given by a live assistor on Toll-free account inquiries.</td>
</tr>
</tbody>
</table>

### 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.

<table>
<thead>
<tr>
<th>Performance Measure Description</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percent Individual Returns Processed Electronically</td>
<td>The number of electronically filed individual tax returns divided by the total individual returns filed.</td>
</tr>
<tr>
<td>Cost per Taxpayer Served ($) (HCTC)</td>
<td>The costs associated with serving the taxpayers including program kit correspondence, registration, and program participation.</td>
</tr>
<tr>
<td>Sign-Up Time (Days) – Customer Engagement (HCTC)</td>
<td>The length of time between the first Program Kit mailing and the first payment received.</td>
</tr>
<tr>
<td>Percent Business Returns Processed Electronically</td>
<td>The percentage of electronically filed business tax returns divided by the total business tax returns filed.</td>
</tr>
<tr>
<td>Refund Timeliness – Individual (Paper)</td>
<td>The percentage of refunds resulting from processing Individual Master File paper returns issued within 40 days or less.</td>
</tr>
<tr>
<td>Taxpayer Self Assistance Rate</td>
<td>The percentage of taxpayer assistance requests resolved using self-assisted automated services.</td>
</tr>
</tbody>
</table>

### Goal 2: Enforcement the Law to Ensure Everyone Meets Their Obligation to Pay Taxes

<table>
<thead>
<tr>
<th>Performance Measure Description</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Examination Coverage – Individual (1040)</td>
<td>The sum of all individual 1040 returns closed by Small Business/Self Employed (SB/SE), Wage &amp; Investment (W&amp;I), and Large and Mid-Sized Business (LMSB) (Field Exam and Correspondence Exam programs) divided by the total individual return filings for the prior calendar year.</td>
</tr>
<tr>
<td>Field Examination National Quality Review Score</td>
<td>The score awarded to a reviewed field examination case by a Quality Reviewer using the National Quality Review System quality attributes.</td>
</tr>
<tr>
<td>Office Examination National Quality Review Score</td>
<td>The score awarded to a reviewed office examination case by a Quality Reviewer using the National Quality Review System quality attributes.</td>
</tr>
<tr>
<td>Examination Quality – Industry</td>
<td>Average of the scores of Industry Cases reviewed. Case scores are based on the percentage of elements passed within each auditing standard.</td>
</tr>
<tr>
<td>Examination Quality – Coordinated Industry</td>
<td>Average of the scores of Coordinated Industry Cases reviewed. Case scores are based on the percentage of elements passed within each auditing standard.</td>
</tr>
<tr>
<td>Examination Coverage – Business (Corps. &gt;$10M)</td>
<td>The number of LMSB returns (C and S Corporations with assets over $10 million and all partnerships) examined and closed by LMSB during the current fiscal year divided by the number of filings for the preceding calendar year.</td>
</tr>
<tr>
<td>Examination Efficiency – Individual (1040)</td>
<td>The sum of all individual 1040 returns closed by SB/SE, W&amp;I, and LMSB (Field Exam and Correspondence Examination programs) divided by the total Full-Time Equivalent (FTE) expended in relation to those individual returns.</td>
</tr>
</tbody>
</table>
### Appendix D

#### Performance Measures Descriptions (Continued)

<table>
<thead>
<tr>
<th>Measure</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Automated Underreporter (AUR) Efficiency</td>
<td>The total number of SB/SE and W&amp;I contact closures (a closure resulting from a case where IRS made contact) divided by the total FTE, including overtime.</td>
</tr>
<tr>
<td>Automated Underreporter (AUR) Coverage</td>
<td>The percentage representing the total number of SB/SE and W&amp;I contact closures (a closure resulting from a case where IRS made contact) divided by the total return filings for the prior year.</td>
</tr>
<tr>
<td>Collection Coverage – Units</td>
<td>The volume of collection work disposed compared to the volume of collection work available.</td>
</tr>
<tr>
<td>Collection Efficiency – Units</td>
<td>The sum of all modules disposed by Automated Collection System (ACS) (SB/SE and W&amp;I) and by SB/SE Field Collection divided by the total collection FTE.</td>
</tr>
<tr>
<td>Field Collection National Quality Review Score</td>
<td>The score awarded to a reviewed collection case by a Quality Reviewer using the NQRS quality attributes.</td>
</tr>
<tr>
<td>Automated Collection System (ACS) Accuracy</td>
<td>The percent of taxpayers who receive the correct answer to their ACS question.</td>
</tr>
<tr>
<td>Criminal Investigations Completed</td>
<td>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.</td>
</tr>
<tr>
<td>Number of Convictions</td>
<td>The number of criminal convictions.</td>
</tr>
<tr>
<td>Conviction Rate</td>
<td>The percent of adjudicated criminal cases that result in convictions.</td>
</tr>
<tr>
<td>Conviction Efficiency Rate ($)</td>
<td>The cost of Criminal Investigation’s (CI) program divided by the number of convictions.</td>
</tr>
<tr>
<td>TE/GE Determination Case Closures</td>
<td>The number of cases closed in the Employee Plans or Exempt Organizations Determination programs, regardless of type of case or type of closing.</td>
</tr>
<tr>
<td>Percent of Major BSM Projects within +/- 10% Cost Variance</td>
<td>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.</td>
</tr>
<tr>
<td>Percent of Major BSM Projects within +/- 10% Schedule Variance</td>
<td>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.</td>
</tr>
</tbody>
</table>

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**Strategic Foundations: Invest for High Performance**

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### 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 2009 accomplishments, actions identified for completion in FY 2010 and beyond, and future challenges. These have been arranged in the order of priority as determined by the TIGTA.

<table>
<thead>
<tr>
<th>Challenge / Issue</th>
<th>Actions Taken in FY 2009 and Actions Planned or Underway</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Modernization of the Internal Revenue Service (Computerized Systems and Business Structure) and IRS Business Systems</strong></td>
<td><strong>Actions Taken:</strong></td>
</tr>
</tbody>
</table>
| 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 FY 2005 High Risk series, has consolidated IRS Business Systems Modernization and IRS Financial Management into one Business Systems Modernization high-risk area. | • Customer Account Data Engine (CADE). The newest CADE Release was delivered on time adding the capabilities to process prior year and decedent returns, remittances received with original returns, process estimated tax payments and payments received with extension requests. For the filing season, CADE processed over 40.0 million returns, issued more than 34.9 million refunds, and processed over 7 million payments totaling $58.6 billion.  
• Delivered the system changes necessary to implement provisions of the American Recovery and Reinvestment Act (ARRA) during the filing season including changes to the First-Time Homebuyer Credit, Net Operating Loss Carryback, and changes to COBRA insurance limits.  
• Account Management Services (AMS). Completed the 2009 releases of AMS providing real-time address changes to CADE, additional account transcript processing from paper to electronic format. AMS automated inventory and workflow capabilities like electronic transcript processing reduce IRS cost for both paper and printing and reduce transcript handling time for customer service representatives. In 2009 more than 2.2 million electronic transcript cases were distributed to IRS campuses. Pilot operations for an additional AMS release were initiated in 2009 to improve response time to taxpayer inquiries by expanding access to tax account information.  
• Modernized e-File (MeF). The 2009 MeF release included the redesigned Form 990 (Return of Organization Exempt from Income Tax) to return processing, on time for the filing season. The processing volumes for Form 1120 returns increased 38% and the redesigned Form 990 increased 307% from 2008. Returns submitted through MeF reduce the processing error rates, under MeF rates are 7% compared to 19% for paper based processing.  
• Delivered 100% of filing season applications and planned modernization project releases on schedule and the majority within cost.  
• Developed a comprehensive Audit Trail Plan for CADE outlining the audit trail requirements necessary to account for assets and processes across the IRS.  
• Developed and implemented CADE computer security incident monitoring procedures critical to assure the confidentiality, integrity and availability of IRS electronic systems, services and data.  
• Conducted assessment of long-term modernization plans resulting in a solution to provide timely access to authoritative individual taxpayer account information and enhance the IRS ability, beyond that of the current CADE approach, to address technology security, financial material weaknesses, and long-term architectural planning and viability.  
• Completed RRACS development. |

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Demonstrated traceability for 98% of the revenue receipts using CDDB Trace ID.
Produced the CDDB Trace ID mismatch reports for accounting reconciliation.

**Actions Planned or Underway for FY 2010 and Beyond:**
- Implement requirements traceability for all corrective actions identified in the Computer Security Material Weakness plan.
- Enhance features in the Security Management and Reporting Tool (C-SMART) to document and track results of internal security inspections conducted by the IRS Cybersecurity office.
- Deliver MeF Release 6.1 (Form 1040 Phase I), providing capability to process Form 1040 (including 22 other schedules and supporting forms) which will reach 61 percent of the e-File population. A plan will be implemented with External Trading Partners to reduce risk and ensure stability of the MeF system.
- Develop milestones necessary to implement CADE 2.
- Deliver production pilot for CADE Release 5 adding capabilities that include allowing individual taxpayer refunds to be applied to the next year’s tax (Credit Elect) and refund hold capability for Criminal Investigation.
- Use CDDB to reconcile all revenue receipts and refunds for the FY 2009 financial audit.
- Implement RRACS release 1 to incorporate USSGL.

### Security of the Internal Revenue Service

**Strengthening the security infrastructure and the applications that guard sensitive data.**

**Actions Taken:**
- Began implementation of the IT Asset Centralization Initiative. Actions included:
  - Completed Enterprise IT Asset Discovery document and developed transition plans for business units owning IT assets.
  - Realigned hardware and personnel.
- Held a second Computer Security Material Weakness Summit and met all summit goals.
- Implemented audit trail capability on modernization projects, CADE, MeF and AMS, to address security vulnerabilities.
- Completed field training for Cybersecurity staff that focused on supporting internal self-inspection capability for computer security oversight and compliance on repeatable business processes.
- Eliminated the use of Social Security Numbers (SSNs) on over 6.5 million Notices of Intent to Levy issued by the Automated Collection System. This is the first large-scale effort to eliminate and reduce the use of SSNs on taxpayer correspondence. Over the next 2 to 5 years IRS will eliminate the use of SSNs on more than 90 million notices and forms.
- Created a "marker" to flag accounts of identity theft victims to indicate to an employee they are dealing with a substantiated case of identity theft.
- Created a portfolio of identity protection services for taxpayers, including letters to inform them of personal information used by another individual to file a return or information that may have been compromised through phishing scams.
- Opened assistance centers (Identity Protection Specialized Units), and established a toll-free number dedicated to providing guidance and help to taxpayers impacted by identity theft. Responded to 120,000 calls and opened nearly 34,000 case files for further action.
- Enhanced the ability to combat increased tax administration-related online fraud against taxpayers by shutting down 3,444 phishing Web sites (1,578 domestic and 1,866 international), with a median shut down time of 2.35 hours for domestic and international sites.
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6.85 hours for international sites.

Actions Planned or Underway for FY 2010 and Beyond:

- Initiate a Sign-on Pilot to improve security and reduce burden of managing multiple passwords for systems and applications utilizing the Homeland Security Presidential Directive-12 SmartID.
- Implement requirements traceability for all corrective actions identified in the Computer Security Material Weakness plan.
- Enhance features in the Security Management and Reporting Tool (C-SMART) to document and track results of internal security inspections conducted by the IRS Cybersecurity office.
- Initiate creation of a Criminal Investigation Disaster Recovery Site in Martinsburg, WV.

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 off-shore tax and financial criminal activity. Address the evolving challenge of unpaid taxes and continuing Earned Income Tax Credit (EITC) non-compliance.

<table>
<thead>
<tr>
<th>Individuals and Businesses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actions Taken:</td>
</tr>
<tr>
<td>• Collected 48.9 billion in enforcement revenue, a 30% increase over FY 2003.</td>
</tr>
<tr>
<td>• Increased examination closures for taxpayers with income over $200,000 by over 11% and increased examination closures with income over $1 million by over 29%.</td>
</tr>
<tr>
<td>• Implemented a National Research Program study to address cases with the highest compliance risk by providing an identification process for returns filed by U.S. persons living abroad.</td>
</tr>
<tr>
<td>• Established alternative methods of workload selection for offshore cases:</td>
</tr>
<tr>
<td>o Offshore Private Banking Initiative – issued summons to one of the largest banks in a Switzerland to obtain the identity of U.S. taxpayers with offshore accounts. As a result, the bank agreed to pay a $780 million fine, of which $380 million will be paid to the IRS. The bank also agreed to provide the names of 4,450 of their U.S. account holders.</td>
</tr>
<tr>
<td>o Entered into a deferred prosecution agreement with another bank. The bank agreed to forfeit $340 million, the largest seizure in IRS history for falsifying outgoing U.S. wire transfers for countries/persons on the U.S. sanctions list.</td>
</tr>
<tr>
<td>o Offshore Merchant Account Initiative – a summons was issued to a large processor of merchant accounts to identify U.S. businesses that deposit unreported business income from debit and credit card sales in accounts located in banks domiciled in secrecy jurisdictions.</td>
</tr>
<tr>
<td>• Developed products and services to assist international taxpayers in complying with tax laws. Actions include:</td>
</tr>
<tr>
<td>o Updated a “one stop” tax page on IRS.gov for the more than 7 million nonmilitary Americans living outside the U.S.</td>
</tr>
<tr>
<td>o Created an “International Tax Gap Series” on IRS.gov to educate the public on a variety of international issues.</td>
</tr>
<tr>
<td>o Released new forms for non-resident entertainers and athletes who plan to work in the U.S. The form calculates the correct amount of withholding based upon net income.</td>
</tr>
<tr>
<td>o Opened a new Tax Attaché office in Beijing, China on schedule.</td>
</tr>
<tr>
<td>• Implemented new schedule M-3 for Form 1120F to gather information on foreign controlled corporations.</td>
</tr>
</tbody>
</table>
| • Enhanced Automated Underreporter (AUR) case selection and inventory modeling utilizing historical results to reduce the number of unnecessary notices issued to
taxpayers, resulting in a 20.1% reduction of no change cases.

- Tested EITC paid preparer education and compliance notices and telephone contacts to determine the effect of early education and intervention on the accuracy of returns prepared by first-time paid preparers. Lessons learned from the first year of the test will be used to perfect methodology for a Year 2 test.
- Timely delivered a training program for campus and functional fraud coordinators.
- Initiated examinations against approximately 2,500 noncompliant locally hired employees of foreign embassies who either failed to report their wages, claimed deductions to which they were not entitled, incorrectly established retirement plans, failed to pay self-employment tax, or failed to file tax returns.
  - Completed screening of taxpayers who did not participate in a settlement initiative and initiated examinations on selected returns.
- Tested an AUR Soft Notice program that provided the taxpayer the opportunity to self-correct income reporting errors.
- Completed new scoring formulas for the Discriminant Analysis System. Returns in active workload inventory system have new scores that reflect the level of reporting noncompliance.
- Updated 16 audit technique guides that serve as reference material for users and stakeholders.

Actions Planned or Underway for FY 2010 and Beyond:

- Use audit results and intelligence from ongoing offshore initiatives to refine case identification and selection methods and to identify promoters, facilitators and participants in abusive offshore arrangements.
- Improve the way compliance risks are identified and addressed in large, complex global businesses and high wealth individuals.
- Modify Examination case selection and modeling to include cases where taxpayers claimed the First-Time Home Buyer Credit.
- Implement improved analytics in AUR case selection while continuing to test soft notices as an alternative to examinations.
- Implement improved case selection models in the Automated Collection System.
- Continue testing the effects of education, compliance notices and telephone contacts for EITC first-time and low-risk paid preparers on the accuracy of returns prepared.
- Continue selection and examination of locally hired employees of foreign embassies who did not elect to participate in settlement initiatives.

**Tax-Exempt and Government Entities**

**Actions Taken:**

- Increased examinations by 17% and overall enforcement contacts by 10%.
- Expanded the use of risk modeling results to adjust filters for cases selection and tested new models for examinations of exempt organizations that report gaming activities on Form 990.
- Shut down 3 promoter schemes that use retirement plans as parties to abusive transactions.
- Secured over 2,700 delinquent employment tax returns from exempt organizations and initiated examination of 1,174 returns involving 297 exempt organizations through a Combined Annual Wage Reporting Project which addresses employment taxes.
- Assisted the Department of Justice in developing criminal cases and preparing prosecutions on over 60 abusive tax-exempt bond situations.
• Released the final report on IRS’s nonprofit hospital study. The report summarizes the reported community benefit and executive compensation data across various demographics.

Actions Planned or Underway for FY 2010 and Beyond:
• Continue to assist the Department of Justice in developing criminal cases and in preparing prosecutions on abusive tax-exempt bond situations.
• Analyze results from governmental bond questionnaires to identify areas of noncompliance and market trends.
• Utilize investigations to identify promoters of abusive transactions involving retirement plans to deter the marketing of abusive promoter schemes.
• Examine a sample of college and universities for unrelated business taxable income and compensation.
• Continue to address emerging compliance issues, including internationally sponsored pension plans, the movement of in-kind charitable gifts offshore, and cross-border commerce using Indian reservations.

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:
• Continued implementation of Taxpayer Assistance Blueprint (TAB) service improvements including creation of the Seamless Taxpayer Experience Group to identify and coordinate enterprise-wide improvements from the taxpayer’s perspective. Initiatives included:
  o Implemented the first release of the Customer Online Decision Support (COLDS) tool to provide taxpayers with tax law information in an easily navigable format.
  o Updated web applications with new web-based calculators and wizards.
  o Implemented single issue toll-free product lines.
  o Expanded service locations for disabled taxpayers.
  o Created 332 "Talking Tax Forms" for visually impaired taxpayers.
  o Launched Spanish versions of the Free File Program, an interactive Spanish application for “How much was my Stimulus Payment?”, and a Spanish Tax Practitioner Tool Kit.
• Developed a web-based application and information on claiming the Recovery Rebate Credit for taxpayers who did not receive an Economic Stimulus Payment or received less than the maximum amount.
• Based on last year’s demand and positive feedback, the IRS held a 2nd annual “Super Saturday” event resulting in the largest one-day outreach service event in IRS history. Successes from Super Saturday include:
  o Assisted over 11,000 taxpayers with a variety of services including tax advice and return preparation.
  o Answered over 33,000 calls and prepared over 53,000 returns for taxpayers needing assistance.
  o Promoted and achieved approximately 200 media stories on Super Saturday.
  o Used over 1,700 VITA sites across the country.
• Provided extensive media attention and expanded electronic outreach activities to make taxpayers aware of new credits, deductions and exclusions for which they qualify.
  o Three days after the American Recovery and Reinvestment Act became law, developed new withholding tables in support of the Make Work Pay Credit.
Management Discussion and Analysis

For the Fiscal Year Ended September 30, 2009

In March, announced that businesses with deductions exceeding their income in 2008 can use a new net operating loss tax provision to get an expedited refund of taxes paid in prior years.

Shifted resources to handle the expected growth of bankruptcies and business workouts.

For the first time, taxpayers were informed of available credits through YouTube videos and iTunes podcasts.

Expanded partnerships with nonprofit and community organizations, opening more than 12,100 free tax preparation sites nationwide. Volunteers at these sites prepared over 3.0 million returns for low-income and elderly taxpayers.

Expanded taxpayers served at IRS Taxpayer Assistance Centers to 6.2 million.

Identified additional locations to expand and improve geographic coverage for walk-in services (e.g. Volunteer Income Tax Assistance (VITA) sites).

Updated web applications, including Economic Stimulus Payment calculators and “Where’s My Stimulus Payment?” to provide timely information to taxpayers.

Actions Planned or Underway for FY 2010 and Beyond:

- Provide topical information, alternative resources, and expedited routing options through the toll-free telephone system.
- Provide greater access to available services on non-workdays through events such as “Super Saturday” and other special service days like EITC awareness days.
- Improve the taxpayer’s experience by implementing new quality initiatives at Taxpayers Assistance Centers and volunteer return preparation sites using sampling reviews of selected returns to determine the accuracy of returns prepared.
- Gather feedback from professional organizations that represent external stakeholders (i.e. Accountants, Reporting Agents, etc.) to simplify forms and the tax filing process.

Human Capital

The IRS ability to meet expectations in personnel management area, such as recruiting, training, and retaining employees.

Actions Taken:

- Increased Enforcement hiring goals 148% over FY 2008, with Mission Critical Occupation positions making up 45% of new hires.
- Increased veteran hiring by 41%, making up 9% of all new hires, and 3% of disabled hires. Targeted recruitment efforts have resulted in an increase in veteran hires from 1 in every 17 new hires in FY 2006 to 1 in every 11 new hires in FY 2009.
- Continued efforts to quickly replace key leaders lost to retirement by expanding the Leadership Succession Review (LSR) process.
  - LSR which identifies leadership competency proficiency and gaps to help address individual and organization developmental strategies has been recognized by The Best Practice Institute as a business “best practice”.
- Implemented “Workforce of Tomorrow” provisions, including:
  - Streamlined hiring process to reduce applicant burden.
  - Revised new employee on-boarding process from a one day orientation to a 12-month experience to help them feel welcomed as members of the IRS community.
  - Developed enhanced career progression strategies, including development of “fast track” training program for identified high potential candidates.
  - Developed a new “Count on me” marketing campaign, which includes a
Management Discussion and Analysis

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2009

- Redesign of the IRS careers website.
  - Established an improved employee recognition program to attract and retain the best employees.

Actions Planned or Underway for FY 2010 and Beyond:

- Develop an overall strategy for improving coaching and mentoring skills at all leadership levels, including implementation of an internal coaching certification program and core workshops for all leaders.
- Continue improvements to Leadership Succession Review utilizing new software to enhance reporting capabilities.
- Implement streamlined hiring enhancements using software that incorporates the full capabilities of automated ranking and rating.
- Implement the Accelerated Leadership Program pilot to test a "fast track" training program for identified high potential candidates.

Erroreous and Improper Payments

Reduce improper payments that include base compliance activities and redesign efforts.

Actions Taken:

- Protected $3.2 billion in revenue through EITC enforcement efforts, which includes the examination of over 500,000 returns and 25,000 amended returns claiming EITC. 314,000 document matching reviews, and 300,000 math error process corrections.
- Identified more than 123,000 fraudulent returns claiming over $361 million in refunds, stopped over $90 million in fraudulent claims using the Electronic Fraud Detection System, with an average refund of $2,867.
- Refined marketing for EITC Awareness Day based on data and internal/external feedback to increase overall participation, targeting the underserved and a new population segment emerging from the economic downturn.
  - Public Service Announcement campaigns were provided in English and Spanish, utilizing TV, radio, and print ads with 57,772 airings/insertions.
  - IRS partners increased free EITC return preparation.
  - EITC dollars distributed, increased by almost 21% over the same period in 2008.
- Completed activities for year four of the EITC Return Preparer Study
  - Analyzed short-term outcomes, including penalties and accuracy of returns and outcomes from due diligence visits, education/compliance notices, and phone calls to first-time EITC preparers.
  - Improved EITC paid preparer due diligence visit by clarifying procedures and completing visits earlier, resulting in a 5% increase in due diligence visits over 2008 and proposed penalties of $462,500.
- Continued to identify and investigate high-impact EITC fraud and tax scheme promoters by transitioning resources into Fraud Detection Center Workload Transition (FDC WLT) project.
  - Identified research-based approaches to improve EITC participation and minimize taxpayer errors.
    - Collaborated with two tax software associations to implement a joint IRS/EITC Software Developer Working Group.
    - Developed an IRS.gov EITC Preparer Toolkit to help tax preparers assist taxpayers.
    - Expanded outreach to ensure preparers were aware of their due diligence requirements on newly issued regulations.
  - Presented two seminars for EITC preparers at the six Nationwide Tax Forums to educate preparers on how to avoid common EITC errors and meet due diligence requirements.


Management Discussion and Analysis

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2009

requirements.
• Completed the second phase of the EITC Longitudinal Study. Analysis of results will be used to identify trends in tax preparer behavior and to design solutions to enhance preparer outreach and compliance.

Actions Planned or Underway for FY 2010 and Beyond:
• Hold a fourth annual EITC Awareness Day, targeting potentially eligible taxpayers and expanding partnerships and media coverage with an emphasis on markets where data suggests underserved communities reside.
• Use Census and market research data, recent EITC legislation, and economic factors to develop the 2009 EITC marketing/awareness campaign.
  o Expand campaign to include more social media and other creative platforms to reach the underserved, increase overall participation and improve compliance.
• Increase the accuracy of EITC returns by refining EITC paid preparer treatment activities including due diligence audits, visits by revenue and criminal investigation agents, streamlined injunctions, and streamlining notice/phone contact treatments.
• Implement an on-line training module for preparers that cover requirements and standards.
• Continue partnerships with key tax software associations to identify program enhancements to help reduce EITC errors and assist preparers in meeting requirements.
• Utilize AUR data to identify outreach and education opportunities for identified patterns of noncompliance that may be replicated in EITC returns.

Complexity of the Tax Law

Actions Taken:
• Developed and implemented multi-faceted treatments that address underlying behaviors that contribute to non-compliance, including:
  o Used a wide range of strategies, outreach products and communication vehicles such as Webinars, tax practitioner institutes, and National Tax Forums to deliver outreach and education to the tax professional community, industry partners, and small business and self-employed taxpayers.
  o Employed the Issue Management Resolution System (IMRS) to identify concerns raised by external partners.
    ▪ Developed presentations for liaison events based on IMRS topics.
  o Requested feedback from stakeholders on existing outreach and educational programs to identify best practices and enhancements.
• Expanded IRS.gov outreach products to include online versions of the Small Business Resource Guide, Tax Calendar, and the small business Tax Center.
• Implemented an online Q&A database to facilitate issue resolution on emerging issues like ARRA for external stakeholders.
• Expanded access to outreach and education materials along with subscription services for IRS newsletters, e-news for Tax Professionals and Small Businesses, with approximately 300,000 online readers.
• Created additional Employee Plans Fix-it Guides for the Simplified Employee Pension and the Salary Reduction Simplified Employee Pension Plans to help employers find, fix, and avoid common plan mistakes.
• Streamlined the determination approval process for certain public charities by eliminating the advance ruling process for a section 501(c)(3) organization.
Management Discussion and Analysis

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2009

Published new IRM provisions for Tax-Exempt Bonds’ Voluntary Closing Agreements to include tax-credit bonds and to streamline the program with standardized closing agreement settlement terms.

Developed processes for allocating $2.4 billion of ARRA provided Clean Renewable Energy Bonds (CREBS) and $2 billion of Tribal Economic Development Bonds.

Implemented the Build America Bond (BAB) and other ARRA tax credit bond provisions, including:
- Coordinating development of a new direct payment processing system.
- Development of a new return, Form 8038-CP, and instructions.
- Implementing new compliance programs related to BABs and other new forms of tax credit bonds.
- Conducting ARRA outreach presentations to groups that included underserved territories and tribes.
- Development of seven notices and educational documents related to the new provisions.

Actions Planned or Underway for FY 2010 and Beyond:
- Finalize the allocations of $2.4 billion of Clean Renewable Energy Bonds (CREBS) and $2 billion of Tribal Economic Development Bonds.
- Release forms for Build America Bonds and other tax credit bonds.
- Publish new IRM provisions to clarify the processes for handling rebate refund cases for Tax-Exempt Bonds.
- Streamline examination procedures for both walk-in closing agreements and closing agreements for exempt organizations.
- Expand Spanish language Small Business Tax Workshops to improve compliance.
- Continue to provide customers with access to tax law information on IRS.gov in an easily understandable format.

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:
- Completed an oversight review/approval process for preparer penalties to ensure uniform and consistent application of penalties.
  - Established a single point of contact on return preparer penalties for all field personnel to ensure uniform and consistent application of penalties.
  - Require approval is for all return preparer penalty cases.
  - Coordinate closely with business units to ensure uniform and consistent application.
- Continued efforts to remove or redact Social Security Numbers from outgoing correspondence.
- Completed an analysis of excluding all Social Security Administration recipients below certain income levels from the Federal Payment Levy Program. Results indicate excluding all Social Security Administration (SSA) recipients is not the correct approach. Initiated development of models with TAS to determine SSA recipients to exclude.

Actions Planned or Underway for FY 2010 and Beyond:
- Implement a low-income filter that will exclude taxpayers that are more likely to experience a hardship if included in the Federal Payment Levy Program.
Management Discussion and Analysis

IDENTIFICATION OF TAXPAYER PERSONALLY IDENTIFIABLE INFORMATION

- Identify parameters for contractors regarding the protection of taxpayer Personally Identifiable Information (PII) for inclusion in all publishing contracts.
- Complete and implement models to determine which SSA recipients to exclude from the Federal Payment Levy Program by FY 2011.
- Develop comprehensive set of return preparer recommendations and metrics to ensure uniform and high ethical standards of conduct for preparers.

PROCESSING RETURNS AND IMPLEMENTING TAX LAW CHANGES DURING THE TAX FILING SEASON

The filing season remains a critical IRS program that impacts every American taxpayer. Many programs, activities and resources have to be planned and managed effectively for the filing season to be successful.

Actions Taken:

- Delivered a successful 2009 filing season, mitigating the impact of residual Economic Stimulus payment issues, deduction of real estate taxes for taxpayers who do not itemize deductions, and two versions of the First-Time Homebuyer Tax Credit (FTHBC) for homes purchased in 2008 and in 2009 resulting from the Emergency Economic Stabilization Act of 2008 and the 2009 ARRA.
  - Processed 144.4 million individual returns and issued 111.4 million refunds totaling $339.6 billion.
  - Answered roughly 39 million calls from taxpayers to obtain information on new credits available to them.
  - Processed 1.8 million automated telephone calls through the Toll-free Rebate Hotline for taxpayers to research the amount of their 2008 Economic Stimulus Payment for use in completing their returns.
  - Provided two interactive online web application tools to assist taxpayers in calculating and claiming their recovery rebate credit - the Recovery Rebate Calculator and “How Much Was My 2008 Stimulus Payment?”.
- Reduced the size and age of adjustment inventory levels in order to attain a manageable inventory going into the filing season by balancing resources between phones and paper, training additional Customer Service Representatives to work amended returns, and moving inventory where appropriate to take advantage of trained resources. Best practices techniques were also shared between sites via weekly conference calls.
- Identified erroneous and fraudulent FTHBC claims through new programming and pre-refund filters that reject electronically filed returns claiming the credit when the following conditions were met:
  - Claims in excess of the maximum allowable credit.
  - Claims in excess of allowable amounts for those taxpayers with adjusted gross income exceeding income limitations.

Actions Planned or Underway for FY 2010 and Beyond:

- Continue to identify erroneous and fraudulent claims and schemes on returns claiming the FTHBC and other ARRA credits where appropriate.
- Provide an automated application that allows taxpayers to obtain their PIN for use in electronically submitting their TY 2009 returns.
- Complete assessment of risk for all ARRA provisions and ensure risk mitigation actions are identified and completed.
- Ensure that tax forms and publications all reflect changes resulting from ARRA legislative provisions.
- Deliver a seasonal workforce to ensure stabilization of service levels at all Taxpayer Assistance Centers to respond to the taxpayers’ changing needs.
### Improving Performance and Financial Information for Program and Budget Decisions

<table>
<thead>
<tr>
<th>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.</th>
<th>Actions Taken:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Converted IRS Cost Policy into a published Managerial Cost Accounting IRM that provides:</td>
</tr>
<tr>
<td></td>
<td>o Cost versus budget guidance.</td>
</tr>
<tr>
<td></td>
<td>o Allocation approval guidance.</td>
</tr>
<tr>
<td></td>
<td>o Updated roles and responsibilities.</td>
</tr>
<tr>
<td></td>
<td>• Established standardized methodology for the development of cost-based measures for use in making ongoing performance/program activity decisions.</td>
</tr>
<tr>
<td></td>
<td>• Established an IRS Service-wide Cost user group and held quarterly meetings to provide guidance and share information.</td>
</tr>
<tr>
<td></td>
<td>• Used managerial cost accounting system to complete cost-benefit analyses and cost estimation with Collection, and Examination functions including Correspondence Exam, and AUR.</td>
</tr>
</tbody>
</table>

**Actions Planned or Underway for FY 2010 and Beyond:**

- Continue use of the managerial cost accounting system to conduct cost benefit analyses that provides timely, accurate, and useful data for decision making by business units.
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 2009 and 2008 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.
### Internal Revenue Service
**Balance Sheet**
**As of September 30, 2009 and 2008**

(In Millions)

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Intragovernmental:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fund Balance with Treasury (Note 2)</td>
<td>$2,463</td>
<td>$2,072</td>
</tr>
<tr>
<td>Due from Treasury (Note 6)</td>
<td>4,031</td>
<td>3,064</td>
</tr>
<tr>
<td>Other Assets (Note 3)</td>
<td>147</td>
<td>106</td>
</tr>
<tr>
<td>Total Intragovernmental</td>
<td>6,641</td>
<td>5,322</td>
</tr>
<tr>
<td>Cash and Other Monetary Assets (Notes 4, 6)</td>
<td>63</td>
<td>133</td>
</tr>
<tr>
<td>Federal Taxes Receivable, Net (Notes 5, 6)</td>
<td>29,000</td>
<td>29,000</td>
</tr>
<tr>
<td>Property and Equipment, Net (Note 7)</td>
<td>1,094</td>
<td>1,159</td>
</tr>
<tr>
<td>Other Assets (Note 3)</td>
<td>12</td>
<td>17</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>$36,810</td>
<td>$35,631</td>
</tr>
<tr>
<td><strong>Liabilities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Intragovernmental:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Due to Treasury (Note 5)</td>
<td>$29,000</td>
<td>$29,000</td>
</tr>
<tr>
<td>Other Liabilities (Note 8)</td>
<td>208</td>
<td>197</td>
</tr>
<tr>
<td><strong>Total Intragovernmental</strong></td>
<td>29,208</td>
<td>29,197</td>
</tr>
<tr>
<td>Federal Tax Refunds Payable</td>
<td>4,031</td>
<td>3,064</td>
</tr>
<tr>
<td>Other Liabilities (Notes 8, 9)</td>
<td>1,659</td>
<td>1,685</td>
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<tr>
<td><strong>Total Liabilities</strong></td>
<td>34,898</td>
<td>33,946</td>
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<tr>
<td><strong>Net Position</strong></td>
<td></td>
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<tr>
<td>Unexpended Appropriations</td>
<td>1,675</td>
<td>1,523</td>
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<tr>
<td>Cumulative Results of Operations</td>
<td>237</td>
<td>162</td>
</tr>
<tr>
<td><strong>Total Net Position</strong></td>
<td>1,912</td>
<td>1,685</td>
</tr>
<tr>
<td><strong>Total Liabilities and Net Position</strong></td>
<td>$36,810</td>
<td>$35,631</td>
</tr>
</tbody>
</table>

The accompanying notes are an integral part of these statements.
<table>
<thead>
<tr>
<th>Program</th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Taxpayer Assistance and Education</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross Cost</td>
<td>$556</td>
<td>$623</td>
</tr>
<tr>
<td>Earned Revenue</td>
<td>(5)</td>
<td>(8)</td>
</tr>
<tr>
<td>Net Cost of Program</td>
<td>551</td>
<td>617</td>
</tr>
<tr>
<td><strong>Filing and Account Services</strong></td>
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<tr>
<td>Gross Cost</td>
<td>3,950</td>
<td>3,602</td>
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<tr>
<td>Earned Revenue</td>
<td>(68)</td>
<td>(61)</td>
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<tr>
<td>Net Cost of Program</td>
<td>3,882</td>
<td>3,541</td>
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<td><strong>Compliance</strong></td>
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<tr>
<td>Gross Cost</td>
<td>8,175</td>
<td>8,136</td>
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<tr>
<td>Earned Revenue</td>
<td>(295)</td>
<td>(285)</td>
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<tr>
<td>Net Cost of Program</td>
<td>7,880</td>
<td>7,851</td>
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<tr>
<td><strong>Administration of Tax Credit Programs</strong></td>
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<tr>
<td>Gross Cost</td>
<td>190</td>
<td>184</td>
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<tr>
<td>Earned Revenue</td>
<td>-</td>
<td>-</td>
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<tr>
<td>Net Cost of Program</td>
<td>190</td>
<td>184</td>
</tr>
<tr>
<td><strong>Net Cost of Operations (Note 11)</strong></td>
<td>$12,503</td>
<td>$12,183</td>
</tr>
</tbody>
</table>

The accompanying notes are an integral part of these statements.
Internal Revenue Service  
Statement of Changes in Net Position  
For the Years Ended September 30, 2009 and 2008  
(In Millions)  

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Cumulative Results of Operations</td>
<td>Unexpended Appropriations</td>
</tr>
<tr>
<td>Beginning Balances</td>
<td>162 $</td>
<td>1,523 $</td>
</tr>
<tr>
<td>Budgetary Financing Sources:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Appropriations Received</td>
<td>11,603</td>
<td></td>
</tr>
<tr>
<td>Appropriations Transferred In/Out</td>
<td>130</td>
<td></td>
</tr>
<tr>
<td>Other Adjustments</td>
<td>(112)</td>
<td></td>
</tr>
<tr>
<td>Appropriations Used</td>
<td>11,469</td>
<td>(11,469)</td>
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<tr>
<td>Transfers In/Out Without Reimbursement - Earmarked Funds</td>
<td>10</td>
<td>13</td>
</tr>
<tr>
<td>Other Financing Sources:</td>
<td></td>
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<tr>
<td>Imputed Financing</td>
<td>1,123</td>
<td>1,067</td>
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<tr>
<td>Transfers In/Out Without Reimbursement</td>
<td>21</td>
<td>30</td>
</tr>
<tr>
<td>Transfers to General Fund</td>
<td>(45)</td>
<td>(43)</td>
</tr>
<tr>
<td>Total Financing Sources</td>
<td>12,578</td>
<td>152</td>
</tr>
<tr>
<td>Net Cost of Operations</td>
<td>(12,503)</td>
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</tr>
<tr>
<td>Net Change</td>
<td>75</td>
<td>152</td>
</tr>
<tr>
<td>Ending Balances</td>
<td>237 $</td>
<td>1,675 $</td>
</tr>
</tbody>
</table>

The accompanying notes are an integral part of these statements.
## Financial Statements

### Internal Revenue Service

**Statement of Budgetary Resources**

For the Years Ended September 30, 2009 and 2008

(In Millions)

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Budgetary Resources:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unobligated Balance, Brought Forward, October 1</td>
<td>$690</td>
<td>$664</td>
</tr>
<tr>
<td>Recoveries of Prior Year Unpaid Obligations</td>
<td>94</td>
<td>106</td>
</tr>
<tr>
<td>Budget Authority</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Appropriations</td>
<td>11,851</td>
<td>11,296</td>
</tr>
<tr>
<td>Spending Authority from Offsetting Collections</td>
<td>130</td>
<td>158</td>
</tr>
<tr>
<td>Nonexpenditure Transfers, Net</td>
<td>130</td>
<td>18</td>
</tr>
<tr>
<td>Permanently Not Available</td>
<td>(112)</td>
<td>(68)</td>
</tr>
<tr>
<td><strong>Total Budgetary Resources</strong></td>
<td>$12,783</td>
<td>$12,174</td>
</tr>
</tbody>
</table>

| **Status of Budgetary Resources:** |            |            |
| Obligations Incurred     | $11,896    | $11,484    |
| Unobligated Balance – Available (Note 2) | 384        | 224        |
| Unobligated Balance – Not Available (Note 2) | 503        | 466        |
| **Total Status of Budgetary Resources** | $12,783    | $12,174    |

| **Change in Obligated Balance:** |            |            |
| Obligated Balance, Net, Brought Forward, October 1 | $1,394     | $1,427     |
| Obligations Incurred | 11,896     | 11,484     |
| Gross Outlays        | (11,624)   | (11,388)   |
| Recoveries of Prior Year Unpaid Obligations, Actual (94) (106) | 15        | (33)       |
| Change in Uncollected Customer Payments from Federal Sources | 15        | (23)       |
| **Obligated Balance, Net, End of Period** | $1,587     | $1,394     |

| **Net Outlays:** |            |            |
| Gross Outlays     | $11,624    | $11,388    |
| Offsetting Collections | (144)    | (136)      |
| Distributed Offsetting Receipts | (233)    | (201)      |
| **Net Outlays** | $11,247    | $11,051    |

The accompanying notes are an integral part of these statements.
### Internal Revenue Service

**Statement of Custodial Activity**

For the Years Ended September 30, 2009 and 2008

(In Billions)

<table>
<thead>
<tr>
<th>Revenue Activity</th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Collections of Federal Tax Revenue (Note 13)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Individual Income, FICA/SECA, and Other</td>
<td>$2,036</td>
<td>$2,295</td>
</tr>
<tr>
<td>Corporate Income</td>
<td>$225</td>
<td>$354</td>
</tr>
<tr>
<td>Excise</td>
<td>$47</td>
<td>$52</td>
</tr>
<tr>
<td>Estate and Gift</td>
<td>$25</td>
<td>$30</td>
</tr>
<tr>
<td>Railroad Retirement</td>
<td>$5</td>
<td>$5</td>
</tr>
<tr>
<td>Federal Unemployment</td>
<td>$7</td>
<td>$7</td>
</tr>
<tr>
<td><strong>Total Collections of Federal Tax Revenue</strong></td>
<td>$2,345</td>
<td>$2,743</td>
</tr>
<tr>
<td>Increase in Federal Taxes Receivable, Net</td>
<td>-</td>
<td>$3</td>
</tr>
<tr>
<td><strong>Total Federal Tax Revenue</strong></td>
<td>$2,345</td>
<td>$2,746</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Distribution of Federal Tax Revenue to Treasury</strong></th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase in Amount Due to Treasury</td>
<td>-</td>
<td>$3</td>
</tr>
<tr>
<td><strong>Total Disposition of Federal Tax Revenue</strong></td>
<td>$2,345</td>
<td>$2,746</td>
</tr>
<tr>
<td><strong>Net Federal Revenue Activity</strong></td>
<td>$-</td>
<td>$-</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Federal Tax Refund Activity</th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Refunds of Federal Taxes (Note 14)</td>
<td>$438</td>
<td>$426</td>
</tr>
<tr>
<td>Appropriations Used for Refund of Federal Taxes</td>
<td>($438)</td>
<td>($426)</td>
</tr>
<tr>
<td><strong>Net Federal Tax Refund Activity</strong></td>
<td>$-</td>
<td>$-</td>
</tr>
</tbody>
</table>

The accompanying notes are an integral part of these statements.
INTERNAL REVENUE SERVICE

Notes to the Financial Statements
For the Years Ended September 30, 2009 and 2008

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 was reorganized by Congress and became the Internal Revenue Service in 1953.

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

The organizational structure of the IRS consists of organizations and major programs which administer the tax laws and collect 96 percent of the revenues funding the Federal government.

Organizations

- Operating Divisions
- Functional Divisions
- Support 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 with respect to small businesses, self-employed individuals and others with income from sources other than wages. Tax-Exempt and Government Entities (TEGE) oversees employee plans, tax exempt organizations, and government entities in complying with tax laws and regulations. Large and Mid-Size Business (LMSB) serves corporations, subchapter S corporations, and partnerships with assets greater than $10 million on complex issues involving tax law and accounting principles.

The five functional divisions are Appeals, Criminal Investigation, Communications and Liaison, Taxpayer Advocate Service and the IRS 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. National Taxpayer Advocate Service reports directly to Congress and the IRS Chief Counsel reports to the Secretary of the Treasury.

The seven support divisions are Modernization and Information Technology Services, Agency Wide Shared Services, Stewardship, Wage & Investment Stewardship, Executive Leadership and Direction, Human Capital Office and Chief Financial Officer. These divisions provide shared services support to all 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.
The American Recovery and Reinvestment Act of 2009 (ARRA) was signed into law on February 17, 2009. The IRS has significant responsibilities related to the ARRA for the administration of tax relief programs, additional tax credits and incentives.

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 telecommunications services, payroll processing, and depreciation of property and equipment owned by the WCF. 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. Additionally, the prepayments are netted against liabilities. 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, 2009 and 2008

Abatements
Under the Internal Revenue Code (26 USC) Section 6404, the Commissioner of the IRS has authority to abate the paid or unpaid portion of an assessed tax, interest, and penalty. Abatements occur for a number of reasons and are a normal part of the tax administration process. Abatements may:

- Be allowed for a qualifying corporation claiming a net operating loss which created a credit. The credit can be carried back to reduce a prior year’s tax liability and amend tax returns. Additionally, the credit can correct an assessment from an enforcement program, taxes discharged in bankruptcy, accepted offers in compromise, penalty abatements for reasonable cause, contested assessments made due to mathematical or clerical errors and assessments contested after the liability has been satisfied.
- 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.

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Capitalization Threshold</th>
</tr>
</thead>
<tbody>
<tr>
<td>ADP equipment</td>
<td>Capitalized regardless of acquisition cost</td>
</tr>
<tr>
<td>Non-ADP equipment</td>
<td>Individual asset cost of $5 thousand or greater</td>
</tr>
<tr>
<td>Furniture</td>
<td>Individual asset cost of $5 thousand or greater</td>
</tr>
<tr>
<td>Investigative equipment</td>
<td>Individual asset cost of $5 thousand or greater</td>
</tr>
<tr>
<td>Vehicles</td>
<td>Capitalized regardless of acquisition cost</td>
</tr>
<tr>
<td>Major systems</td>
<td>Projects with costs of $20 million or greater</td>
</tr>
<tr>
<td>Internal Use Software</td>
<td>Major business systems modernization projects independent of cost</td>
</tr>
<tr>
<td>Leasehold Improvements</td>
<td>Capitalized regardless of acquisition cost</td>
</tr>
<tr>
<td>Assets under capital lease</td>
<td>Assets with bulk cost of $50 thousand or greater</td>
</tr>
</tbody>
</table>

ADP Equipment includes related commercial off-the-shelf software. 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.

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 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 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.

- **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 and 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 and 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 approved by Congress. Administrative Expenses - Recovery Act supports the funding for the administration of new and expanded tax credit programs of the ARRA. Health and Insurance Tax Credit Administration provides funding for health insurance and refundable tax credits to qualified individuals. Additional funding was included by the ARRA to implement and administer the health insurance tax credit under the Trade Adjustment Assistance Health Coverage Improvement Act of 2009.

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.
Non-exchange Revenues – Earmarked Funds

Non-exchange revenues represent amounts retained from tax collections for payments to private collection agencies (PCAs) and for enforcement activities. The Private Collection Agent Program authorizes contracts with PCAs to collect delinquent taxes on behalf of the IRS not to exceed 25 percent of the total taxes collected. Additionally, the IRS retains 25 percent of the total taxes collected to fund enforcement activities. This program is discussed in Note 1.L., Earmarked Funds.

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 retirement 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 to assist them in preparing returns accurately. Primary activities include tax forms and instructions; tax publications and information; taxpayer education and outreach programs; walk-in taxpayer assistance; and the National Distribution Center to process orders for forms and publications. Earned revenues are primarily from enrolled agents fees.

Filing and Account Services perform functions of processing tax returns, recording tax payments, issuing refunds, and maintaining taxpayer accounts. Program activities include submission processing; operating taxpayer assistance call centers and websites; and Taxpayer Advocate. Earned revenues are primarily from the Tax Refund Offset Program and tax return copying and verification.

Compliance manages activities to identify and correct possible errors or underpayments. This program includes pre-filing agreements, letter rulings and determinations; exam functions of document matching, desk and field exams; collection functions of notices, Automated Collection Systems and field collections; criminal investigations of tax, money laundering and illegal drug activities; and Appeals and Chief Counsel. Earned revenues are primarily from the Treasury Forfeiture Fund, Financial Crimes Enforcement Network, installment agreement fees, offers in compromise and letter rulings and determinations.

Administration of Tax Credit Programs oversees the Earned Income Tax Credit (EITC) and Health Coverage Tax Credit (HCTC) programs. EITC performs expanded customer service, public outreach, enforcement, and research efforts to reduce claims and erroneous filings associated with the program. EITC comprises the full spectrum of taxpayer services and compliance activities. However, EITC payments actually refunded to individuals or credited against other 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.
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 disposition of these revenues is reported on the Statement of Custodial Activity and as distribution of federal tax revenue to the general fund of the U.S. Treasury.

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 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. The IRS was authorized to enter into contracts with PCAs to assist in the collection of delinquent Federal tax liabilities. A portion of the collections was retained by the IRS to pay the PCAs and fund enforcement activities. The Omnibus Appropriations Act, 2009 (P.L. 111-8), Section 106, stipulated “None of the funds made available in this Act may be used to enter into, renew, extend, administer, implement, enforce or provide oversight of any qualified tax collection contract.” The PCA Program effectively ended on March 5, 2009 when the IRS Commissioner announced the program would not renew contracts with the private debt collection agencies.

M. Allocation Transfers

The IRS is a party to allocation transfers from the Department of Transportation’s (Transportation) Federal Highway Administration 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.
Financial activity for the allocations transfers are reported in the financial statements of
Transportation.

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.
Beginning in FY 2009, fiduciary activities are not recognized on the balance sheet. (See Notes 4 and
15)

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 participated 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 11.2% of employees’ gross pay for regular and
24.9% for law enforcement officers’ retirement.

Employees covered by CSRS and FERS are eligible to contribute to a Thrift Savings Plan (TSP). 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.

**Employee Health and Life Insurance Benefits**

Employees are eligible to participate in the Federal Employees Health Benefit Program (FEHBP) and Federal Employees Group Life Insurance Program (FEGLI). 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.
Note 2. Fund Balance with Treasury

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Funds</td>
<td>$2,300</td>
<td>$1,986</td>
</tr>
<tr>
<td>Special Funds</td>
<td>158</td>
<td>82</td>
</tr>
<tr>
<td>Revolving Funds</td>
<td>6</td>
<td>5</td>
</tr>
<tr>
<td>Other Funds</td>
<td>(1)</td>
<td>(1)</td>
</tr>
<tr>
<td>Fund Balance with Treasury</td>
<td>$2,463</td>
<td>$2,072</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unobligated balances:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Available</td>
<td>$384</td>
<td>$224</td>
</tr>
<tr>
<td>Unavailable</td>
<td>503</td>
<td>466</td>
</tr>
<tr>
<td>Obligated Balance not yet disbursed</td>
<td>1,586</td>
<td>1,304</td>
</tr>
<tr>
<td>Non-Budgetary FBWT</td>
<td>(10)</td>
<td>(12)</td>
</tr>
<tr>
<td>Status of Fund Balance with Treasury</td>
<td>$2,463</td>
<td>$2,072</td>
</tr>
</tbody>
</table>

Note 3. Other Assets

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intra-governmental</td>
<td>Intra-</td>
<td>Intra-</td>
</tr>
<tr>
<td></td>
<td>governmental</td>
<td>governmental</td>
</tr>
<tr>
<td>Accounts receivable, net</td>
<td>26</td>
<td>2</td>
</tr>
<tr>
<td>Forfeited property held for sale</td>
<td>-</td>
<td>2</td>
</tr>
<tr>
<td>Clearing accounts</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>Other Assets</td>
<td>$147</td>
<td>$186</td>
</tr>
</tbody>
</table>

Note 4. Cash and Other Monetary Assets

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Imprest Fund</td>
<td>$4</td>
<td>$4</td>
</tr>
<tr>
<td>Other monetary assets</td>
<td>59</td>
<td>129</td>
</tr>
<tr>
<td>Cash and Other Monetary Assets</td>
<td>$63</td>
<td>$133</td>
</tr>
</tbody>
</table>

In FY 2009, fiduciary assets are not recognized on the balance sheet. In FY 2008, other monetary assets included fiduciary cash totaling $9 million.
Note 5. Federal Taxes Receivable, Net and Due to Treasury

The following table presents the Federal taxes receivable, net and due to Treasury:

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal taxes receivable</td>
<td>$ 128</td>
<td>$ 112</td>
</tr>
<tr>
<td>Allowance for uncollectible taxes receivable</td>
<td>(99)</td>
<td>(83)</td>
</tr>
<tr>
<td>Federal taxes receivable, net and Due to Treasury</td>
<td>$ 29</td>
<td>$ 29</td>
</tr>
</tbody>
</table>

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

The following table presents the non-entity assets:

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Due from Treasury</td>
<td>$ 4,031</td>
<td>$ 3,064</td>
</tr>
<tr>
<td>Federal taxes receivable, net</td>
<td>-</td>
<td>29,000</td>
</tr>
<tr>
<td>Other monetary assets</td>
<td>-</td>
<td>59</td>
</tr>
<tr>
<td>Non-entity Assets</td>
<td>$ 4,031</td>
<td>$ 29,059</td>
</tr>
</tbody>
</table>

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.
## Note 7. Property and Equipment

<table>
<thead>
<tr>
<th>(In Millions)</th>
<th>Useful Life (Years)</th>
<th>Cost</th>
<th>Accumulated Depreciation</th>
<th>2009 Net Book Value</th>
<th>2008 Net Book Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>ADP assets</td>
<td>3 to 7</td>
<td>$1,522</td>
<td>(1,111)</td>
<td>$411</td>
<td>$420</td>
</tr>
<tr>
<td>Internal use software</td>
<td>3 to 7</td>
<td>969</td>
<td>(540)</td>
<td>429</td>
<td>383</td>
</tr>
<tr>
<td>Leasehold improvements</td>
<td>10</td>
<td>397</td>
<td>(258)</td>
<td>139</td>
<td>153</td>
</tr>
<tr>
<td>Major systems</td>
<td>7</td>
<td>422</td>
<td>(422)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Internal use software – work in process</td>
<td>75</td>
<td>-</td>
<td>75</td>
<td>172</td>
<td></td>
</tr>
<tr>
<td>Vehicles</td>
<td>5</td>
<td>64</td>
<td>(37)</td>
<td>27</td>
<td>30</td>
</tr>
<tr>
<td>Furniture and non-ADP equipment</td>
<td>8 to 10</td>
<td>37</td>
<td>(29)</td>
<td>12</td>
<td>13</td>
</tr>
<tr>
<td>Assets under capital lease</td>
<td>4</td>
<td>19</td>
<td>(19)</td>
<td>-</td>
<td>7</td>
</tr>
<tr>
<td>Investigative equipment</td>
<td>10</td>
<td>8</td>
<td>(7)</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td><strong>Property and Equipment</strong></td>
<td></td>
<td><strong>$3,513</strong></td>
<td><strong>(2,419)</strong></td>
<td><strong>$1,094</strong></td>
<td><strong>$1,159</strong></td>
</tr>
</tbody>
</table>

The Cost column represents the historical cost of property and equipment, net of disposals. The cost basis for FY 2009 and FY 2008 is $3,513 million and $3,924 million, respectively. Accumulated depreciation for FY 2009 and FY 2008 is $2,419 million and $2,765 million, respectively.

The IRS has 11 internal use software projects, including deployed and work in process.

- Modernized E-File is an electronic filing system for tax returns.
- Current Customer Account Data Engine (CADE) is a project to replace the master files for taxpayer accounts.
- 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.
- Integrated Financial System (IFS) is the IRS administrative financial system.
- 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.
- Security and Technology Infrastructure Release (STIR) is the infrastructure for information technology security.
- Customer Communications is a customer service telephone system.
- Internet Refund Fact of Filing allows taxpayers to review the status of their refund.
- Redesign Revenue and Accounting System (RRACS) will add enhancements to financial reporting of taxpayer receipts and add traceability between summary records and the detailed subsidiary ledger (CDDB).
- The Custodial Detail Database (CDDB) is the subsidiary ledger for RRACS which provides the functionality needed for custodial financial management and reporting.

In FY 2009, the IRS terminated the Filing & Payment Compliance software system. This system provided functionality to enable private debt collection and manage delinquent tax cases. The net costs have been recognized as a loss on disposal in FY 2009.
### Deployed Internal Use Software

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current CADE</td>
<td>$267</td>
<td>$(82)</td>
<td>$185</td>
<td>$95</td>
</tr>
<tr>
<td>Modernized E-File</td>
<td>183</td>
<td>(113)</td>
<td>70</td>
<td>96</td>
</tr>
<tr>
<td>Integrated Financial System</td>
<td>147</td>
<td>(94)</td>
<td>53</td>
<td>73</td>
</tr>
<tr>
<td>E-Services</td>
<td>141</td>
<td>(111)</td>
<td>30</td>
<td>51</td>
</tr>
<tr>
<td>AMS</td>
<td>79</td>
<td>(3)</td>
<td>76</td>
<td>-</td>
</tr>
<tr>
<td>STIR</td>
<td>76</td>
<td>(11)</td>
<td>5</td>
<td>16</td>
</tr>
<tr>
<td>Customer Communications</td>
<td>25</td>
<td>(25)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Enterprise Systems Management</td>
<td>16</td>
<td>(15)</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>Internet Refund Fact of Filing</td>
<td>15</td>
<td>(14)</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>CDDB</td>
<td>8</td>
<td>(1)</td>
<td>7</td>
<td>-</td>
</tr>
<tr>
<td>Other</td>
<td>12</td>
<td>(11)</td>
<td>1</td>
<td>5</td>
</tr>
<tr>
<td>Filing &amp; Payment Compliance</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>21</td>
</tr>
<tr>
<td><strong>Deployed Internal Use Software</strong></td>
<td><strong>$969</strong></td>
<td><strong>$(540)</strong></td>
<td><strong>$429</strong></td>
<td><strong>$363</strong></td>
</tr>
</tbody>
</table>

### Work in Process Internal Use Software

<table>
<thead>
<tr>
<th>(In Millions)</th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Modernized E-File</td>
<td>$49</td>
<td>$14</td>
</tr>
<tr>
<td>Current CADE</td>
<td>23</td>
<td>108</td>
</tr>
<tr>
<td>RRACS</td>
<td>3</td>
<td>-</td>
</tr>
<tr>
<td>AMS</td>
<td>-</td>
<td>48</td>
</tr>
<tr>
<td>CDDB</td>
<td>-</td>
<td>2</td>
</tr>
<tr>
<td><strong>Work in Process Internal Use Software</strong></td>
<td><strong>$75</strong></td>
<td><strong>$172</strong></td>
</tr>
</tbody>
</table>
### Note 8. Liabilities

#### Other Liabilities

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(In Millions)</td>
<td>(In Millions)</td>
</tr>
<tr>
<td></td>
<td>Current</td>
<td>Non-Current</td>
</tr>
<tr>
<td>Intragovernmental:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accrued payroll and benefits</td>
<td>$ 80</td>
<td>$ -</td>
</tr>
<tr>
<td>Accrued FECA liability</td>
<td>43</td>
<td>55</td>
</tr>
<tr>
<td>Accrued expense</td>
<td>30</td>
<td>-</td>
</tr>
<tr>
<td>Other Liabilities</td>
<td>$ 153</td>
<td>$ 55</td>
</tr>
<tr>
<td>With the Public:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accrued annual leave</td>
<td>$ 531</td>
<td>$ -</td>
</tr>
<tr>
<td>Actuarial FECA liability</td>
<td>-</td>
<td>426</td>
</tr>
<tr>
<td>Accrued payroll and benefits</td>
<td>340</td>
<td>-</td>
</tr>
<tr>
<td>Accrued expenses</td>
<td>215</td>
<td>-</td>
</tr>
<tr>
<td>Liability for Deposit Funds and Clearing Accounts</td>
<td>62</td>
<td>-</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>85</td>
<td>-</td>
</tr>
<tr>
<td>Net capital lease liability (Note 9)</td>
<td>3</td>
<td>-</td>
</tr>
<tr>
<td>Other Liabilities</td>
<td>$ 1,233</td>
<td>$ 426</td>
</tr>
</tbody>
</table>
Liabilities Not Covered by Budgetary Resources

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Intra-</td>
<td>With the</td>
</tr>
<tr>
<td></td>
<td>governmental</td>
<td>Public</td>
</tr>
<tr>
<td>Accrued annual leave</td>
<td>-</td>
<td>$531</td>
</tr>
<tr>
<td>Actuarial FECA liability</td>
<td>-</td>
<td>426</td>
</tr>
<tr>
<td>Accrued FECA liability</td>
<td>98</td>
<td>-</td>
</tr>
<tr>
<td><strong>Liabilities Not Covered by Budgetary Resources</strong></td>
<td><strong>98</strong></td>
<td><strong>957</strong></td>
</tr>
</tbody>
</table>

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

As of September 30, 2009, there is no net capital lease liability. In FY 2008, the net capital lease liability was $3 million and the lease for the ADP equipment was covered by budgetary resources. There are no future lease payments.

Operating Leases

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Lease Payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>$11</td>
</tr>
<tr>
<td>2011</td>
<td>12</td>
</tr>
<tr>
<td>2012</td>
<td>10</td>
</tr>
<tr>
<td>2013</td>
<td>5</td>
</tr>
<tr>
<td>2014</td>
<td>-</td>
</tr>
<tr>
<td>After 2014</td>
<td>-</td>
</tr>
</tbody>
</table>

**Total Future Lease Payments** $38

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 are cancelable or renewable 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.
INTERNAL REVENUE SERVICE
Notes to the Financial Statements
For the Years Ended September 30, 2009 and 2008

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, 2009 and 2008, 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, 2009 and 2008, there were two 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, 2009 and 2008, the IRS does not have contractual commitments for payments on obligations related to canceled appropriations.

Note 11. Cost and Earned Revenue by Programs

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(In Millions)</td>
<td>(In Millions)</td>
</tr>
<tr>
<td></td>
<td>Taxpayer Assistance and Education</td>
<td>Filing and Account Services</td>
</tr>
<tr>
<td>Intragovernmental Gross Cost</td>
<td>$ 88</td>
<td>$ 1,639</td>
</tr>
<tr>
<td>Gross Costs with the Public</td>
<td>468</td>
<td>2,311</td>
</tr>
<tr>
<td>Program Costs</td>
<td>556</td>
<td>3,950</td>
</tr>
<tr>
<td>Intragovernmental Earned Revenue</td>
<td>(2)</td>
<td>(12)</td>
</tr>
<tr>
<td>Earned Revenue from the Public</td>
<td>(3)</td>
<td>(56)</td>
</tr>
<tr>
<td>Program Revenues</td>
<td>(5)</td>
<td>(68)</td>
</tr>
<tr>
<td>Net Cost of Operations</td>
<td>$ 551</td>
<td>$ 3,882</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>(In Millions)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Taxpayer Assistance and Education</td>
<td>Filing and Account Services</td>
</tr>
<tr>
<td>Intragovernmental Gross Cost</td>
<td>$ 119</td>
<td>$ 1,494</td>
</tr>
<tr>
<td>Gross Costs with the Public</td>
<td>504</td>
<td>2,108</td>
</tr>
<tr>
<td>Program Costs</td>
<td>623</td>
<td>3,602</td>
</tr>
<tr>
<td>Intragovernmental Earned Revenue</td>
<td>(3)</td>
<td>(19)</td>
</tr>
<tr>
<td>Earned Revenue from the Public</td>
<td>(3)</td>
<td>(46)</td>
</tr>
<tr>
<td>Program Revenues</td>
<td>(8)</td>
<td>(61)</td>
</tr>
<tr>
<td>Net Cost of Operations</td>
<td>$ 617</td>
<td>$ 3,541</td>
</tr>
</tbody>
</table>
Note 12. Statement of Budgetary Resources

Obligations Incurred

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct - Category B</td>
<td>$11,782</td>
<td>$11,342</td>
</tr>
<tr>
<td>Reimbursable - Category B</td>
<td>114</td>
<td>142</td>
</tr>
<tr>
<td><strong>Obligations Incurred</strong></td>
<td><strong>$11,896</strong></td>
<td><strong>$11,484</strong></td>
</tr>
</tbody>
</table>

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 Statement of Budgetary Resources and the President's Budget

<table>
<thead>
<tr>
<th>(In Millions)</th>
<th>Budgetary Resources</th>
<th>Obligations Incurred</th>
<th>Distributed Offsetting Receipts</th>
<th>Net Outlays</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statement of Budgetary Resources (SBR)</td>
<td>$12,174</td>
<td>$11,484</td>
<td>$201</td>
<td>$11,051</td>
</tr>
<tr>
<td>Included on SBR, not in President’s Budget</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expired Funds</td>
<td>(414)</td>
<td>(29)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Distributed Offsetting Receipts</td>
<td>-</td>
<td>-</td>
<td>(201)</td>
<td>201</td>
</tr>
<tr>
<td>Other</td>
<td>-</td>
<td>8</td>
<td>-</td>
<td>2</td>
</tr>
<tr>
<td>Included in President’s Budget, not on SBR</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax credits and interest refunds to taxpayers</td>
<td>94,484</td>
<td>94,484</td>
<td>-</td>
<td>94,484</td>
</tr>
<tr>
<td>Payments to informants</td>
<td>22</td>
<td>22</td>
<td>-</td>
<td>22</td>
</tr>
<tr>
<td><strong>Budget of the United States Government</strong></td>
<td><strong>$106,266</strong></td>
<td><strong>$105,969</strong></td>
<td><strong>-</strong></td>
<td><strong>$105,760</strong></td>
</tr>
</tbody>
</table>

The FY 2011 Budget of the United States Government (President’s Budget) presenting the actual amounts for the year ended September 30, 2009 has not been published as of the issue date of these financial statements. The FY 2011 President’s Budget is scheduled for publication in February 2010. A reconciliation of the FY 2008 column on the Statement of Budgetary Resources (SBR) to the actual amounts for FY 2008 in the FY 2010 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 and informant payments totaling $94.5 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.
Financial Statements

INTERNAL REVENUE SERVICE

Notes to the Financial Statements
For the Years Ended September 30, 2009 and 2008

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 $985 million and $917 million for the periods ended September 30, 2009 and 2008, respectively.

Note 13. Collections of Federal Tax Revenue

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>Individual income, FICA/SECA, and other</th>
<th>Corporate income</th>
<th>Excise</th>
<th>Estate and gift</th>
<th>Railroad retirement</th>
<th>Federal unemployment</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>$1,297 *</td>
<td>137 **</td>
<td>34</td>
<td>4</td>
<td>4</td>
<td>5</td>
<td>$1,477</td>
</tr>
<tr>
<td>2008</td>
<td>$702</td>
<td>69</td>
<td>13</td>
<td>1</td>
<td>-</td>
<td>-</td>
<td>$791</td>
</tr>
<tr>
<td>2007</td>
<td>$22</td>
<td>2</td>
<td>-</td>
<td>1</td>
<td>1</td>
<td>-</td>
<td>$25</td>
</tr>
<tr>
<td>Prior Years</td>
<td>$20</td>
<td>17</td>
<td>47</td>
<td>20</td>
<td>5</td>
<td>7</td>
<td>$52</td>
</tr>
<tr>
<td>FY 2009</td>
<td>$2,036</td>
<td>225</td>
<td>47</td>
<td>25</td>
<td>5</td>
<td>-</td>
<td>$2,345</td>
</tr>
<tr>
<td>FY 2008</td>
<td>$2,295</td>
<td>354</td>
<td>52</td>
<td>30</td>
<td>5</td>
<td>-</td>
<td>$2,743</td>
</tr>
</tbody>
</table>

* Includes other collections of $514 million.
** Includes tax year 2010 corporate income tax receipts of $9 billion.

In FY 2009, individual income, FICA/SECA, and other taxes include $83 billion in payroll taxes collected from other Federal agencies.

Note 14. Federal Tax Refund Activity

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>Individual income, FICA/SECA, and other</th>
<th>Corporate income</th>
<th>Excise</th>
<th>Estate and gift</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>$1</td>
<td>7</td>
<td>-</td>
<td>-</td>
<td>$8</td>
</tr>
<tr>
<td>2008</td>
<td>$294</td>
<td>33</td>
<td>1</td>
<td>1</td>
<td>$328</td>
</tr>
<tr>
<td>2007</td>
<td>$31</td>
<td>17</td>
<td>-</td>
<td>1</td>
<td>$40</td>
</tr>
<tr>
<td>Prior Years</td>
<td>$38</td>
<td>38</td>
<td>1</td>
<td>1</td>
<td>$49</td>
</tr>
<tr>
<td>FY 2009</td>
<td>$340</td>
<td>95</td>
<td>2</td>
<td>1</td>
<td>$438</td>
</tr>
<tr>
<td>FY 2008</td>
<td>$369</td>
<td>55</td>
<td>1</td>
<td>1</td>
<td>$426</td>
</tr>
</tbody>
</table>

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. In FY 2008, the IRS disbursed $94.3 billion of recovery rebates to eligible taxpayers. (See Other Accompanying Information for discussion of refundable tax credits.)
Note 15. Fiduciary Activities

The fiduciary net assets, end of the year balance of $18 million remains in the fiduciary fund 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, 2009 and 2008

Note 16. Reconciliation of Net Cost of Operations to Budget

<table>
<thead>
<tr>
<th>(In Millions)</th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Resources used to finance activities:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Obligations incurred</td>
<td>$11,896</td>
<td>$11,484</td>
</tr>
<tr>
<td>Spending authority from offsetting collections and recoveries</td>
<td>(224)</td>
<td>(264)</td>
</tr>
<tr>
<td>Distributed offsetting receipts</td>
<td>(233)</td>
<td>(201)</td>
</tr>
<tr>
<td>Other exchange revenues not in budget</td>
<td>(51)</td>
<td>(40)</td>
</tr>
<tr>
<td>Imputed financing</td>
<td>1,123</td>
<td>1,067</td>
</tr>
<tr>
<td>Transfers in/out without reimbursement</td>
<td>21</td>
<td>30</td>
</tr>
<tr>
<td><strong>Total Resources used to finance activities</strong></td>
<td><strong>12,532</strong></td>
<td><strong>12,076</strong></td>
</tr>
</tbody>
</table>

| Resources that do not fund net cost of operations:|        |        |
| Changes in goods, services and benefits ordered but not yet received or provided | (64)   | 40     |
| Costs capitalized on the balance sheet            | (300)  | (321)  |
| **Total Resources that do not fund net cost of operations** | **(364)** | **(281)** |

| Costs that do not require resources in current period: |        |        |
| Depreciation and amortization                       | 320    | 333    |
| Increase (Decrease) in unfunded liabilities         | (29)   | 41     |
| Revaluation of assets and liabilities               | 42     | 22     |
| Other                                              | 2      | 2      |
| **Total Costs that do not require resources in current period** | **335** | **398** |

| Net Cost of Operations | $12,503 | $12,193 |

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 and the accrual basis of financial accounting reports the net cost of resources used.
### Schedule of Budgetary Resources by Major Budget Accounts

<table>
<thead>
<tr>
<th></th>
<th>2009 (In Millions)</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Taxpayer Service</td>
<td>Enforcement</td>
<td>Operations Support</td>
<td>Other Appropriations</td>
<td>Total</td>
</tr>
<tr>
<td><strong>Budgetary Resources</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unobligated Balance, Brought Forward, October 1</td>
<td>$181</td>
<td>$100</td>
<td>$184</td>
<td>$225</td>
<td>$690</td>
</tr>
<tr>
<td>Recoveries of Prior Year Unpaid Obligations</td>
<td>23</td>
<td>30</td>
<td>47</td>
<td>4</td>
<td>94</td>
</tr>
<tr>
<td><strong>Total Budgetary Resources</strong></td>
<td><strong>$2,607</strong></td>
<td><strong>$5,266</strong></td>
<td><strong>$4,152</strong></td>
<td><strong>$758</strong></td>
<td><strong>$12,783</strong></td>
</tr>
</tbody>
</table>

### Status of Budgetary Resources

<table>
<thead>
<tr>
<th></th>
<th>2009 (In Millions)</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Status of Budgetary Resources</td>
<td><strong>$2,607</strong></td>
<td><strong>$5,266</strong></td>
<td><strong>$4,152</strong></td>
<td><strong>$758</strong></td>
<td><strong>$12,783</strong></td>
</tr>
</tbody>
</table>

### Change in Obligated Balance:

<table>
<thead>
<tr>
<th></th>
<th>2009 (In Millions)</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Obligated Balances, Net, End of Period</td>
<td><strong>$2,607</strong></td>
<td><strong>$5,266</strong></td>
<td><strong>$4,152</strong></td>
<td><strong>$758</strong></td>
<td><strong>$12,783</strong></td>
</tr>
</tbody>
</table>

### Net Outlays:

<table>
<thead>
<tr>
<th></th>
<th>2009 (In Millions)</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Outlays</td>
<td><strong>$2,417</strong></td>
<td><strong>$4,984</strong></td>
<td><strong>$3,779</strong></td>
<td><strong>$57</strong></td>
<td><strong>$11,247</strong></td>
</tr>
</tbody>
</table>
## Required Supplementary Information

### INTERNAL REVENUE SERVICE

Required Supplementary Information - Unaudited

For the Years Ended September 30, 2009 and 2008

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**Schedule of Budgetary Resources by Major Budget Accounts**

<table>
<thead>
<tr>
<th></th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Taxpayer Service</td>
</tr>
<tr>
<td><strong>Budgetary Resources</strong></td>
<td>$1,834</td>
</tr>
<tr>
<td><strong>Status of Budgetary Resources</strong></td>
<td>$2,577</td>
</tr>
<tr>
<td><strong>Change in Obligated Balance</strong></td>
<td>$224</td>
</tr>
<tr>
<td><strong>Net Outlays</strong></td>
<td>$2,385</td>
</tr>
</tbody>
</table>

---

### Notes

- **Budget Authority**
- **Spending Authority from Offsetting Collections**
- **Nonexpenditure Transfers, Net**
- **Permanently Not Available**
- **Total Budgetary Resources**
- **Obligations Incurred**
- **Unobligated Balance – Available**
- **Unobligated Balance – Not Available**
- **Total Status of Budgetary Resources**
- **Net Outlays**

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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 2009, the total estimated payout (including principal and interest) for claims pending judicial review by the Federal courts is $4.7 billion and by Appeals is $6.3 billion. In FY 2008, the total estimated payout (including principal and interest) for claims pending judicial review by the Federal courts was $5.0 billion and by Appeals was $17.0 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.

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:

<table>
<thead>
<tr>
<th>(In Billions)</th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total unpaid assessments</td>
<td>$308</td>
<td>$278</td>
</tr>
<tr>
<td>Compliance assessments</td>
<td>(75)</td>
<td>(67)</td>
</tr>
<tr>
<td>Write-offs</td>
<td>(105)</td>
<td>(99)</td>
</tr>
<tr>
<td>Gross Federal taxes receivables</td>
<td>128</td>
<td>112</td>
</tr>
<tr>
<td>Allowance for uncollectible taxes receivable</td>
<td>(99)</td>
<td>(83)</td>
</tr>
<tr>
<td>Federal taxes receivable, net</td>
<td>$29</td>
<td>$29</td>
</tr>
</tbody>
</table>

The IRS cannot reasonably estimate the amount of allowance for uncollectible taxes receivable 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 $3 billion as of September 30, 2009 and $4 billion as of September 30, 2008, which 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.
### Statement of Net Cost by Responsibility Segment

<table>
<thead>
<tr>
<th>(In Millions)</th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Operating divisions:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>WAGE</td>
<td>$3,323</td>
<td>$3,266</td>
</tr>
<tr>
<td>SBSE</td>
<td>2,702</td>
<td>2,585</td>
</tr>
<tr>
<td>LMSB</td>
<td>884</td>
<td>842</td>
</tr>
<tr>
<td>TEGE</td>
<td>286</td>
<td>272</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>7,195</td>
<td>6,965</td>
</tr>
<tr>
<td><strong>Functional divisions:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Appeals</td>
<td>238</td>
<td>218</td>
</tr>
<tr>
<td>Chief Counsel</td>
<td>349</td>
<td>326</td>
</tr>
<tr>
<td>Criminal Investigations</td>
<td>662</td>
<td>632</td>
</tr>
<tr>
<td>Taxpayer Advocate</td>
<td>222</td>
<td>207</td>
</tr>
<tr>
<td>Communications</td>
<td>28</td>
<td>28</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>1,499</td>
<td>1,411</td>
</tr>
<tr>
<td><strong>Operating Net Cost</strong></td>
<td>8,694</td>
<td>8,376</td>
</tr>
<tr>
<td>General and Administration</td>
<td>1,574</td>
<td>1,598</td>
</tr>
<tr>
<td>Information Technology</td>
<td>1,872</td>
<td>1,864</td>
</tr>
<tr>
<td>Depreciation/Loss on Disposal</td>
<td>363</td>
<td>355</td>
</tr>
<tr>
<td><strong>Net Cost of Operations</strong></td>
<td>$12,503</td>
<td>$12,193</td>
</tr>
</tbody>
</table>

### Refundable Tax Credits

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. There exists an additional class of tax credits however which are fully payable to the taxpayer, even if the credit exceeds the tax liability. These refundable credits provide a greater economic benefit as the taxpayer realizes the full benefit of the calculated credit, unlimited by any 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). The ARRA temporarily increased the benefits for several existing refundable credits including the Earned Income Tax Credit (EITC) and the Child Tax Credit. Additionally, ARRA authorized several new refundable credits. The bulk of tax provisions in ARRA affect tax years 2009 and 2010.
Stimulus Credit
In 2008 the Economic Stimulus Act provided taxpayers with a one-time rebate. These rebates were mailed or sent via direct deposit to individuals who filed a 2007 tax return and met certain eligibility requirements. The IRS calculated the amount of the rebate based on 2007 income information. The maximum rebate payment was $600 for unmarried persons and $1,200 for married couples, plus an additional $300 per qualifying child.

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 earn enough money to be obligated to file a tax return.

ARRA temporarily increased the earned income tax credit for working families to forty-five percent (45%) of the family’s first $12,570 of earned income for families with three or more children. Additionally, the initial phase-out range for all married couples filing a joint return increased (regardless of the number of children) by $1,880.

Additional Child Tax Credit
The 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. Benefits of the credit were augmented under ARRA by increasing eligibility for the credit in 2009 and 2010.

Health Care Tax Credit
The Health Care Tax Credit was established 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. 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
The Individual AMT 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

Last year, Congress provided taxpayers with a refundable tax credit equivalent to an interest-free loan equal to 10 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, if earlier, when 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).

Under ARRA, the bill eliminates the repayment obligation for taxpayers who purchase homes after January 1, 2009, increases the maximum value of the credit to $8,000, and removes 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.

Making Work Pay Credit and Credit for Certain Government Retirees

The Making Work Pay Credit 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.

Build America and Recovery Zone Bonds

Build America Bonds are a new 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.

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 9 months for workers who have been involuntarily terminated. Additionally, this subsidy applies to health care continuation coverage if required by states for small employers.

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-
Other Accompanying Information

INTERNAL REVENUE SERVICE
Other Accompanying Information - Unaudited
For the Years Ended September 30, 2009 and 2008

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.

The following table summarizes refundable tax credit amounts paid in 2009 and 2008.

<table>
<thead>
<tr>
<th>(In Millions)</th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stimulus Credit</td>
<td>$2,024</td>
<td>$15,281</td>
</tr>
<tr>
<td>Earned Income Tax Credit a</td>
<td>42,418</td>
<td>40,600</td>
</tr>
<tr>
<td>Additional Child Tax Credit a</td>
<td>24,284</td>
<td>34,019</td>
</tr>
<tr>
<td>Health Care Tax Credit a</td>
<td>113</td>
<td>97</td>
</tr>
<tr>
<td>Individual Alternative Minimum Tax (AMT) Credit</td>
<td>711</td>
<td>-</td>
</tr>
<tr>
<td>First-Time Homebuyer Credit a</td>
<td>9,386</td>
<td>-</td>
</tr>
<tr>
<td>Making Work Pay Credit and Credit for Certain Government Retirees ∆</td>
<td>663</td>
<td>-</td>
</tr>
<tr>
<td>Build America and Recovery Zone Bonds ∆</td>
<td>19</td>
<td>-</td>
</tr>
<tr>
<td>COBRA Credit ∆</td>
<td>313</td>
<td>-</td>
</tr>
<tr>
<td>Corporate Alternative Minimum Tax (AMT) Credit</td>
<td>24</td>
<td>-</td>
</tr>
<tr>
<td>Refundable Tax Credits</td>
<td>$79,955</td>
<td>$89,997</td>
</tr>
</tbody>
</table>

a Existing refundable credits expanded under the ARRA.
∆ New refundable credits resulting from the ARRA.
INTERNAL REVENUE SERVICE
Other Accompanying Information - Unaudited
For the Years Ended September 30, 2009 and 2008

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 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 12.4 percent on self employment income up to $106,800 for calendar year 2009. The income ceiling for both wages and tips and self-employment income was $102,000 for calendar year 2008. 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 $661 billion and $665 billion in FY 2009 and FY 2008, respectively. Medicare taxes collected by the IRS were estimated to be approximately $192 billion and $195 billion in FY 2009 and FY 2008, 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 amount of noncompliance with the tax laws. Underreporting of tax liability accounts for 42 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
collection gap includes only amounts that have been assessed (a small portion of all noncompliance). 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 only 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 from 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, 2009 and 2008

AVERAGE INDIVIDUAL INCOME TAX LIABILITY AND AVERAGE ADJUSTED GROSS INCOME (AGI)
TAX YEAR 2007

<table>
<thead>
<tr>
<th>Adjusted gross income (AGI)</th>
<th>Number of taxable returns (in thousands)</th>
<th>AGI (in millions)</th>
<th>Total income tax (in millions)</th>
<th>Average AGI per return (in millions)</th>
<th>Average income tax per return (in whole dollars)</th>
<th>Income tax as a percentage of AGI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under $15,000</td>
<td>37,597</td>
<td>186,000</td>
<td>3,022</td>
<td>4,947</td>
<td>80</td>
<td>1.6%</td>
</tr>
<tr>
<td>$15,000 under $30,000</td>
<td>30,229</td>
<td>669,952</td>
<td>22,211</td>
<td>22,162</td>
<td>735</td>
<td>3.3%</td>
</tr>
<tr>
<td>$30,000 under $50,000</td>
<td>25,978</td>
<td>1,015,283</td>
<td>61,396</td>
<td>39,082</td>
<td>2,363</td>
<td>6.0%</td>
</tr>
<tr>
<td>$50,000 under $100,000</td>
<td>31,260</td>
<td>2,216,021</td>
<td>191,293</td>
<td>70,890</td>
<td>6,119</td>
<td>8.6%</td>
</tr>
<tr>
<td>$100,000 under $200,000</td>
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<td>1,501</td>
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<td>222,058</td>
<td>37,843</td>
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<tr>
<td>$250,000 or more</td>
<td>3,002</td>
<td>2,317,016</td>
<td>528,770</td>
<td>771,824</td>
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<tr>
<td>Totals</td>
<td>143,030</td>
<td>8,531,398</td>
<td>1,092,909</td>
<td>-</td>
<td>-</td>
<td>-</td>
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</tbody>
</table>

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

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2009 and 2008

INDIVIDUAL INCOME TAX LIABILITY AS A PERCENTAGE OF AGI
TAX YEAR 2007

(All figures are estimates and based on samples provided by the Statistics of Income (SOI) Office)
INTERNAL REVENUE SERVICE
Other Accompanying Information - Unaudited
For the Years Ended September 30, 2009 and 2008

CORPORATION TAX LIABILITY AS A PERCENTAGE OF TAXABLE INCOME
TAX YEAR 2006 DATA

<table>
<thead>
<tr>
<th>Total Assets (in thousands)</th>
<th>Income subject to tax (in millions)</th>
<th>Total income tax after credits (in millions)</th>
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<td>Total</td>
<td>1,291,431</td>
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<td>27.3%</td>
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(All figures are estimates and based on samples provided by the Statistics of Income (SOI) Office)
Appendix I: Material Weaknesses and Compliance Issues

Material Weaknesses

During our audits of the Internal Revenue Service’s (IRS) fiscal years 2009 and 2008 financial statements, we identified two material weaknesses in internal control. These material weaknesses have given rise to significant management challenges that 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 effectively managing its unpaid 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 appropriately protected. The issues that we have identified and discuss in this report relate to IRS’s internal control over (1) unpaid tax assessments and (2) information security. We reported on each of these issues last year\(^1\) and in prior audits. We highlight these issues in the following sections.

In previous years, we reported a material weakness in IRS’s internal control over financial reporting. IRS has worked steadily over a number of years to address several deficiencies that constituted this material weakness and has made steady progress. During fiscal year 2009, IRS (1) continued to develop its ability to provide managerial cost accounting information and developed full cost data on several programs and (2) substantially completed developing the capability to trace its revenue and refund transactions from its general ledger to supporting detailed transaction information, thus providing full transaction traceability of its tax refunds and more than 98 percent of its tax revenue collections. Based on IRS’s progress, we no longer consider the remaining issues to represent a material weakness in internal control. While we no longer consider the remaining issues related to IRS’s development and use of cost accounting to be an internal control deficiency, they continue to present IRS with significant operational and financial management challenges requiring further attention. Additionally, IRS’s core financial system for unpaid tax assessments and other tax related transactions, the Interim Revenue Accounting Control System (IRACS), continued to be noncompliant with the U.S. Government Standard General Ledger (SGL) at the transaction level, and this system and its related subsidiary records continued to be noncompliant with the SGL.

\(^1\)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.

Appendix I: Material Weaknesses and Compliance Issues

unable to provide the capability to trace transactions related to taxes receivable and other unpaid assessments. We have therefore included this deficiency as a component of the material weakness in internal control over unpaid assessments in fiscal year 2009.

Unpaid Tax Assessments

During fiscal year 2009, we continued to find serious internal control issues that affected IRS’s management of unpaid tax assessments. Specifically, we continued to find (1) IRS’s reported balances for taxes receivable and other unpaid assessments were not supported by its core general ledger system for tax administration—related transactions (IRACS), (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, and (3) IRS experienced errors and delays in recording taxpayer information, payments, and other activities.

As we reported in prior years, IRS’s balance for federal taxes receivable, which comprised nearly 80 percent of IRS’s total assets as reported on its fiscal year 2009 balance sheet, was not produced by IRACS. IRS’s master files and IRACS were not designed to classify and report unpaid assessments in accordance with federal accounting standards. To compensate for this, IRS must apply statistical sampling and estimation techniques to data from its master files 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.

3 Federal accounting standards classify unpaid 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 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 net federal taxes receivable are reported on the financial statements.

4 GAO-09-119.

5 IRS reports federal taxes receivable on its balance sheet, net of an allowance for amounts considered uncollectible.

6 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.
Appendix I: Material Weaknesses and Compliance Issues

in its required supplementary information. While IRS reports the taxes receivable balance derived from this process on its balance sheet, and the balances of compliance assessments and write-offs in its required supplementary information, it does not record these amounts into IRACS because they are the product of an annual statistical estimation process rather than a summation of taxpayer account transaction data. As a result, IRS does not have records to trace transactions from the taxes receivable amount and other unpaid assessment amounts reported on IRS’s financial statements, through its general ledger system, and back to underlying transaction-level taxpayer source documents. Such traceability is necessary to enable IRS to ensure that recorded transactions are complete, accurate, and supported by underlying records. Consequently, IRACS does not substantially comply with the U.S. Government Standard General Ledger (SGL) at the transaction level, and Federal Financial Management Systems Requirements (FFMSR) embodied in OMB Circular No. A-127, Financial Management Systems.7

Recognizing the seriousness of this deficiency, IRS began phasing in the use of the Custodial Detail Data Base (CDDB) in 2006. One key objective of CDDB is 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 IRACS, thus providing the transactional traceability. In fiscal year 2008, IRS enhanced CDDB to weekly analyze and record unpaid assessments balances from its master file, 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 debt.

However, IRS cannot yet use CDDB as its subsidiary ledger for recording transaction-based tax debt information to its general ledger in a manner that ensures reliable internal and external reporting. While CDDB analyzes and classifies master file tax debt information into the various financial reporting categories, the analysis and classification contained material inaccuracies. For example, through its use of its statistical sampling and estimation techniques, IRS identified errors necessitating almost $8 billion

in adjustments to the 2009 fiscal year-end gross taxes receivable balance produced by CDDDB. Accordingly, IRS must continue to use a statistical sampling and estimation technique in order to derive reliable amounts for taxes receivable and other unpaid assessments categories for internal and external reporting. While the use of CDDDB has refined this process, it continued to take IRS several months to complete, required multibillion-dollar adjustments, and produced amounts that were only reliable as of the last day of the fiscal year. Consequently, the lack of an effective transaction-level subsidiary ledger continues to inhibit IRS’s ability to timely develop reliable financial and management reports useful for ongoing management decisions and external reporting in accordance with federal accounting standards.

During our fiscal year 2009 audit, we identified several systemic limitations in the programs used by CDDDB that resulted in misclassifying tax debt accounts among the three financial reporting categories—taxes receivable, compliance assessments, and write-offs. We identified instances in which CDDDB was unable to correctly classify an account module. Specifically, IRS had not written sufficient details into the CDDDB classification program to allow it to sort through, identify, and analyze all the relevant transaction-level information required for proper classification. For example, when IRS records multiple tax assessments on a single account module, CDDDB is currently unable to distinguish among and separately classify the various balances. In one instance we identified, a taxpayer filed a tax return but did not pay the entire amount of the tax liability reported on the return, which resulted in the amount owed being classified as a tax receivable. IRS later assessed additional taxes against the taxpayer for the same tax period through its Automated Underreporter program, but the taxpayer did not concur with the additional tax assessment. The additional assessment should have been classified as a

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8A taxpayer may have multiple account modules within IRS’s master files under a unique taxpayer identification number (i.e., 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.).

9According to federal accounting standards, the self-reporting of an outstanding tax liability establishes the outstanding balance as a tax receivable for financial reporting purposes.

10Automated Underreporter is an IRS program that compares information on tax returns to related information submitted electronically by third parties to identify potential unreported taxable income.
Appendix I: Material Weaknesses and Compliance Issues

Compliance assessment. However, CDDB classified the entire outstanding balance as taxes receivable because the taxpayer's master file account module contained information that the taxpayer had filed a tax return.

In another example, CDDB was unable to analyze and properly classify related account modules associated with unpaid payroll taxes if IRS (1) assessed a trust fund recovery penalty (TFRP) against the officer of a business for a specific tax period and (2) assessed the same individual a TFRP from a different business for the same tax period. IRS assessed a TFRP against an officer related to a defunct business's unpaid payroll taxes for a particular tax period. The business had filed a tax return reporting the unpaid payroll taxes for the period. However, since the business was defunct, IRS's only recourse was to pursue collection on the TFRP that it assessed against 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 assessment that is not counted for financial reporting purposes, and (3) classified any remaining balance from the business's unpaid payroll tax account that is above the TFRP amount as a write-off. However, in this case, IRS had also assessed this same individual a TFRP related to another business for the same tax period. Because there were two separate TFRP assessments recorded on the individual'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, CDDB defaulted to classifying the business's outstanding payroll tax account as

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11 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 a court order in favor of IRS's assessment.

12 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 guidance for IRS policy in the Internal Revenue Manual at § 4.23.9.13, Trust Fund Recovery Penalty (May 14, 2008).

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.
Appendix I: Material Weaknesses and Compliance Issues

taxes receivable and classifying the individual’s TFRP account as a duplicate assessment. Since the business was defunct and the amount of the payroll tax owed by the business was more than the amount of the TFRP assessment against the individual, this overstated the taxes receivable balance. Consequently, IRS had to make an adjustment to reduce the balance of taxes receivable on this account.

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 2009 audit, we again found errors in taxpayer records resulting from IRS’s not recording information accurately and timely. Such errors directly affect the accuracy of the tax debt information being classified by CDDB. Additionally, such errors can cause frustration to taxpayers who either have already paid taxes owed or who owe significantly lower amounts.

For example, in one case we reviewed, a taxpayer submitted a gift tax return with an associated payment of approximately $3 million in fiscal year 2009. IRS recorded the tax return information in the taxpayer’s master file account module but failed to record the receipt of the payment. This created a balance due within the account and led to IRS issuing two notices to the taxpayer requesting payment for an amount that had already been paid. Although IRS subsequently found and recorded the taxpayer’s payment, it did so only after inconveniencing the taxpayer. In another case, IRS accepted a business’s offer-in-compromise in April 2002 but did not record this information on the business’s master file account module. Instead, IRS only recorded the submission of the offer, which suspended the automated countdown to the expiration date of the statutory collection period for the outstanding tax debt on the master file record. Because the taxpayer did not satisfy all the conditions of its offer, IRS did not abate the balance of the outstanding tax debt. If IRS had recorded the

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14 An offer-in-compromise is an agreement between a taxpayer and IRS that resolves the taxpayer’s tax debt by accepting less than full payment. See 26 U.S.C. § 7122, 26 C.F.R. § 601.203.

15 IRS has a statutory limitation on the length of time it can pursue unpaid taxes, generally 10 years from the date of the tax assessment. See 26 U.S.C. § 6502.

16 Abatements are reductions in tax assessments and are a normal part of IRS’s tax administration process. Abatements may occur for a number of reasons. For example, a taxpayer may file an amended return claiming a lower tax liability than previously reported or a qualifying corporation may claim a net operating loss which created a credit that can be carried back to reduce a prior year’s tax liability.
acceptance of the offer in 2002, the countdown of the statutory collection period would have resumed and the taxpayer’s account module would have been removed from IRS’s systems when the statutory collection period expired in May 2008. Instead, as a result of IRS’s processing error, the taxpayer’s account balance was erroneously included in IRS’s inventory of unpaid assessments during fiscal year 2009.

We again continued to find errors involving IRS’s failure to properly record payments to all related taxpayer accounts associated with unpaid payroll taxes. As in prior years, IRS’s systems are unable to automatically reflect a reduction in the amounts owed on the related accounts when the business or any officer of that business pays some or all of the outstanding taxes. Although IRS has made improvements in its processes for recording TFRPs over the last several years, our work in fiscal year 2009 continued to find deficiencies in this process, leading to errors in taxpayers’ accounts. In our testing of 92 statistically selected payments received in the first 3 months of fiscal year 2009 that were recorded on TFRP accounts, we found 8 instances in which IRS did not properly record payments received on all related taxpayer accounts. Based on our testing, we estimate that about 8.7 percent of TFRP payment transactions in the first 3 months of fiscal year 2009 that were posted on TFRP accounts could contain inaccuracies.

Furthermore, processing errors contributed to IRS’s inability to timely release federal tax liens against taxpayers who have fully satisfied or are otherwise relieved of their tax liability. Such errors delayed the recording of taxpayers’ satisfying payments, resulting not only in inaccurate tax records but also delays in IRS’s release of federal tax liens. This, in turn, causes undue burden to taxpayers who are attempting to sell property or apply for commercial credit.

Current systemic limitations and processing errors that caused inaccurate tax records resulted in IRS having to make numerous adjustments as part of its process for estimating the balance of net taxes receivable and other unpaid tax assessments. When IRS identified misclassified cases resulting from systemic limitations and errors similar to those described above

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17GAO-09-119.

18We are 95 percent confident that the error rate does not exceed 15.1 percent.

19This issue is discussed further in the Compliance Issues section of this report.
when reviewing its sample of unpaid assessment cases, it recorded adjustments to the affected account to reflect the correct value of that account 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 multibillion-dollar adjustments to the year-end balances of all three categories of unpaid assessments generated by CDDB in order to produce reliable amounts for external reporting on its balance sheet and required supplementary information. Absent the use of this statistical estimation process, the various unpaid assessment balances produced by CDDB would have been materially inaccurate.

The progress IRS has made to date with using CDDB data is an important step in moving toward a fully functioning subsidiary ledger that could provide for full traceability of detailed transaction information to the general ledger with respect to taxes receivable and the other unpaid tax assessments categories. Using unadjusted CDDB information to support the general ledger for the external reporting of taxes receivable and the other unpaid assessments categories would move IRS towards compliance with the SGL and FFMSR. However, IRS must fully address the issues that cause material inaccuracies in the unpaid assessments information produced by CDDB before it can rely on unadjusted CDDB data for financial reporting. This will require further enhancements to CDDB to enable it to more accurately distinguish between the three categories of unpaid tax assessments so that reliable transaction-based balances for each are ultimately recorded in the general ledger.

Information Security

IRS has demanding responsibilities in collecting taxes, processing tax returns, and enforcing the nation’s tax laws, and relies extensively on computerized systems to support its financial and mission-related operations. Ensuring that taxpayer and financial information is adequately protected from inadvertent or deliberate misuse, fraudulent use, and improper disclosure, modification, or destruction requires effective information system controls. Further, ineffective information system controls can impair the accuracy, completeness, and timeliness of information used by management and, in the absence of effective compensating procedures, increase the potential for undetected material misstatements in the agency’s financial statements.

This issue is discussed further in the Compliance Issues section of this report.
Appendix I: Material Weaknesses and Compliance Issues

During fiscal year 2009, IRS made progress in addressing numerous information security weaknesses we identified in previous audits. For example, IRS (1) documented approved access privileges for its mainframe user groups, (2) implemented role-based access controls to reduce the number of users with special privileged access on the system supporting the Integrated Financial System (IFS), and (3) changed vendor-supplied database accounts and passwords to avoid potential use by malicious users.

Despite these actions, previously identified weaknesses in internal control over information security continue to place IRS systems at risk. For example, for its procurement system, IRS had not restricted users’ ability to bypass application controls, and was not removing separated employees’ access in a timely manner. Further, managers did not always follow required procedures to timely review employee access to sensitive areas at data centers to ensure that access was limited only to employees who needed it to perform their jobs. These unresolved weaknesses increase the risk that data processed by the agency’s financial management systems are not reliable.

During our fiscal year 2009 audit, we identified additional significant weaknesses in internal control over information security that, along with previously identified weaknesses, continued to jeopardize the confidentiality, availability, and integrity of information processed by IRS’s key systems, increasing the risk of material misstatement for financial reporting. For example, the operating system software supporting IFS has reached its “end of service” life. As a result, IRS may receive limited or no vendor maintenance support and security patches, thus increasing the risk that known information security vulnerabilities may be exploited. Also, about 120 IRS employees had access to key documents, including cost data for input to IFS and a critical process-control spreadsheet used in IRS’s cost allocation process. However, fewer than 10 employees needed access to perform their jobs. The large number of employees with access

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21IFS is IRS’s administrative accounting system, which IRS uses to facilitate its core financial management activities, including general ledger, budget formulation, accounts payable, accounts receivable, funds management, cost management, and financial reporting.

22A vendor will typically make support available to a buyer for a number of years after the product is shipped. However, after the product has reached its “end of service” life, the buyer will not receive patches, including security patches, unless it purchases additional services.
Appendix I: Material Weaknesses and Compliance Issues

to these documents increases the chances that they may intentionally or unintentionally corrupt the data in these documents, which could result in incorrect input and processing, or both, thus jeopardizing the accuracy of the cost allocation output. In addition, IRS used weak encryption controls for user login to IFS servers, increasing the risk that user IDs and passwords could be used for malicious intent. Further, IRS was not always logging and auditing security-relevant events on its procurement system; this increased the risk that IRS may not be able to detect unauthorized access. Additionally, IRS had not always ensured it had appropriate separation of duties for its procurement system, as one individual was performing the roles of system and database administrators—critical functions that should be performed by separate individuals or groups. IRS used vulnerable software on key servers, exposing the organization to a vulnerability that could allow a malicious user to capture user IDs and passwords by redirecting internal users’ access requests to other systems without their knowledge.

The weaknesses in IRS’s financial systems are due in part to IRS’s not fully implementing its information security program\(^2\) to ensure that controls are effectively established and maintained. IRS has developed and documented its program, but it has not fully or consistently implemented program requirements for key information systems. For example, although IRS has developed and implemented a process to address deficiencies in its information security policies, procedures, and practices, it did not sufficiently verify whether remedial actions were implemented or effective in mitigating the vulnerability. To illustrate, IRS informed us that it had corrected about 40 percent of the previously reported weaknesses. However, we found that IRS had not fully implemented the remedial actions it reported for at least a third of those that IRS considered corrected. Until IRS takes additional steps to fully implement key elements of its information security program, such as improving its remedial action process and ensuring employee adherence to its security-related policies and procedures, 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.

Collectively, the newly identified deficiencies in fiscal year 2009 and the unresolved deficiencies from prior audits reduce IRS’s ability to ensure that its financial and taxpayer information is secure and, in the absence of effective compensating procedures, increase the potential for undetected material misstatements in the agency’s financial statements. We plan to issue a separate report on the deficiencies identified during fiscal year 2009 and the status of previously identified deficiencies.

To address its information security weaknesses, IRS has various initiatives underway. IRS has developed and documented a detailed roadmap to guide its efforts in targeting critical weaknesses. The agency is also in the process of implementing a comprehensive plan to address numerous information security weaknesses, such as those associated with network and system access, audit trails, system software configuration, and contingency planning. According to the plan, the last of these weaknesses is scheduled to be resolved in the first quarter of fiscal year 2014. Additionally, IRS has targeted initiatives covering identity and access management, auditing and monitoring, and disaster recovery for fiscal year 2010. These efforts, if fully and effectively implemented, are positive steps towards improving the agency’s overall information security posture.

Our tests of IRS’s compliance with selected provisions of laws and regulations 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).

The Internal Revenue Code grants IRS the power to file a lien against the property of any taxpayer who neglects or refuses to pay all assessed federal taxes. The lien becomes effective when it is filed with a designated office, such as a courthouse in the county where the taxpayer’s property is located. 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 credit reports of individuals. 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 of the tax liability being either paid off or abated, as required by the Internal Revenue Code.\(^\text{25}\) In response, IRS has taken a number of actions over the past several years to improve its lien processing. For example, IRS centralized all lien processing at its Cincinnati Service Center Campus in 2005. In addition, in July 2006, IRS enhanced various lien processing–related exception reports to include a cumulative list of unresolved lien releases, allowing it to more readily track the release status and take corrective action.

Despite the actions IRS has taken to date to improve its lien release process, our work in fiscal year 2009 continued to find that IRS did not always timely release all tax liens where the taxpayer had paid in full or was otherwise relieved of a tax liability. In prior audits, 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 under audit. Beginning in fiscal year 2006, IRS began performing its own test of the effectiveness of its lien release process as part of implementing the requirements of the revised OMB Circular No. A-123\(^\text{26}\) and we reviewed its 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 2009, we noted that IRS’s testing identified 8 instances in which it did not release the applicable federal tax lien within the statutorily mandated 30 days. The time between...

\(^{25}\)GAO-09-119.

\(^{26}\)OMB's revised Circular No. A-123, *Management's Responsibility for Internal Control*, became effective on October 1, 2005. Appendix 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.
Appendix I: Material Weaknesses and Compliance Issues

satisfaction of the liability and release of the lien ranged from 35 days to more than 123 days. On the basis of the sample, IRS did not release the lien within 30 days for an estimated 14 percent of unpaid tax assessment cases resolved in fiscal year 2009 for which it had filed a tax lien.

Various IRS processing errors and delays resulted in IRS not releasing these liens timely. These issues are similar to those we reported in prior audits. We previously issued a report that discussed factors contributing to IRS’s failure to timely release federal tax liens and made recommendations to address those issues. IRS has not yet completed actions to fully address all of these recommendations. Until IRS addresses the deficiencies we previously reported, as well as those it has identified through its own testing, IRS will not be able to ensure the timely release of liens. 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 2009, we continued to find that IRS’s financial management systems did not substantially comply with FFMIA requirements. Specifically, IRS’s systems did not substantially comply with FFMSR, federal accounting standards (U.S. generally accepted accounting principles), and the SGL at the transaction level. In its fiscal year 2009 Federal Managers’ Financial Integrity Act of 1982 assurance statement to the Department of the Treasury, IRS also reported that its financial management systems did not substantially comply with FFMIA requirements.

IRS’s core general ledger system for tax-related activities, IRACS, does not conform to the requirements of FFMSR, which are contained in OMB

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27IRS reports it is 95 percent confident that the percentage of cases in which the lien was not released within 30 days does not exceed 23 percent.

28GAO-09-119.

Appendix I: Material Weaknesses and Compliance Issues

Circular No. A-127, and also does not comply with the SGL at the transaction level. Specifically, as we noted earlier in this report, IRS continues to lack transaction traceability for taxes receivable, which in fiscal year 2009 was again the product of a complex statistical estimation process and was not recorded in IRACS, although it accounted for nearly 80 percent of the assets reported by IRS on its balance sheet as of September 30, 2009. IRACS also does not post transactions in conformance with SGL posting models. Also, as discussed previously, material weaknesses in IRS’s internal control over information security continue to threaten the (1) integrity of the financial statements and the accuracy and availability of financial information needed to support day-to-day decision making and (2) confidentiality of proprietary information. In fiscal year 2009, we continued to identify weaknesses in controls for protecting access to systems and information, as well as weaknesses in other information security controls that affect IRS's key financial systems, specifically IFS. As discussed earlier, a key reason for the presence of these information security weaknesses in IRS’s financial systems is that IRS has not yet fully implemented a security program to ensure that controls are effectively established and maintained.

IRS is in the process of implementing a significant enhancement to IRACS that it expects will bring this system into full conformance with the requirements of the SGL. This enhanced system, referred to as the Redesign Revenue Accounting and Control System (RRACS), is scheduled to become fully operational in February 2010. We will assess the SGL conformance of RRACS during our audit of IRS's fiscal years 2010 and 2009 financial statements.

IRS’s financial management systems did not substantially comply with federal accounting standards in fiscal year 2009 because (1) IRS’s automated systems for tax related transactions did not support the net taxes receivable amount on IRS’s balance sheet and other required supplemental information related to uncollected taxes—compliance assessments, and write-offs—in accordance with Statement of Federal

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Appendix I: Material Weaknesses and Compliance Issues

Financial Accounting Standards No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*. To compensate, IRS relied on a complex statistical sampling process to estimate these amounts, and (2) IRS had two material weaknesses in its internal control.

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, many of which are long-term in nature and are tied to IRS's systems modernization efforts.\(^3\)

\(^3\)Section 803(c)(4) of FFMIA requires that 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 Treasury official who shall be responsible for bringing its systems into substantial compliance by that date.
Appendix II: Management’s Report on Internal Control over Financial Reporting

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

November 5, 2009

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, 2009, 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, 2009, IRS internal control over financial reporting was effective.

Douglas H. Shulman
Commissioner

Alison L. Doone
Chief Financial Officer

November 5, 2009

Date

November 5, 2009

Date
November 5, 2009

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

Dear Mr. Sebastian:

Thank you for the opportunity to comment on the draft report titled, Financial Audit: IRS’s Fiscal Years 2009 and 2008 Financial Statements. We are pleased that the Internal Revenue Service (IRS) received an unqualified opinion on the combined financial statements for the tenth consecutive year. The unqualified opinion demonstrates that the IRS accurately accounts for approximately $2.3 trillion in tax revenue receipts, $438 billion in tax refunds, and $12 billion in IRS appropriated funds.

We also are pleased that the Government Accountability Office (GAO) recognizes the significant accomplishments the IRS made this year in addressing its financial management challenges and material weaknesses in internal controls. As a result of the IRS progress, GAO no longer considers the remaining issues over financial reporting to constitute a material weakness. Further, GAO concluded that the remaining issues regarding tax revenue and refunds no longer constitute a significant deficiency.

We are dedicated to continuing to improve financial management at the IRS, as evidenced by the following additional FY 2009 achievements:

- Conducted A-123 activities by testing transaction processes material to Treasury’s Consolidated Financial Statements, including 16 administrative processes related to $12 billion in administrative transactions and three custodial tax processes related to $2.3 trillion in tax revenues
- Established the Custodial Detail Database (CDDB) as the subsidiary ledger to the Interim Revenue Accounting Control System (IRACS) for revenue and refunds, including traceability of 98% of all revenue receipts to the detailed taxpayer transactions
Appendix III: Comments from the Internal Revenue Service

- Enhanced financial management structure and processes to provide key management data on costs and enforcement tax revenue by publishing an IRS-wide Cost Accounting Manual and developing a plan to standardize the use of cost-based measures
- Ensured the continuity and resiliency of critical business processing systems by completing the development of disaster recovery plans for all General Support Systems

Improving information security continues to be a priority for the IRS. During FY 2009 the IRS made notable accomplishments in this area. Specifically, we increased the security of IRACS, the Integrated Financial System, and the Treasury Information Executive Repository environment, by limiting access to a reduced number of authorized staff. IRS also instituted role-based access in financial management systems and implemented controls to enforce the use of strong passwords in accordance with the Internal Revenue Manual.

I want to recognize 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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