United States Government Accountability Office

GAO

Report to the Secretary of the Treasury

November 2010

FINANCIAL AUDIT

IRS's Fiscal Years 2010 and 2009 Financial Statements

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Highlights

Highlights of GAO-11-142, a report to the Secretary of the Treasury

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FINANCIAL AUDIT

IRS's Fiscal Years 2010 and 2009 Financial Statements

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 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 2010. GAO will continue to monitor and report on IRS's progress in implementing the 173 recommendations that remain open as of the date of this report. In addition, as appropriate, we will report separately on any recommended actions to address the new deficiencies identified in this year's audit.

IRS agreed that identified weaknesses continue to exist and stated that it has taken actions to reduce the risks associated with these identified weaknesses. IRS expressed confidence that GAO would find that significant progress has been made during its fiscal year 2011 audit.

View GAO-11-142 or key components.
For more information, contact Steven J. Sebastian at (202) 512-3406 or sebastians@gao.gov.

What GAO Found

In GAO's opinion, IRS's fiscal years 2010 and 2009 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, 2010, 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 2010, IRS continued to make strides in addressing its internal control deficiencies. Specifically, IRS made progress in addressing its financial management systems' noncompliance with the requirements of FFMIA by bringing its financial management systems into compliance with the *United States Standard General Ledger*. IRS also corrected several information security weaknesses that GAO identified in previous audits. However, remaining deficiencies pertain to IRS's (1) material weaknesses in internal control over unpaid tax assessments and information security, (2) noncompliance with the law concerning the timely release of tax liens, and (3) financial management systems' substantial noncompliance with FFMIA requirements. Additionally, GAO's fiscal year 2010 financial audit identified a significant deficiency in IRS's internal control over tax refund disbursements.

IRS also faces serious challenges due to continued reliance on financial management systems that do not substantially comply with FFMIA requirements and that affect IRS's ability to (1) produce reliable financial statements without significant compensating procedures and (2) make well-informed decisions. IRS's continued material weakness in internal control over information security, which jeopardizes the reliability of the financial information it processes, could have implications for GAO's future ability to determine whether IRS's financial statements are fairly stated because as IRS continues to automate its processes, the availability of alternative methods of obtaining reasonable assurance that its financial statements are fairly stated diminish. This weakness also significantly increases the risk that sensitive taxpayer information may be compromised.

Further, during fiscal year 2010, IRS continued to face management challenges in developing and institutionalizing the use of financial management information, specifically cost- and revenue-based performance information, to assist it in making operational decisions and measuring the effectiveness of its programs. Sustained management efforts will be necessary to build on the progress made to date and to fully address IRS's remaining internal control, compliance, and systems deficiencies and remaining financial management challenges.

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Abbreviations

CDDB	Custodial Detail Data Base
CFO	Chief Financial Officer
FFMIA	Federal Financial Management Improvement Act of 1996
FFMSR	*Federal Financial Management System Requirements*
FMFIA	Federal Managers' Financial Integrity Act of 1982
FTHBC	First-Time Home Buyer Credit
IFS	Integrated Financial System
IRACS	Interim Revenue Accounting Control System
IRS	Internal Revenue Service
MD&A	Management Discussion and Analysis
OMB	Office of Management and Budget
RRACS	Redesign Revenue Accounting Control System
TFRP	Trust Fund Recovery Penalty
USSGL	*United States Standard General Ledger*

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

November 10, 2010

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, 2010, and 2009. 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, 2010, (3) conclusion that IRS did not comply with one of the legal provisions we tested, and (4) conclusion that IRS's financial management systems were not in substantial compliance with the requirements of the Federal Financial Management Improvement Act of 1996, as of September 30, 2010. 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 2010, IRS continued to make progress in addressing its financial management challenges. Specifically, IRS made progress in addressing weaknesses in its financial management systems' compliance with the Federal Financial Management Improvement Act of 1996 by bringing its financial systems into compliance with *United States Standard General Ledger* requirements. IRS also addressed numerous information security weaknesses we identified in previous audits by upgrading key Integrated Financial System (IFS) servers, restricting privileges on certain service accounts used for transferring IFS data, and limiting access to certain key financial documents used for input into IFS.

However, despite these actions, deficiencies in internal control we identified over unpaid tax assessments and information security continued to constitute material weaknesses[1] in IRS's internal control. In addition, IRS also faces significant challenges in resolving a significant deficiency[2] in internal control over tax refund disbursements we are reporting in this year's audit.

In fiscal year 2010, IRS continued to have a material weakness in its internal control over unpaid tax assessments. We found a continuing deficiency in IRS's ability to maintain a subsidiary ledger for unpaid tax assessments supporting federal taxes receivable on its balance sheet and the related compliance assessments and write-off amounts in its required supplementary information. To compensate for this deficiency, IRS relied on a resource-intensive statistical sampling process to estimate these amounts. As a result, IRS could not trace amounts reported in its financial statements and required supplementary information through its general ledger back to underlying source documents on a transaction-by-transaction basis.

Also in fiscal year 2010, 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 processing sensitive information. As a result, IRS could not rely on the internal controls contained in its automated financial management system to provide reasonable assurance that (1) its financial statements, taken as a whole, were fairly stated, (2) the information IRS relied on to make decisions on a daily basis was accurate, complete, and timely, and (3) proprietary financial and taxpayer information was appropriately safeguarded. These ongoing internal control deficiencies continued to constitute a material weakness in IRS's internal control over its information systems security in fiscal year 2010.

In addition to these material weaknesses, during fiscal year 2010, we found continuing deficiencies in internal control over manual tax refunds as well

[1]A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis.

[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.

as other, related deficiencies identified for the first time in this year's audit. We also identified deficiencies in IRS's internal control over the processing of claims for the First-Time Home Buyer Credit. As a result, we identified instances of duplicate or otherwise erroneous tax refund disbursements. The existence of these internal control deficiencies, coupled with the rise in the materiality of the dollar value of manual tax refunds in relation to IRS's financial statements, led us to conclude that collectively, they constitute a significant deficiency in IRS's internal control over tax refund disbursements. As a result, there is an increased risk that additional undetected erroneous tax refund payments have been disbursed.

During fiscal year 2010, IRS also continued to experience challenges with respect to developing full cost information across all of its programs and activities, institutionalizing the use of cost accounting agencywide, and developing and routinely using cost-based (and, where appropriate, enforcement revenue-based) performance metrics to 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 improvement initiatives it has under way in order to achieve comprehensive and lasting financial management reform.

We are sending copies of this report to the Chairmen and Ranking Members of the Senate Committee on Appropriations; Senate Committee on Finance; Senate Committee on Homeland Security and Governmental Affairs; Subcommittee on Financial Services and General Government, Senate Committee on Appropriations; Subcommittee on Federal Financial Management, Government Information, Federal Services, and International Security, Senate Committee on Homeland Security and Governmental Affairs; House Committee on Appropriations; House Committee on Ways and Means; House Committee on Oversight and Government Reform; Subcommittee on Financial Services and General Government, House Committee on Appropriations; and Subcommittee on Government Management, Organization, and Procurement, House Committee on Oversight and Government Reform. We are also sending copies of this report to the Chairman and Vice Chairman of the Joint Committee on Taxation, the Commissioner of Internal Revenue, the Director of the Office of Management and Budget (OMB), the Chairman of the IRS Oversight Board, and other interested parties. The report is available at no charge on GAO's 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

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

To the Commissioner of Internal Revenue

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

In our audits of IRS's fiscal years 2010 and 2009 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, 2010;
- IRS did not comply with one of the legal provisions we tested; and

[1]See the CFO Act of 1990, Pub. L. No. 101-576, 104 Stat. 2838 (Nov. 15, 1990); *codified in relevant part, as amended at* 31 U.S.C. § 3521(g). Under the authority of 31 U.S.C. § 3515, the Office of Management and Budget requires IRS to issue separate annual audited financial statements.

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

[3]Tax expenditures 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.

- IRS's financial management systems were not in substantial compliance with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA)[4] as of September 30, 2010.

In its role as the nation's tax collector, IRS has a demanding responsibility in collecting federal taxes, processing federal tax returns, and enforcing the nation's tax laws. IRS is a large and complex organization, posing unique operational and financial management challenges for its management. IRS employs over 100,000 people in its Washington, D.C., headquarters and over 700 offices in all 50 states and U.S. territories and in some U.S. embassies and consulates. In fiscal years 2010 and 2009, IRS collected about $2.3 trillion in federal tax payments, processed hundreds of millions of tax and information returns, and paid about $467 billion and $438 billion, respectively, in refunds to taxpayers.

In fiscal year 2010, for the 11th consecutive year, IRS's financial statements 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. However, despite its progress, IRS continued to (1) have material weaknesses and other deficiencies in its internal control, and (2) not comply with certain laws and regulations. Specifically, we identified

- A continuing material weakness[5] in internal control over unpaid tax assessments[6] and inability to rely on its financial management systems for tax-related transactions and its underlying subsidiary records to report taxes receivable, compliance assessments, or write-offs in accordance with federal accounting standards. These issues also lead to increased taxpayer burden.

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

[5]A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis.

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

- A continuing material weakness in internal control over information security that resulted 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.

- A significant deficiency[7] in internal control over tax refund disbursements that resulted from the continuation of control deficiencies that we have found in the past as well as newly identified deficiencies in internal control over manual tax refunds,[8] and deficiencies we identified during fiscal year 2010 related to the processing of claims for the First-Time Home Buyer Credit (FTHBC)[9]

[7]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.

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

[9]See FTHBC, 26 U.S.C. § 36. The FTHBC was originally authorized by section 3011 of the Housing and Economic Recovery Act of 2008. The new credit was originally available for a limited time only, applying to taxpayers who purchased a principal residence after April 8, 2008, and before July 1, 2009. Taxpayers were permitted to claim a fully refundable credit equal to 10 percent of the purchase price of the home, with a maximum available credit of $7,500. This credit was to be repaid within 15 years with payments beginning two years after the credit was claimed. Section 1006 of the American Recovery and Reinvestment Act of 2009 extended the First-Time Home Buyer Credit to include purchases made on or after January 1, 2009, and before December 1, 2009; increased the maximum credit to $8,000; and eliminated the repayment requirement as long as the taxpayer retains the residence for 36 months. Taxpayers qualifying for the revised credit may claim the $8,000 credit on either their 2008 or 2009 individual income tax returns. Section 11 of the Worker, Homeownership, and Business Assistance Act of 2009, as amended by section 2 of the Homebuyer Assistance and Improvement Act of 2010, extended the deadline for home purchases to May 1, 2010, (with the requirement that the taxpayer with a binding contract settle on the home purchase before October 1, 2010) and expanded eligibility for the credit (with a maximum available credit of $6,500) to qualifying long-time resident homebuyers.

that in some instances resulted in the disbursement of duplicate or otherwise erroneous refunds.

- Two instances of noncompliance with provisions of laws and regulations. Specifically, (1) IRS did not always release federal tax liens against taxpayers' property within 30 days of the satisfaction of the tax debt, and (2) IRS's financial management systems did not substantially comply with the requirements of FFMIA.

Opinion on IRS's Financial Statements

IRS's financial statements including the accompanying notes present fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, IRS's assets, liabilities, and net position as of September 30, 2010, and 2009; 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.

In conformity with U.S. generally accepted accounting principles, IRS's financial statements reflect federal tax revenues collected during the fiscal year, as well as the total unpaid federal taxes for which IRS and the taxpayers or courts agree on the amounts owed. Cumulative unpaid federal tax assessments for which there is no future collection potential or for which there is no agreement on the amounts owed are not reported in the financial statements. Rather, they are reported as write-offs and compliance assessments, respectively, in required supplemental information to IRS's financial statements. To the extent that taxes owed in accordance with the nation's tax laws are not reported by taxpayers and are not identified through IRS's various enforcement programs (often referred to as the tax gap), they are not reported in the financial statements or in required supplemental information to the financial statements. Tax expenditures, which represent the amount of federal tax revenue the federal government forgoes resulting from federal tax law provisions that (1) allow a special exclusion, exemption, or deduction from gross income, or (2) provide a special credit, preferential rate, or deferred tax liability, are not reported in the financial statements, but rather are presented as other accompanying information.

Opinion on Internal Control

Because of the two material weaknesses in internal control discussed below, IRS did not maintain, in all material respects, effective internal control over financial reporting as of September 30, 2010, and thus did not provide reasonable assurance that losses and misstatements material in relation to the financial statements would be prevented or detected and corrected on a timely basis. Our opinion is based on criteria established under 31 U.S.C. sec. 3512 (c), (d), commonly known as the Federal Managers' Financial Integrity Act of 1982 (FMFIA).

Despite its material weaknesses in internal control, IRS was able to prepare financial statements that were fairly stated in all material respects for fiscal years 2010 and 2009. Nonetheless, IRS continues to face significant challenges in addressing its material weaknesses in internal control over (1) unpaid tax assessments and (2) information security, as described below.

The material weaknesses in internal control over unpaid tax assessments and information systems security 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 2010 FMFIA assurance statement to the Department of the Treasury, and (2) Management's Report on Internal Control over Financial Reporting. We considered these material weaknesses in determining the nature, timing, and extent of our audit procedures on IRS's fiscal years 2010 and 2009 financial statements.

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

Material Weakness in Internal Control over Unpaid Tax Assessments

During fiscal year 2010, IRS continued to have a material weakness in its internal control over unpaid tax assessments. This material weakness encompasses internal control deficiencies concerning IRS's (1) inability to rely on its general ledger system for tax transactions and underlying subsidiary records to report federal taxes receivable, compliance assessments, and write-offs in accordance with federal accounting standards without significant compensating procedures,[10] (2) lack of transaction traceability for the reported balance in taxes receivable that comprises over 80 percent of IRS's total assets as of September 30, 2010, and an effective transaction-based subledger for unpaid tax assessment transactions, and (3) inability to effectively prevent or timely detect and correct errors in taxpayer accounts. These internal control deficiencies are caused primarily by IRS's continued reliance on software applications that were not designed to provide 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.

Material Weakness in Internal Control over Information Security

During fiscal year 2010, IRS continued to have a material weakness in its internal control related to its management of information systems security. IRS made progress during fiscal year 2010 in addressing several information security weaknesses identified in our previous audits. Specifically, IRS (1) upgraded key Integrated Financial System (IFS)[11] servers, (2) discontinued the use of unencrypted protocols for the servers supporting its procurement system, and (3) limited access to certain key financial documents used for input into IFS. Nevertheless, persistent,

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

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

serious deficiencies in IRS's internal control over information security remain uncorrected. For example, IRS continued to allow individuals more access to sensitive information contained on the network than they needed to perform their jobs and had not effectively addressed a vulnerability in its procurement system that allowed users to bypass normal application controls. In addition, access control weaknesses in the Redesign Revenue Accounting Control System (RRACS)[12] compromised IRS's ability to segregate incompatible duties and jeopardized the integrity of the application's data. Also, visitor badges to secured areas at one data center continued to provide cardholders unnecessary access. As a result of these deficiencies, IRS was (1) 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) unable to ensure the reliability of other financial management information produced by its systems, and (3) at increased risk of compromising confidential IRS and taxpayer information.

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, including those to ensure the integrity of electronic signatures, built into these systems to assist in obtaining reasonable assurance of the reliability of reported balances. Thus far, we have been able to compensate for these deficiencies to obtain reasonable assurance that IRS's financial statements are presented fairly by utilizing other evidence. However, as IRS's modernization effort progresses, these options are diminishing as its records become more automated. 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 the future.

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

Significant Deficiency in Internal Control over Tax Refund Disbursements

During fiscal year 2010, we identified several deficiencies in IRS's internal control over tax refund disbursements that do not individually or collectively represent a material weakness, but in our judgment (1) do collectively represent a significant deficiency in the design or operation of internal control that adversely affects IRS's ability to meet the internal control objectives described in this report and (2) are important enough to merit the attention of those charged with IRS governance. Specifically, IRS has not effectively addressed the deficiencies in internal control over manual tax refunds that we have reported in previous years.[13] We also identified new deficiencies in internal control over manual tax refunds during this year's audit, as well as deficiencies in IRS's internal control over processing of claims for the FTHBC during fiscal year 2010. We identified instances in which these deficiencies resulted in duplicate or otherwise erroneous tax refund disbursements. The existence of these control deficiencies, coupled with the rise in the materiality of manual tax refunds to IRS's financial statements, led us to conclude that they collectively constitute a significant deficiency in IRS's internal control over tax refund disbursements. As a result, there is an increased risk that additional undetected erroneous tax refund payments have been disbursed.

We have reported on IRS's internal control weaknesses in prior audits and have provided IRS recommendations to address these and other less-significant issues.[14] As of the date of this report, 173 recommendations were still open, of which 14 relate to the material weakness in internal control over unpaid tax assessments, 88 relate to the material weakness in internal control over information security, and 6 relate to issues encompassed by the significant deficiency in internal control over tax refund disbursements. For more details on the material weaknesses and the significant deficiency identified as a result of our audit, see appendix I.

[13]We have reported these deficiencies and recommendations to address them in various management reports to IRS. We report the outstanding deficiencies and our recommendations to address them in our annual Status of Recommendations reports to IRS. See GAO, *Internal Revenue Service: Status of GAO Financial Audit and Related Financial Management Report Recommendations*, GAO-10-597 (Washington, D.C.: June 30, 2010).

[14]GAO, *Internal Revenue Service: Status of GAO Financial Audit and Related Financial Management Report Recommendations*, GAO-10-597 (Washington, D.C.: June 30, 2010); and GAO, *Information Security: IRS Needs to Continue to Address Significant Weaknesses*, GAO-10-355 (Washington, D.C.: Mar.19, 2010).

During our fiscal year 2010 audit, we also identified other deficiencies in IRS's system of internal control that we do not consider to be material weaknesses or significant deficiencies. We have communicated these matters to management informally and as appropriate, will be reporting them to IRS separately at a later date.

Compliance with Laws and Regulations

Our tests of IRS's compliance with selected provisions of laws and regulations for fiscal year 2010 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 our findings with respect to this compliance issue, see appendix 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 requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA) as of September 30, 2010.[16] Specifically, IRS's financial management systems did not substantially comply with (1) *Federal Financial Management System Requirements* (FFMSR) and (2) federal accounting standards (U.S. generally accepted accounting principles). IRS's financial management systems substantially complied with the *United States Standard General Ledger* (USSGL) at the transaction level. Our conclusion is based on criteria established under FFMIA for federal financial management systems, U.S. generally accepted accounting principles, and the USSGL.

[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).

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

The deficiencies resulting in IRS's financial management systems' lack of substantial compliance with the FFMIA requirements relate to the material weaknesses discussed previously. Further, IRS reported on these deficiencies in its (1) fiscal year 2010 FMFIA assurance statement to the Department of the Treasury and (2) Management's Report on Internal Control over Financial Reporting. IRS's FFMIA remediation plan details its planned corrective actions for the weaknesses that render its financial management systems substantially noncompliant with the requirements of FFMIA. For more details on the IRS financial management systems' FFMIA compliance issue, see appendix I.

Consistency of Other Information

IRS's 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, or applicable requirements of OMB Circular No. A-136, *Financial Reporting Requirements*.

Other Financial Management Challenges

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

Performance Measurement

During fiscal year 2010, IRS continued to face 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, *Objectives of Federal Financial Reporting*,[17] provides that federal entities' financial data should

[17]FASAB Statement of Federal Financial Accounting Concept 1: *Objectives of Federal Financial Reporting, as codified in FASAB Pronouncements as Amended, Version 9* (Washington, D.C.: June 30, 2010).

facilitate accountability and decision-making on the costs and the outputs and outcomes achieved, and for evaluating service efforts, costs, and accomplishments. A key objective of the CFO act is for federal agencies to routinely provide and ensure the use of appropriate financial management information needed to evaluate program effectiveness, make fully informed operational decisions, and ensure accountability. IRS's existing performance metrics only partially achieve those goals in that its metrics are focused primarily on process-oriented workload measures of program outputs rather than on metrics that measure program outcomes, such as specific IRS enforcement programs' costs and revenues.

IRS has not yet fully developed and integrated the use of cost-based (and when appropriate, enforcement revenue-based[18]) performance information into its routine managerial decision-making processes or to its externally reported performance metrics. Specifically, IRS has not yet developed full cost[19] information on the range of its programs and activities that could provide important resource allocation-related information, nor has it developed cost- or revenue-based[20] performance metrics for its programs and activities. Completing the task of developing full cost information and adding outcome-oriented performance metrics for all its programs and activities should help improve IRS's ability to establish measurable outcome goals; evaluate the relative merits of various program options, especially its enforcement programs and new initiatives; and highlight opportunities for optimizing the allocation of resources.

We acknowledge that IRS faces 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 activities and optimize the allocation of resources among them. It would also provide IRS better information with which to

[18]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.

[19]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.

[20]Section 1204 of the Internal Revenue Restructuring and Reform Act of 1998 restricts the uses of records of tax enforcement results. *See* Pub. L. No. 105-106, § 1204, 112 Stat. 685, 722; and implementing IRS guidance in IRM 1.5.2, Uses of Section 1204 Statistics (rev. June 1, 2010).

defend its budgets and more credibly demonstrate to Congress and the public that it is using its appropriations wisely.

Safeguarding Taxpayer Receipts and Associated Information

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 it receives. As long as IRS continues to receive such large volumes of hard-copy taxpayer payments and supporting data, there will continue to be a significant risk to the government and taxpayers alike that loss of receipts or inappropriate disclosure or compromise of taxpayer information may occur during this process. Safeguarding these taxpayer receipts and associated taxpayer information to prevent such events are among IRS's most important and demanding responsibilities, and congressional and taxpayer expectations in this regard are justifiably high. 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.

Objectives, Scope, and Methodology

IRS management is responsible for (1) preparing the financial statements in conformity with U.S. generally accepted accounting principles, (2) establishing and maintaining effective internal control over financial reporting and evaluating its effectiveness, (3) ensuring that IRS's financial management systems substantially comply with FFMIA requirements, and (4) complying with applicable laws and regulations. IRS management evaluated the effectiveness of IRS's internal control over financial reporting as of September 30, 2010, based on the criteria established under FMFIA. IRS management's assertion based on its evaluation is included in appendix II.

We are responsible for planning and performing the audit to obtain reasonable assurance and provide our opinion about whether (1) IRS's financial statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, (2) IRS management maintained, in all material respects, effective internal control over financial reporting as of September 30, 2010, and (3) IRS's financial management systems substantially comply with FFMIA requirements. We are also responsible for (1) testing compliance with selected provisions of laws and regulations that have a direct and material effect on the financial statements, and (2) performing limited procedures with respect to certain other information accompanying the financial statements.

In order to fulfill these responsibilities, we

- examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements. This included selecting statistical samples of unpaid tax assessments, revenue, refunds, payroll and nonpayroll expenses, property and equipment, and undelivered order transactions;[21]

- assessed the accounting principles used and significant estimates made by IRS management;

- evaluated the overall presentation of IRS's financial statements;

- obtained an understanding of IRS and its operations, including its internal control over financial reporting;

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

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

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

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

- tested compliance with selected provisions of the following laws and regulations: Internal Revenue Code; Anti-Deficiency Act, as amended; Purpose Statute; Prompt Payment Act; Pay and Allowance System for

[21]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 amount 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.

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; American Recovery and Reinvestment Act of 2009; Worker, Homeownership, and Business Assistance Act of 2009; Homebuyer Assistance Improvement Act of 2010; Economic Stimulus Act of 2008; and the Financial Services and General Government Appropriations Act, 2010;

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

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

An entity's internal control over financial reporting is a process affected by those charged with governance, 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. Our internal control testing was for the purpose of expressing an opinion on the effectiveness of internal control over financial reporting and may not be sufficient for other purposes. Consequently, our audit may not identify all deficiencies in internal control over financial reporting that are less severe than a material weakness. Because of inherent limitations in internal control, internal control may not prevent or detect and correct misstatements due to error or fraud, losses, or noncompliance. We also caution that projecting any evaluation of effectiveness to future periods is subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with policies or procedures may deteriorate.

We did not test compliance with all 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, 2010. We caution that noncompliance may occur and not be detected by these tests and that such testing may not be sufficient for other purposes. Also, our work on FFMIA would not necessarily disclose all instances of noncompliance with FFMIA requirements.

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

Agency Comments and Our Evaluation

In commenting on a draft of this report, IRS stated that there are identified weaknesses that continue to exist and that while challenges remain, it has established its ability to consistently produce accurate and reliable financial statements, has a solid management team in place that is dedicated to promoting the highest standard of financial management, and would continue to increase the focus on information security and internal controls while improving financial reporting. IRS stated that it continued to make information security a top priority during fiscal year 2010 and had made notable improvements again this year, including (1) completing corrective actions in network access controls; (2) implementing standard security configurations and establishing metrics in the areas of inventory management and configuration management, auditing, access authorization, and change management for network access systems and devices; and (3) upgrading its IFS servers and the UNIX operating system to Solaris 10.

IRS also stated that it took significant steps to strengthen controls and reduce risks of duplicate, erroneous, or fraudulent refunds associated with the manual refund process. IRS stated that while the timing of our testing did not provide sufficient opportunity to demonstrate positive improvements during the year under audit, it noted that it was already seeing positive improvements as a result of the corrective actions it has taken. With respect to processing FTHBC claims, IRS stated that given the complexity of tax administration and the time constraints the IRS faced implementing the FTHBC, it was impossible to address all potentially erroneous FTHBC claims. IRS stated that it would continue its aggressive approach to ensuring the accuracy and legitimacy of FTHBC claims and continue to put a high priority on working FTHBC claims in its post-refund enforcement work that were not addressed during its pre-refund compliance activities. IRS expressed confidence that we will find it has made significant progress in addressing its internal control deficiencies during our fiscal year 2011 audit.

We will evaluate the effectiveness of IRS's corrective actions during our audit of IRS's fiscal year 2011 financial statements. The complete text of IRS's response is included in appendix III.

Sincerely yours,

Steven J. Sebastian
Director
Financial Management and Assurance

November 5, 2010

The Internal Revenue Service FY 2010 Management Discussion and Analysis

AT A GLANCE

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

History

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

Vision

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

Mission

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

Organization

The IRS organizational structure (Appendix A) closely resembles the private sector model of organizing around customers with similar needs. The scope of IRS operations includes collection of individual and corporate taxes, examination of returns, taxpayer assistance, 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.

Operating Divisions
♦ **Wage and Investment**
♦ **Small Business and Self-Employed**
♦ **Large and Mid-Size Business**
♦ **Tax-Exempt and Government Entities**

Employees

The IRS employs over 100,000 employees.

Location

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

IRS FY 2010 Statistics	
Total Revenue Collected	$2.3 trillion
Total Enforcement Revenue Collected	$57.6 billion
Total Refunds	$467 billion
Number of Hits on IRS.gov	1.7 billion
Number of Downloads from IRS.gov	213.3 million
Number of Returns Filed	230.6 million
"Where's My Refund?" Usage	66.9 million
Number of Taxpayers Assisted	78.2 million
Number of Returns Filed Electronically	110.3 million
Average Individual Refund	$3,048
Number of Customers served at Taxpayer Assistance Centers	6.4 million

Financial Resources

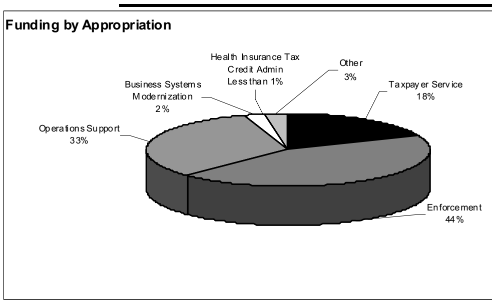
The IRS FY 2010 budget was $12.15 billion in direct appropriations, supplemented by $290.5 million in user fee revenue and $135.5 million in reimbursable resources for a total operating level of $12.58 billion.

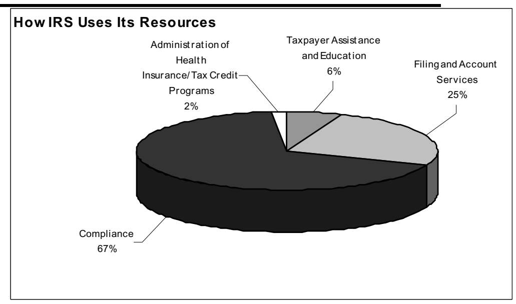
Internet

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

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

IRS RESOURCES





Funding by Appropriations ($ thousands)

In FY 2010, funding for the three core operating appropriations was allocated as follows:

- **Taxpayer Services** *[$2,278,830]* funds processing tax returns and related documents, and assistance for taxpayers in filing returns and paying taxes due.
- **Enforcement** *[$5,504,000]* funds examination of tax returns, collection of balances, the administrative and judicial settlement of taxpayer appeals of examination findings, as well as providing resources for strengthened enforcement to reduce invalid claims and erroneous filings associated with the Earned Income Tax Credit (EITC) program.
- **Operations Support** *[$*4,083,884*]* funds administrative services, policy management and IRS-wide support. The appropriation also funds staffing, equipment, and related costs to manage, maintain, and operate critical information systems that support tax administration.

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

- **Business Systems Modernization** *[$263,897]* funds capital asset acquisitions of information technology systems to modernize key tax administration systems.
- **Health Insurance Tax Credit Administration** *[$15,512]* funds the administration of the Health Coverage Tax Credit (HCTC).
- **Other:** User Fees *[$290,452]* are receipts from payment for services provided and reimbursable agreements *[*$135,504*]*.
- **Affordable Care Act of 2010** ($6,682) funds the administration of the Therapeutic Discovery Program Grants and Administration.

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 2010 and 2009 data on the use of IRS resources by major programs:

Use of Resources ($ thousands)		
Program	**FY 2010**	**FY 2009**
Taxpayer Assistance and Education	$793,492	$555,735
Filing and Account Services	$3,527,840	$3,950,070
Compliance	$9,330,435	$8,174,550
Administration of Health Insurance/Tax Credit Programs	$249,577	$189,685

2

INTERNAL REVENUE SERVICE
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Austin Incident

In February 2010, a single-engine plane intentionally crashed into the IRS office in Austin, Texas, resulting in the death of our employee Vernon Hunter, the injury of many others, and destroying the workspace of nearly 200 IRS employees.

Shortly after the incident, Commissioner Shulman and Secretary Geithner visited Austin to express their condolences. On February 22, President Barack Obama posted a message on the White House website where he said the following:

"I want the dedicated employees of the IRS to know that I am thankful for your dedication, courage, and professionalism as we rebuild in Austin."

The rebuilding of Austin started immediately with IRS and GSA restoring service in temporary workspace within six workdays of the incident. A "One Stop Shop" was set up to help employees, providing counseling services and other services to assist employees. Employees moved into new permanent office space early in July.

During a formal ribbon-cutting ceremony held on July 29, 2010, Commissioner Shulman announced the creation of an annual award "to honor the career, dedication, and values of Vernon Hunter." The annual award will recognize IRS employees who have achieved a lifetime of service honoring the spirit and values of the best of the IRS.

High Priority Performance Goals

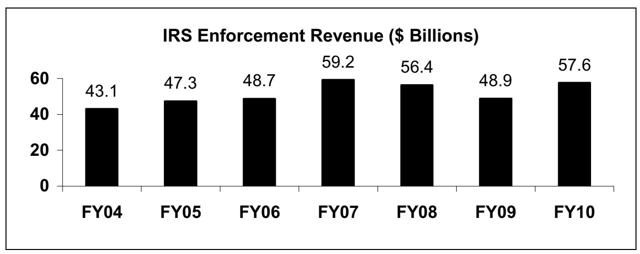
In FY 2010, the IRS established a set of High Priority Performance Goals to address high priority issues that can have measurable accomplishment in the next 12 to 24 months. The IRS goals through FY 2011 are:

- Make progress against the Tax Gap through improved service & enhanced enforcement of the tax laws:
  - Achieve more than 4 million document matching closures in FY 2011.
  - Increase individual income tax filers' ACSI (customer satisfaction) score to 69 percent.
  - Improve telephone level of service to 75 percent by the end of FY 2011.
  - Increase individual e-File rate to 81 percent in 2011.

Fiscal Year (FY) 2010 Performance

The IRS achieved an overall success rate of 66% in meeting or exceeding the targets for 21 of its 32 performance measures.[1] Nine of the eleven measures that fell below the target were within 96 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 $57.6 billion, a 34% increase over FY 2004.



The IRS remains committed to finding ways to increase compliance and reduce the tax gap. In FY 2010, the IRS developed new methodologies for estimating the corporate income tax gap; updated the estate and gift tax nonfiling and underreporting tax gap estimates, and developed a new basis for estimating the individual income tax nonfiler gap.

Research allows the IRS to target specific areas of noncompliance to improve voluntary compliance and allocate resources more effectively to reduce the tax gap. The FY 2010 National Research Program (NRP) efforts included a study to assess the reporting compliance of employment taxes. The study will span three tax years, from 2008 through 2010, examining approximately 2,200 randomly-selected taxpayers each year. The new study complements the ongoing study of individual reporting compliance and the study of subchapter S Corporations due to be released in 2011.

The IRS continues to study the effects of services it offers to taxpayers on the internet, at walk-in sites, and on its toll-free telephone lines as well as exploring the relationships between taxpayer errors and unclear correspondence. As part of this effort, the IRS is testing the impact of on-line assistance and instruction, and the impact of service quality to aid in the development of new approaches to service.

In FY 2010, the IRS developed a strategic plan for the IRS Research Community. The plan features strategies that support continuing growth of the Research Community and serves as a roadmap for providing world-class research to support the administration of the tax system.

[1] In addition, to the 32 measures, the methodology for estimating the Percent of Eligible Taxpayers Who File for EITC is being revised and data is not available for FY 2010.

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

The Affordable Care Act (ACA) was signed into law on March 23, 2010, and later amended by the Health Care and Education Reconciliation Bill of 2010 on March 30, 2010.

ACA represents the largest set of tax law changes in more than 20 years, with more than 40 provisions that amend the tax laws. Although the new law goes into effect gradually over many years, numerous provisions require the IRS to take immediate action like the Small Business Health Care Tax Credit, the Qualifying Therapeutic Discovery Credit, and the expanded Adoption Credit.

To enact the range of provisions that were retroactive to 2009 and immediately effective for calendar year 2010, the IRS established teams to implement respective provisions by affected taxpayer groups - individual taxpayers, small businesses, large industry, and tax-exempt and government entities. During FY 2010, IRS efforts focused on:

- Developing new systems and business processes for near-term provisions.
- Conducting initial planning for longer-term provisions.
- Defining appropriate outreach activities for each affected group.

Provisions that will become effective in later years, when new options for buying health insurance through state-sponsored exchanges go into effect, place significant new administrative responsibilities on the IRS requiring the design and development of complex new systems and business processes along with substantial coordination with other federal and state entities.

The IRS and the Department of Health and Human Services (HHS) partnered to form a Coordinating Committee to assess cross-cutting policy considerations. Also, interagency working teams have formed to assess operational needs such as data infrastructure, eligibility, enrollment, customer service, communications, and payment of premium tax credits.

Many Taxpayers Took Advantage of the American Recovery and Reinvestment Act of 2009 (ARRA) Tax Credits

The IRS accomplished 100% of its activities that were planned in FY 2010 to implement provisions of ARRA, including preparing systems and products in a timely manner, enabling taxpayers to take advantage of the Recovery Act tax provisions, and providing benefit to the economy as soon as possible.

Implementation was accomplished via education and outreach, guidance and instructions, IRS programming and processing changes, and compliance and reporting. The IRS issued news releases, published up-to-date information and pertinent questions and answers on IRS.gov. Forums, including conference calls with targeted groups like professional tax preparers were held, toll-free telephone assistance to taxpayers on the Recovery Act was provided, and the IRS also published fact sheets on many of the provisions. The guidance and instruction provided assisted taxpayers in determining which credits applied to them and how to claim them. Tax forms, schedules, publications, and instructions were updated and issuance of Internal Revenue Bulletin Notices and Revenue Procedures also provided information for filers. The IRS outreach efforts were designed to ensure that tax credits were correctly claimed and that benefits were only going to those eligible.

In FY 2010, taxpayers benefited from the Recovery Act tax provisions in the following ways:

- An estimated $82.6 billion was made available to taxpayers through the Making Work Pay provision.
- Over 2.6 million taxpayers claimed over $19 billion in First-Time Homebuyer credits for houses purchased in 2009 and 2010.
- Nearly 4 million households have benefited from the COBRA premium assistance program.
- Over $3.5 billion in Net Operating Loss Carryback Adjustments were claimed by businesses to offset taxable income for the preceding 3 to 5 years.
- Issued over 1,600 Build America Bonds, which provided $115 billion in financing for education, transportation, environmental and other public projects.
- Allocated $2.4 billion of Clean Renewable Energy Bonds (CREBS) to 1,067 applicants and $1 billion of Tribal Economic Development Bonds to 76 Indian tribal governments.

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

In FY 2010, the IRS continued efforts to assist taxpayers in complying with their federal tax obligations while satisfying demand for services. One such effort has been to improve automated web services that provide timely and accurate information. Notable automated accomplishments include:

- Created a special section on IRS.gov entitled “Tax Center to Assist Unemployed Taxpayers” for taxpayers who are struggling financially.
- Developed an automated service for taxpayers to obtain a PIN to satisfy signature requirements when e-filing a current year return, an alternative to providing prior year adjusted gross Income.
- Provided website and phone tools for taxpayers needing information on the one-time $250 Economic Recovery Payment (ERP). More than 5.6 million web and 815,300 telephone requests were completed.
- Developed the “VITA Site List” pilot on IRS.gov to provide taxpayers updated information on locations and availability of VITA sites throughout the nation, attracting over 45,000 visits to its webpage.

Improve Service to Make Voluntary Compliance Easier

Helping taxpayers understand their tax reporting and payment obligations is vital to maintaining public confidence in the tax system. In FY 2010, the IRS met or exceeded 83% (10 of 12) of the Taxpayer Service performance targets.

During FY 2010, the IRS continued to develop and improve on products and services such as updating forms to help taxpayers comply with filing requirements, converting forms for visually impaired taxpayers, translating more tax products into Spanish, implementing a multilingual website to facilitate participation in the tax system by individuals who do not speak English, reducing taxpayer telephone wait time, and working with banks so taxpayers without bank accounts could receive refunds on a prepaid debit card in the 2011 filing season.

Highlights of the 2010 Filing Season

The IRS delivered a successful 2010 filing season, rising to challenges posed by the implementation of provisions in the American Reinvestment and Recovery Act of 2009 (ARRA), the Worker, Homeownership, and Business Assistance Act of 2009 (WHBAA), and increased telephone demand for Economic Recovery Payment inquiries. Results of the 2010 filing season include:

- Processed 141.9 million individual returns and issued more than 109.5 million refunds totaling $366 billion compared to 144.4 million returns resulting in 111.4 million refunds totaling over $339.6 billion in 2009.
- Achieved a 74.0% telephone level of service, an increase from 70.0% in 2009, while answering 36.7 million assistor calls.
- Answered 35.1 million automated calls, a 21% increase from 2009, reflecting a growing public appetite for quality self-service options.
- Correctly responded to 92.7% of tax law questions and 95.7% of account questions.
- Processed over 2.9 million Free File returns.

Millions of taxpayers continue to file their returns electronically. There is, however, a growing trend for Home-Computer filing, versus returns filed by paid preparers. As a result:

- Home-Computer filing increased to 34.6 million returns, up from 32.2 million in 2009.
- Individual returns electronically filed increased to 69.3%, up from 65.9% in 2009, with the total number of individual returns filed electronically reaching 98.4 million.
- Business returns electronically filed increased 11.9% over 2009, reaching 25.5%.
- Tax professional use of e-file reached 62.3 million returns.

Reaching Taxpayers through Social Media

The IRS expanded outreach and educational services through social media networks (Facebook, Twitter, YouTube, etc.), which are used by more and more taxpayers as a source for information, news, and social interaction.

In FY 2010, the IRS produced and posted 258 YouTube videos on a variety of subjects including the Education Tax Credit, Making Work Pay, Health Care, Return Preparer, and the Homebuyer Credit. These videos attracted more than 963,800 upload views and were available in English, Spanish, and American Sign Language. In addition, the IRS:

- ♦ Provided links on Facebook and Twitter to the "Tax Toolkit," which explains tax responsibilities and the benefits of complying with tax laws to taxpayers new to the tax system.
- ♦ Created an Earned Income Tax Credit (EITC) Awareness Day Twitter account to provide taxpayers and partners with information on EITC and upcoming events.
- ♦ Launched an iTunes podcast to share information about ARRA tax provisions and other tax credits, which received more than 4,500 downloads.
- ♦ Posted 73 YouTube videos in American Sign Language, targeting the deaf and hard of hearing community, which received more than 74,000 hits.
- ♦ Enhanced recruitment efforts by posting employment opportunities on YouTube, Facebook, and the professional network, LinkedIn.

During the 2010 filing season, IRS.gov remained a preferred source of information for taxpayers seeking answers to their questions on preparing and filing their tax returns accurately and timely, and on the economic recovery legislation. With online services such as the Electronic Federal Tax Payment System (EFTPS), the IRS website also helped taxpayers fulfill their tax reporting and payment obligations. As a result:

- ♦ Over 1.7 billion web pages were viewed.
- ♦ More than 66.9 million taxpayers used "Where's My Refund?" an increase of 23.8% from 2009.
- ♦ Over 213.3 million downloads of various tax products by taxpayers, an increase of almost 12%.
- ♦ More than 108.8 million electronic payments totaling over $1.9 trillion were processed through EFTPS.

Taxpayer Education and Outreach

The IRS partners with state taxing authorities, volunteer groups, and other organizations to enhance taxpayer outreach and education. Each year, the IRS and its partners provide free tax assistance to the elderly, disabled, and limited English proficient individuals and families at Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) sites. In FY 2010, more than $13.5 million in VITA and TCE Grants were awarded to a total of 171 organizations, a 17% increase in the number of organizations from 2009. Consequently, assistors at the more than 12,000 VITA and TCE sites throughout the nation prepared more than 3.1 million tax returns, including 360,500 returns for individuals with disabilities and/or families with disabled dependents.

In an effort to assist the taxpayer community during the economic downturn, the IRS and its partners hosted five Open House events at 200 Taxpayer Assistance Centers (TACs) and partner sites, including at least one in every state. The goal of these events was to improve the taxpayer's experience by creating seamless case resolution on a variety of tax issues. As a result, more than 31,400 taxpayers were served and over 7,700 returns were prepared. Other noteworthy efforts in FY 2010 included:

- ♦ Held two special Saturday events in which more than 9,500 taxpayers struggling to resolve tax related issues were assisted and over 4,000 returns prepared.
- ♦ Expanded service in the preparation of state income tax returns for low-income taxpayers from 20 to 27 states, contributing to more than 57,000 returns being prepared.
- ♦ Created a system that allows taxpayers to self screen and make on-line appointments for return preparation in the TACs. Taxpayers made approximately 19,000 or 18% of scheduled appointments on-line.
- ♦ Provided a dedicated toll-free telephone line and hosted a Gulf Coast Assistance Day at seven TACs in the Gulf region, to provide

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Improving Taxpayer Experience

In an effort to better serve the taxpayer community, the IRS continued to develop and improve on products and services, which offer the taxpayer a seamless and positive experience.

As a result, actions taken by the IRS in FY 2010 include:

- Reducing taxpayer telephone wait time by expanding capability to manually transfer calls to the appropriate function, replacing the process of asking taxpayers to call back on the appropriate toll-free number.
- Converting forms to accessible formats for visually impaired taxpayers.
- Developing a multi-dimensional assessment of the international taxpayer population in order to better assist taxpayers abroad.
- Producing a web-based EITC Due Diligence Training Module, which was completed by over 11,000 tax preparers, and EITC webinars, in which over 5,500 preparers participated. Over 7,000 preparers attended presentations on EITC at the Nationwide Tax Forums.
- Developing clearer, shorter forms in English and Spanish to simplify the ordering of tax transcripts.
- Implementing the Hiring Incentives to Restore Employment (HIRE) Act, which provides tax benefits to employers who hire previously unemployed individuals. Efforts included:
    - Collaborating with the payroll industry to develop comprehensive Frequently Asked Questions.
    - Soliciting input from the industry to revise Forms 941, W-2, and
    - W-3.
    - Creating Form W-11 for use by businesses as an affidavit to document HIRE.
    - Developing internal compliance filters.

guidance to taxpayers affected by the oil spill in the Gulf of Mexico.

Furthermore, the IRS also provided assistance to taxpayers who owed delinquent taxes, especially those who were having difficulties meeting their tax obligations because of unemployment or other financial problems, by:

- Granting assistors greater authority to suspend collection actions in certain hardship cases, preventing an automatic default of an installment agreement, and expediting levy releases, if warranted.
- Considering Offers in Compromise from taxpayers facing economic troubles, including those who are recently unemployed.
- Increasing the taxpayer's ability to speak to an assistor by expanding the number of call sites for taxpayers looking to resolve their balance due and/or delinquent return account while experiencing shorter wait times.

The Earned Income Tax Credit (EITC) is one of the federal government's largest benefit programs for working families and individuals. In FY 2010, the IRS conducted its 4th annual EITC Awareness Day to educate the public on the availability and benefits of this important tax credit. As part of a national outreach strategy, the IRS hoped to reach qualifying taxpayers by communicating the benefits of EITC through:

- Interviews with prominent newspapers with nationwide audience bases.
- Over 50 satellite television media tours in English and Spanish.
- Interviews with radio networks reaching more than 1,000 radio stations.
- 72 news conferences held around the country.

Throughout FY 2010, the IRS continued the redesign and revision of taxpayer correspondence in an effort to improve the clarity, accuracy, and effectiveness of written communications. Notable accomplishments in FY 2010 included:

- Submitting programming requirements for 115 notices (25 in Spanish).
- Posting translation of new notices in five different languages on IRS.gov.
- Redesigning IRS.gov web pages to provide information on locating specific notices and an explanation of the redesign process.

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

OBJECTIVES

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

Enforcement Facts

- Increased revenue from enforcement programs by 34%, from FY 2004 to FY 2010, yielding a 4.7 to 1 return on investment in 2010 based on the $57.6 billion in enforcement revenue with a budget of $12.15 billion.
- Audited over 49,000 small business returns and almost 15,000 large corporate returns.
- Increased collection case closures by 6.3%.
- Completed over 41,400 tax-exempt and government entities enforcement contacts.

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 will always remain a high priority.

Highlights of Enforcement Performance

The IRS met 56% (10 of 18) of its enforcement performance measures in FY 2010.

Total enforcement revenue was $57.6 billion in FY 2010, which exceeds the $48.9 billion in revenue received in FY 2009, increasing by 18%. The IRS showed steady progress, building on its FY 2009 successes in key enforcement programs:

- Total individual audits increased 11%.
- Automated underreporter contact closures increased 19.8%.
- Number of high-income/high-wealth audits increased 5.5%.
- Large corporate audits increased 8.1%, a significant achievement given the size (more than $10 million) and complexity of these corporate entities.

In FY 2010, the IRS continued to focus on identifying those who hide assets overseas to avoid paying tax. As part of an overall strategy to improve offshore compliance, the IRS continued to take aggressive steps to track tax evaders who hide their wealth by engaging in tax evasion schemes through the use of offshore accounts.

The voluntary disclosure program the IRS offered in 2009, combined with powerful whistle-blower initiatives, yielded information on illegal transactions and violations of international laws and fraud by banks and professionals, including foreign professionals. The pressure on offshore financial institutions known to facilitate concealment of income by U.S. citizens resulted in:

- A large Swiss bank entering into a deferred prosecution agreement on charges of conspiring to defraud the United States. Investigations resulted in indictments or guilty pleas of clients and bankers on federal income tax related charges including filing false income tax returns, failing to report foreign bank accounts, and concealing millions in income subject to taxation.
- A bank in Scotland agreeing to forfeit $500 million as part of a deferred prosecution agreement. The bank violated the Bank Secrecy Act (BSA) and conspired to defraud the U.S. Certain offices, branches, affiliates, and subsidiaries altered or removed names and references from payment messages to sanctioned countries thereby allowing these entities to move hundreds of millions of dollars through

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International Tax Administration

In FY 2010, successes with complex, high profile, international investigations led to increases in voluntary disclosures and the self-reporting of significant income and resulting tax.

The IRS more than doubled its offshore presence by opening new offices in Asia and Central America, as well as placing additional law enforcement personnel at each of its existing offices throughout the world.

The IRS also expanded its interaction with key international organizations involved in tax and financial law compliance, such as the Organisation of Economic Co-Operation and Development (OECD) and the Financial Action Task Force (FATF).

In addition, the IRS formed the Global High Wealth (GHW) Industry, a new tax examination group, to address one of its top priorities, to promote voluntary compliance of high-wealth individuals and focus compliance expertise on these individuals along with the enterprises they control.

The U.S. is expanding the crackdown on offshore tax evasion beyond the largest Swiss bank to Europe's biggest lender by market value. The IRS along with the Justice Department is conducting criminal investigations of clients who kept accounts at overseas branches of the bank and failed to report them to the IRS.

The IRS Foreign Resident Compliance group closed 17,888 audits with tax deficiencies totaling over $1.64 billion.

Original Issue Discount Scheme

Original Issue Discount (OID) redemption is a tax scheme in which promoters convince taxpayers to file a series of false returns, to request fraudulent refunds based on fictional claims of large income tax withholding. The IRS identifies and blocks the vast majority of these refund requests. In FY 2010, the IRS set up a task force to investigate OID cases resulting in:

- 100 open investigations.
- Drop in frivolous scheme returns from 14,290 in 2009 to 5,540 in 2010.
- Drop in frivolous refund claims from $24 trillion in 2009 to $1.2 trillion in 2010.

the U.S. financial system without identification.

- A Swiss corporation agreeing to forfeit $536 million to the United States. The violations relate to transactions illegally conducted on behalf of customers and other countries sanctioned in programs administered by the Department of the Treasury. The corporation deliberately removed material information from payment messages so that wire transfers would pass undetected through filters at U.S. financial institutions.

Through the offshore voluntary disclosure program, the IRS has identified previously unreported foreign bank accounts from every continent except Antarctica.

Additionally, the IRS Accounts Management Taxpayer Assurance Program (AMTAP) and Questionable Refund Program (QRP) are designed to identify fraudulent returns and to stop payment of fraudulent refunds. In FY 2010, the IRS had the following successes:

- Identified 807,898 potentially fraudulent returns claiming over $5.2 billion in fraudulent refunds through the AMTAP.
- Identified 1,576 schemes in potentially fraudulent refund claims through the QRP.
  - Initiated 504 investigations, achieved a 92.4% conviction rate, an 83.8% incarceration rate, and an 84.6% publicity rate on adjudicated cases.

In FY 2010, the IRS proposed new requirements for certain large business taxpayers to annually report information about their uncertain tax positions that could affect their federal income tax liability. This new requirement will benefit taxpayers and the IRS by:

- Strengthening tax compliance and administration.
- Improving consistency and efficiency of large business examinations by identifying issues on returns sooner, thereby reducing taxpayer burden.
- Selecting and prioritizing taxpayer issues for examination more accurately.

The IRS Compliance Assurance Process (CAP) has been the most successful example of enhanced transparency between the IRS and large corporate taxpayers. In exchange for more openness and transparency before filing, the IRS helps to resolve issues early and ensure accurate returns are filed. The CAP program allows taxpayers that are transparent with their tax issues to get certainty with their tax obligations at the time the return is filed, rather than waiting for the IRS to examine issues during the regular audit process. The CAP program benefits both the IRS and the taxpayer by fostering compliance, reducing the time it takes to process a return, and improving both customer and employee satisfaction while maintaining a high level of quality. In FY 2010, participation increased to 112 corporate taxpayers, with all 102 from 2009 returning.

Tax Return Preparer Strategy

In FY 2010, as part of a Tax Return Preparer Strategy developed in FY 2009, the IRS began implementing a number of the recommendations to ensure that more than one million tax return preparers are competent to help ensure the IRS collects the right amount of tax. Key elements of the strategy include:

- Requiring registration for all paid tax return preparers.
- Establishing mandatory testing and continuing education.
- Developing a public database for tax return preparer registration with the IRS.
- Making all tax return preparers subject to ethical standards.

Setting higher standards for the tax return preparer community will significantly enhance protections and services for taxpayers, increase confidence in the tax system and result in greater compliance with tax laws.

In FY 2010, the IRS also worked with the Department of Justice to pursue questionable tax return preparers, an effort that:

- Initiated 397 investigations.
- Led to 182 indictments and 145 convictions.
- Achieved a 98.6% conviction rate.
- Achieved an 88.6% incarceration rate.
- Achieved a 94.7% publicity rate.

Tax Return Preparer Visits

Another key element of the Tax Return Preparer Strategy includes increasing the IRS enforcement presence in the tax return preparer community. In FY 2010, the IRS made a number of due diligence visits to tax return preparers and conducted more than 5,000 field visits to ensure compliance with the tax laws.

During the filing season, the IRS conducted 265 undercover visits to tax return preparers. During these visits, IRS agents posed as taxpayers to seek out and stop unscrupulous preparers from filing inaccurate returns.

In FY 2010, the IRS introduced a new quality examination process replacing the old joint audit planning process. The new process improves efficiency by streamlining internal administrative processes, increasing consistency, clearly defining roles and responsibilities, and providing the examination teams with more administrative flexibility. The taxpayer benefits from improved communication and interaction from planning the audit to execution, and ultimately, to resolution. This approach ensures taxpayers are actively engaged with the audit team throughout the entire examination process.

Colleges and universities make up one of the largest non-profit segments in terms of revenue and assets. The Colleges and Universities project is part of an ongoing effort by IRS to review the largest, most complex organizations in the tax-exempt sector to identify issues that warrant additional guidance or scrutiny. In FY 2010, the IRS released an interim report summarizing responses to compliance questionnaires sent to 400 public and private colleges and universities. The report discusses the respondents' organizational structures, demographics, exempt and unrelated business activities, endowments, executive compensation, and governance practices. The preliminary data shows:

- A large number of organizations reported having related entities, the most common type being related to tax-exempt organizations.
- Many organizations reported conducting a wide variety of activities that could be either exempt or taxable. Some organizations reported that they conducted activities other than those reported on Form 990-T as taxable.
- Nearly all of the organizations reported maintaining an endowment fund directly or through another entity. The majority of colleges and universities reported making foreign investments through their endowments.

Examinations will be completed in FY 2011, with the final report issued in FY 2012.

The IRS criminal investigation program continued investigating egregious tax, money laundering, and other financial crimes that adversely affect tax administration. Improved case development and selection methods, coupled with heightened fraud awareness, resulted in the successful prosecution of taxpayers involved in abusive tax schemes, high-income nonfilers, employment tax evasion cases, and other flagrant forms of tax evasion. Using its unique statutory jurisdiction and financial expertise, the IRS made significant contributions to important national law enforcement priorities. Performance levels for the IRS criminal investigation program remained high in FY 2010:

- Completion of 4,325 criminal investigations.
- A conviction rate of 90.2%.
- A Department of Justice acceptance rate of 93.9%, with a U.S. Attorney acceptance rate of 91.8%, which compares favorably with other federal law enforcement agencies.
- 2,184 convictions secured.

Strategic Foundations
Invest For High Performance

OBJECTIVES

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

Strategic Foundation Facts

- Successfully delivered 200 filing season applications and modernization projects.
- Refreshed over 15,500 laptops and 10,260 desktops.
- Deployed over 32,000 aircards, 350 scanners, and 1,100 printers to employees across the country.
- Completed a "Reduced Sign-on" pilot to improve security and reduce burden of managing multiple systems and applications passwords using the Homeland Security Presidential Directive-12 (HSPD-12) SmartID.
- Processed and mitigated emerging threats posed by over 5,200 cyber and over 2,800 physical incidents.

The IRS is One of the Most Improved Agencies on the Best Places to Work in Government List

Results from the Federal Viewpoint Survey, used to rank agencies across the Federal Government and encourage "the best and brightest" to work in government, ranked the Department of Treasury, with IRS the key driver, as one of the top 10 most improved agencies in government in all four of the survey indices. IRS achieved a 20 percentage point gain over its 2008 rank on Business Week's 2009 annual list of best places to launch a career.

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. In FY 2010, the IRS achieved 50 percent (1 of 2) of its Business System Modernization targets. The following highlights the IRS accomplishments in FY 2010:

- Customer Account Data Engine (CADE). CADE posted more than 41.2 million tax returns and processed more than 35.8 million refunds. For the first time, CADE posted over 7.2 million payments submitted with taxpayer returns and issued 8,128 Savings Bonds Refunds to taxpayers requesting them.
- Modernized e-File (MeF). The IRS deployed an additional release that enabled the acceptance of individual Forms 1040 (federal and state returns), Form 4868 extensions, and 21 other supporting 1040 forms and schedules. In FY 2010, MeF accepted over 6.9 million returns.
- Accounts Management Services (AMS). The final AMS Release 2.1 provided all AMS users the ability to view correspondence images online and on demand, eliminating users' reliance on the manual processes to obtain copies of images. Direct access to images via AMS reduced the case cycle time from 10 to 14 days to zero. In 2010, 1.329 million images were viewed using the View Image option.

CADE to CADE2

The IRS launched the Customer Account Data Engine (CADE) in 2000 as one of the cornerstones of the Business Systems Modernization (BSM) programs. Since its inception, CADE has made significant progress towards replacing the IRS aged master file processing system. It has delivered increased value to taxpayers as well as operational efficiencies for the IRS.

In FY 2010, IRS implemented a revised CADE2 strategy, with completion of Transition State 1 expected for the 2012 filing season. Transition State 1 will allow the migration of 140 million individual taxpayer accounts to a modernized database that will support daily processing resulting in faster refunds for all individual refund filers, improving taxpayer service. This new processing environment will also have improved data security and allow the development of new tools to combat fraud and improve enforcement activities.

In addition, completion of the taxpayer account database is the prerequisite for other major initiatives, including significant expansion of online services and transactions and the next generation of enforcement technologies.

Workforce of Tomorrow

One of the key efforts to make the IRS the best place to work was the establishment of the Workforce of Tomorrow (WOT) task group. In FY 2010, the IRS completed 41 of 58 recommendations outlined in the 2009 WOT report. The recommendations address the most significant challenges facing current employees and managers. Implementation included the recognition of employee successes through the web, issuing anniversary congratulations messages, enhancing the Career Management Resource Center website, and developing a comprehensive on-boarding strategy for new IRS employees, which includes providing forms and benefit information, as well as orientation information.

The IRS also ensured employees received training they needed in a timely manner, with 104,900 IRS employees attending at lease one training course. The Tuition Assistance Program was revamped to provide IRS employees an opportunity to take up to four college courses to improve their skills.

Results of the annual employee engagement survey are also used to improve the workplace. The level of employee engagement affects the overall ability of the organization to meet goals, minimize attrition, and increase productivity. In FY 2010, a record 79% of employees participated in the annual survey, with overall employee satisfaction increasing from 73.7% in FY 2009 to 74.4% in FY 2010.

Hiring Reform

The IRS implemented Federal Government hiring reform. Hiring persons with severe physical disabilities or other targeted disabilities was streamlined through the development of a stand-alone system that gives the disabled, students, veterans, attorneys, and rehired annuitants the ability to electronically submit their applications for consideration under various programs.

Veteran Hiring

In FY 2010, the IRS partnered with veterans' organizations, other government agencies, and job fairs to recruit and hire more veterans. The IRS met its goal of hiring 1,000 military veterans for the third year in a row. Veterans comprise 11% of total hires in FY10, up from 9% in FY09.

Information and Cyber Security

The IRS takes the issue of identity theft very seriously. In FY 2010, to preserve and enhance public confidence, the IRS advocated the protection and proper use of identity information by:

- Placing markers on more than 284,000 taxpayer accounts to alert employees the account belongs to a substantiated identity theft victim.

- Ensuring identity theft indicators and business rules isolate returns for additional screening to validate whether the true taxpayer filed the return. More than 82,000 returns were selected for additional screening and closed, and $245 million was protected from being refunded to perpetrators on more than 48,000 fraudulent returns.

The IRS also protects its systems and taxpayers from increasing and evolving online threats. By monitoring, identifying, and mitigating fraudulent sites and phishing scams, the IRS helps to reduce the number of taxpayers who fall victim to online fraud schemes. During FY 2010, the IRS shut down 4,109 phishing sites (899 domestic and 3,210 international), compared to 3,444 sites shut down through all of 2009.

Human Capital

In FY 2010, the IRS continued to focus on attracting, retaining, and developing a quality workforce to support workforce management activities that contribute to making the IRS one of the best places to work in government.

To attract the best and increase the number of qualified and diverse applicants, the IRS enhanced its recruitment programs and introduced a new recruitment brand, "Count on Me!" on print materials, USAjobs.gov, IRS Careers website, Internet advertisements, and social media.

Leadership competencies are the foundation for hiring, promoting, developing, and evaluating IRS leaders. The IRS uses leadership competencies to assess employee skills, abilities, and knowledge to determine their readiness for leadership in the IRS. For 2010, the IRS phased in a new and improved leadership competency model that comprises four leadership competencies, each of which has either three or four supporting behaviors. This replaces the old model that had 21 competencies, reducing managerial burden associated with employee assessment, and making the overall process easier to use.

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

IRS conducted the required evaluation of the effectiveness of its internal control over financial reporting in accordance with OMB Circular A-123.

In FY 2010, the IRS conducted the following A-123 activities:

- Tested 21 transaction processes material to Treasury's Consolidated Financial Statements consisting of:
  - 15 administrative processes related to $12.58 billion in administrative transactions.
  - Three information system processes..
  - Three custodial revenue processes related to the over $2.3 trillion in tax revenue receipts.
- Performed supplemental testing of the FY 2010 transactions in the fourth quarter to verify that controls remained effective throughout the year.
- Reviewed controls over financial reporting, including Treasury Information Executive Repository reporting, and determined controls are primarily in place but ineffective.
- 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 2010 and 2009.

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 Fiscal Year (FY) 2010, the IRS adhered to the internal control requirements of the Federal Managers' Financial Integrity Act (FMFIA), the Federal Financial Management Improvement Act (FFMIA), the Office of Management and Budget (OMB) Circular A-123, and the Reports Consolidation Act of 2000.

The objectives of systems of management control for the IRS organizations are to provide management with reasonable assurance that:

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

Because the IRS has outstanding material weaknesses and the financial management systems do not substantially comply with FFMIA, the IRS provides qualified assurance that the above-listed systems of management control objectives were achieved by the IRS during FY 2010. This assurance is provided relative to Sections 2 and 4 of FMFIA.

The FMFIA material weaknesses are:

- Improve Modernization Management Controls and Processes
- Computer Security
- Unpaid Tax Assessments

Federal Financial Management Improvement Act (FFMIA)

In January 2010, the IRS implemented the Redesign Revenue Accounting Control System (RRACS), which enabled the custodial financial management system to substantially comply with the United States Standard General Ledger (USSGL) chart of accounts to address noncompliance with FFMIA. RRACS now records all tax revenue and

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Federal Information Security Management Act (FISMA)

In accordance with the requirements of the Federal Information Security Management Act (FISMA), the IRS maintained an agency-wide information security program and provided a comprehensive framework for ensuring the effectiveness of information security controls over information resources that support Internal Revenue Service business operations and goals. Specifically, the IRS inventory of FISMA reportable systems is compliant with security requirements from the OMB, the National Institute of Standards and Technology, the Department of Treasury, and the IRS. These systems have compliant Annual Security Control tests, Security Authorizations, and Plans of Actions and Milestones. Additionally, security training has been completed by all IRS employees with security responsibilities.

Actions	Status
Certification and Testing of Systems	100%
Systems Accreditation	97%
Specialized training	99.8%
Annual Awareness Training	97%
Contractor Systems Reviews	100%
Annual Security Controls Testing	100%
Annual IT Contingency Plan Testing	100%
Privacy Impact Assessment	100%
System of Record Notice	100%

In addition to the sustained performance from last year:

To address concerns regarding information security controls affecting IRS key financial systems and mainframe operations in Detroit, the IRS transferred RRACS to the Martinsburg Computing Center (MCC). The IRS also upgraded its Integrated Financial System (IFS) servers, upgraded the UNIX operating system to Solaris 10, and deployed Internet Protocol Security (IPSec).

The IRS also completed corrective actions in Network Access Controls and the Enterprise Security Audit Trail (ESAT) Program and established a process for collecting and reporting on metrics on inventory and configuration management, auditing, access authorization, and change management for network access systems and devices. The IRS implemented auditing capability that identifies auditable events and event content consistent with IRS policy to include monitoring, collection analysis, storage, and reporting.

refunds using the USSGL format and for the first time records the taxes receivable and allowance for doubtful accounts addressing this component of the Unpaid Tax Assessments material weakness. RRACS generates amounts for the monthly Treasury Information Executive Repository File submission and produced the Statement of Custodial Activities for the FY 2010 financial statements. The IRS also implemented interfaces between RRACS and the lockbox deposit system and the Integrated Submission and Remittance Processing (ISRP) system which enabled traceability for 98.6 percent of the over $2.3 trillion in revenue collections reported in its financial statements from the revenue summary records to the individual taxpayer transactions.

Lien Release Non-Compliance Issue

As of September 30, 2010, the IRS did not consistently comply with section 6325 of the Internal Revenue Code regarding the timely release of federal tax liens. The IRS Financial and Management Controls Executive Steering Committee (FMC ESC) continues to monitor the action plan, which addresses lien release issues identified by the IRS, Government Accountability Office (GAO), and the Treasury Inspector General for Tax Administration (TIGTA).

Reports Consolidation Act of 2000

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

Continuity of Operations (COOP)

The IRS has made major enhancements to the disaster recovery program to ensure the continuity and resiliency of the IRS critical business processing systems. The IRS developed 161 application disaster recovery plans and 23 General Support System disaster recovery plans; updated all FISMA IT Contingency Plans; executed over 400 tests and exercises; and completed an enterprise business impact analysis evaluating over 600 business processes.

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

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Overview of Revenue and Administrative Accounts

The IRS FY 2010 financial statements received an unqualified audit opinion for the eleventh consecutive year.

The Balance Sheet reflects total assets of $43 billion of which $35 billion (81.3%) are Federal Taxes Receivable, which represents amounts expected to be collected from past due accounts. The $6 billion increase in total assets is primarily attributable to the $6 billion increase in taxes receivable. 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 $2.3 trillion in federal tax receipts.

challenges and high-risk areas. The following are the management and performance challenges identified by GAO in its January 2009 High Risk Series Update and by TIGTA in the October 15, 2009, memorandum titled Management and Performance Challenges Facing the Internal Revenue Service for Fiscal Year 2010.

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

- TIGTA Management Challenges
  - Modernization of the Internal Revenue Service (Computerized Systems and Business Structure) and IRS Business Systems
  - Security of the Internal Revenue Service
  - Tax Compliance Initiatives
  - Implementing Tax Law Changes
  - Providing Quality Taxpayer Service Operations
  - Human Capital
  - Erroneous and Improper Credits and Payments
  - Globalization
  - Taxpayer Protection and Rights
  - Leveraging Data to Improve Program Effectiveness and Reduce Costs

Limitations of Financial Statements

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

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Financing Sources

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

Financial Highlights

Revenue and Refund Trend Information

FY 2010 revenue receipts collected by IRS remained constant at $2.3 trillion. Federal tax revenues are collected through six major classifications: individual income and FICA/SECA, corporate income, excise taxes, estate and gift taxes, railroad retirement, and federal unemployment taxes.

FY 2010 tax refund activity totaled $467 billion, representing an increase of approximately 7% from FY 2009. Federal tax refunds include refunds of tax overpayments, payments for interest, and disbursements for refundable tax credits such as Earned Income Tax Credit and the Additional Child Care Tax.

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 2007 through September 2009. The Department of the Treasury prepares the warrants and allocations to the trust funds.

	Liability Quarter Ended	
	December 2007 – September 2008	**December 2008 – September 2009**
Airport & Airway Trust Fund	$11,734,723,000	$10,533,488,000
Black Lung Disability Trust Fund	644,590,000	631,138,000
Highway Trust Fund	38,052,198,000	36,445,773,000
Total	**$50,431,511,000**	**$47,610,399,000**

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

The unpaid assessment balance includes amounts owed by taxpayers who file returns without sufficient payment as well as amounts assessed through the IRS enforcement programs. As reflected in the supplemental information to the IRS FY 2010 Financial Statements, the unpaid assessment balance was $330 billion as of September 30, 2010, and $184 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

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Integrated Financial System (IFS)

FY 2010 accomplishments include:

- Replaced IFS servers and upgraded to Solaris 10.
- Migrated IFS mainframe information from Detroit to Martinsburg.
- Conducted IFS Certification & Accreditation on time with zero Plan of Action & Milestones items.
- Modified the Automated Lien System (ALS) processing to standardize the payment of court recording fees, which reduce labor costs.

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

- Taxes receivable represent $138 billion (42%) of unpaid assessments and increased $10 billion (8%) from $128 billion as of September 30, 2010. About $103 billion (75%) 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 $35 billion (25%) of taxes receivable is estimated to be collectible.
- Compliance assessments of $93 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 $99 billion include amounts owed by defunct corporations with no assets and failed financial institutions. The remaining amounts are owed by taxpayers with extreme economic and/or financial hardships, deceased taxpayers, and taxpayers who are insolvent due to bankruptcy.

The Integrated Financial System (IFS)

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

In addition, IFS provides the core processes of General Ledger, Accounts Payable, Accounts Receivable, Budget Execution, Cost Accounting, Administrative Tax and Travel Accounting, Cost Allocations, some tax processing functionality for Health 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.

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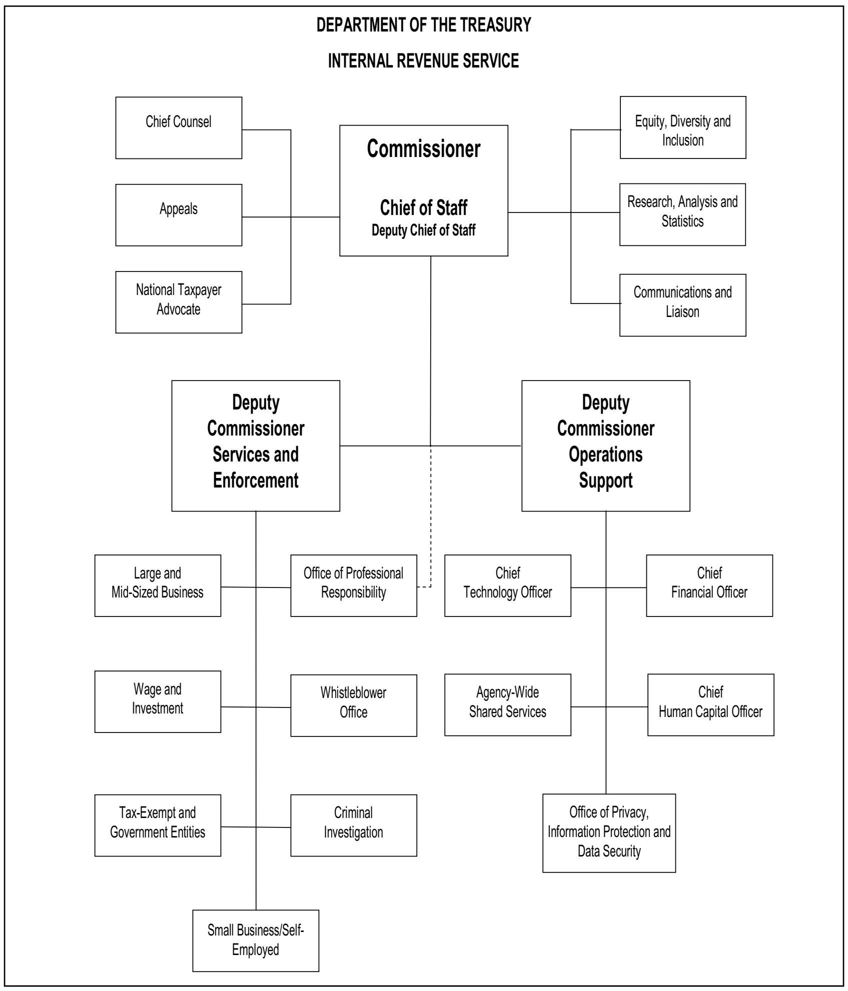
Appendix A
Organization Chart



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Appendix B
Performance Measurement Data

Measure	2007	2008	2009	2010 Target	2010 Actual
Goal 1: Improve Service to Make Voluntary Compliance Easier					
Customer Service Representative (CSR) Level of Service	82.1%	52.8%	70.0%	71.0%	74.0%
Customer Contacts Resolved per Staff Year	7,648	12,634	12,918	9,398	10,744
Percent of Eligible Taxpayers Who File for EITC (CY)	*	*	NA	75%-80%	*
Customer Accuracy – Tax Law Phones	91.2%	91.2%	92.9%	91.2%	92.7%
Customer Accuracy – Customer Accounts (Phones)	93.4%	93.7%	94.9%	93.7%	95.7%
Timeliness of Critical Individual Filing Season Tax Products to the Public	83.5%	92.4%	96.8%	94.0%	95.3%
Timeliness of Critical TE/GE and Business Tax Products to the Public	84.0%	89.5%	95.2%	90.0%	97.7%
Percent Individual Returns Processed Electronically	57.1%	57.6%	65.9%	70.2%	69.3%
Cost per Taxpayer Served ($) (HCTC)	$14.90	$16.94	$13.79	Baseline[1]	$9.52
Sign-Up Time (Days) – Customer Engagement (HCTC)	93.3	94.0	91.3	Baseline[1]	124.0
Percent Business Returns Processed Electronically	19.1%	19.4%	22.8%	24.3%	25.5%
Refund Timeliness – Individual (Paper)	98.9%	99.1%	99.2%	98.4%	96.1%
Taxpayer Self Assistance Rate	49.5%	66.8%	69.3%	61.3%	64.4%
Goal 2: Enforcement the Law to Ensure Everyone Meets Their Obligation to Pay Taxes					
Examination Coverage – Individual	1.0%	1.0%	1.0%	1.1%	1.1%
Field Examination National Quality Review Score	85.9%	86.0%	85.1%	86.3%	84.9%
Office Examination National Quality Review Score	89.4%	90.0%	92.1%	90.9%	91.6%
Examination Quality – Industry	87.0%	88.0%	88.0%	89.0%	87.0%
Examination Quality – Coordinated Industry	96.0%	97.0%	95.0%	96.0%	95.0%
Examination Coverage – Business (Corps. >$10M)	6.8%	6.1%	5.6%	5.1%	5.7%
Examination Efficiency – Individual (1040)	137	138	138	132	140
Automated Underreporter (AUR) Efficiency	1,956	1,982	1,905	1,868	1,924
Automated Underreporter (AUR) Coverage	2.5%	2.6%	2.6%	3.0%	3.0%
Collection Coverage – Units	54.0%	55.2%	54.2%	50.5%	50.1%
Collection Efficiency – Units	1,828	1,926	1,845	1,898	1,822
Field Collection Embedded Quality	84.0%	79.0%	80.5%	81.0%	80.6%
Automated Collection System (ACS) Accuracy	92.9%	95.3%	94.3%	92.5%	95.9%
Criminal Investigations Completed	4,269	4,044	3,848	3,900	4,325
Number of Convictions	2,155	2,144	2,105	2,135	2,184
Conviction Rate	90.2%	92.3%	87.2%	92.0%	90.2%
Conviction Efficiency Rate ($)	$301,788	$315,751	$327,328	$331,000	$324,776
TE/GE Determination Case Closures	109,408	100,050	96,246	140,465	105,247
Strategic Foundations: Invest for High Performance					
Percent of BSM Projects within +/- 10% Cost Variance	**	92.0%	60.0%	90.0%	40.0%
Percent of BSM Projects within +/- 10% Schedule Variance	**	92.0%	90.0%	90.0%	100.0%

*The methodology for estimating the eligibility rate is being revised.
[1] An increase in participation is expected due to the Recovery Act. IRS will establish a new baseline by the end of FY 2010.
**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.

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Appendix C
Explanation of Shortfalls

Percent Individual Returns Processed Electronically: Actual paper receipts for the year were over 5% higher than plan resulting in target not being met.

Refund Timeliness: Refund timeliness fell short of the target due to delays caused by the computation of the Making Work Pay credit and the First-Time Homebuyer Credit.

Field Examination National Quality Review Score: Exam continues to focus on improving the lowest scoring quality attributes, including income probes and efficient resolution/time frames met. Actions to improve quality include: ongoing delivery of Income Toolkit training; establishing a Process Improvement Challenge team to focus on the quality of income determinations; and more emphasis placed on quality casework by Area Directors (especially income determinations, and timeframes) during their Operational Reviews and staff meetings.

Exam Quality – Industry: Factors contributing to the shortfall include: large, unusual and questionable items not identified by the agent and mandatory referrals to a specialist not made; taxpayer interviews not conducted as required or documentation of interviews inadequate in the case file; and report writing procedures not being followed regarding no-change reports. Feedback continues to be provided to field teams through the development and circulation of quality articles, reports, memos, and partnering with the Industries in improvement efforts.

Exam Quality – Coordinated Industry: Factors contributing to the shortfall include: work papers not fully documenting the audit trail; techniques used and how conclusions are reached; and lack of examiner and manager signatures. The quality management staff continues to focus on the importance of meeting the quality measures through direct feedback to field teams, partnering with the Industries in quality improvement efforts, quality articles, quarterly reports/memos, and outreach to field teams.

Collection Coverage: The target was not met primarily due to the 10% (2M) decrease in planned balance due first notices issued resulting in a corresponding 10% (1.2M) decrease in balance due notice dispositions. The IRS will continue to ensure dispositions are keeping up with the notices being issued in the future, however, a similar decrease in balance due first notices issued (1.6M) is projected in FY 2011. Although this will have a positive impact on potentially collectible inventory, the notice decrease will negatively impact collection coverage and efficiency.

Collection Efficiency: The yearend target will not be met due primarily to Balance Due First Notices Issued being down 11% due to lower balance due return volumes, causing Balance Due Dispositions to be down 10%.

Field Collection National Quality Review Score: The yearend target was not met. The shortfall is attributed to transition issues associated with the new quality attributes. To minimize the impact of the changes, Collection developed a training module on quality and presented it at the spring all-manager CPE, included monthly “Quality Tip” articles in the technical digest, and implemented a quarterly conference call to provide managers with a forum to ask questions about factors driving performance. Future plans include holding another Summit focusing on lower scoring attributes to look for additional improvement opportunities.

Conviction Rate: The reason for the shortfall is the increase in the number of dismissals. These dismissals are primarily money laundering investigations where more than three years passed since the date of indictment.

TEGE Determination Case Closures: The shortfall is attributable to two factors: a planned system conversion took longer than anticipated, requiring EO determinations staff to switch to manual processing on multiple occasions; and receipt of fewer defined contribution Form 5307 (Adopter of Master or Prototype Plans or Volume Submitter Plans) applications than expected, the work plan called for 100,000 Form 5307 applications; however, only 41,600 applications were received, of which only 16,600 met the criteria for minimal review. To address these issues TE/GE is currently analyzing determination processing improvements for future implementation. Additionally, TE/GE will conduct research on Form 5307 filers to determine the factors that contributed to lower than anticipated receipts in FY 2010.

Percent of BSM Projects within +/- 10% Cost Variance: 2 out of 5 releases met the cost variance threshold. The cost of AMS Release 2.1 Milestone 5 deployment was less than planned due to the required realignment of AMS project funds to support R1.3 software and infrastructure design activities, and the cost of CADE Release 5.2 Milestone 4b was less than planned because legislative and Filing Season changes were reduced in scope and complexity. The MeF Release 6.1 Milestone 4a-5 required additional funding to support unplanned, required needs including Disaster Recovery activities, an automated interface to support external users, the development of a transactional national account profile and expanded software/hardware needs.

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Appendix D

Performance Measures Descriptions

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

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Appendix D

Performance Measures Descriptions (Continued)

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

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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 2010 accomplishments, actions identified for completion in FY 2011 and beyond, and future challenges. These have been arranged in the order of priority as determined by the TIGTA.

Challenge / Issue	Actions Taken in FY 2010 and Actions Planned or Underway
Modernization of the Internal Revenue Service (Computerized Systems and Business Structure) and IRS Business Systems	
Bring the IRS's business systems and financial systems to a level that provides management current and reliable information to support informed decision making. GAO continues to include IRS business systems modernization on its high risk list.	**Actions Taken:** • Customer Account Data Engine (CADE). CADE posted more than 41.2 million tax returns and processed more than 35.8 million refunds. For the first time, CADE posted over 7.2 million payments submitted with taxpayer returns and issued 8,128 Savings Bonds Refunds to taxpayers requesting them. ° Deployed release for current CADE that included capability to apply refunds to future tax liabilities (Credit Elect) and refund hold capability for Criminal Investigation. ° Delivered production pilot supporting tax law changes and requirements for the 2011 filing season. • Modernized e-File (MeF). The IRS deployed an additional release that enabled the acceptance of individual Forms 1040 (federal and state returns), Form 4868 extensions, and 21 other supporting 1040 forms and schedules. In FY 2010, MeF accepted over 6.9 million returns. ° Initiated MeF Release to provide enhanced Disaster Recovery capabilities that ensure operational risk is managed appropriately. • Account Management Services (AMS). The final AMS Release 2.1 provided all AMS users the ability to view correspondence images online and on demand, eliminating users' reliance on the manual processes to obtain copies of images. Direct access to images via AMS reduced the case cycle time from 10 to 14 days to zero. In 2010, 1.329 million images were viewed using the View Image option. • Delivered Vision & Strategy, Program Initiation and Architecture for CADE2. Began the Integrated Design Phase that outlines business benefits and opportunities. • Developed baseline set of CADE2 business and technical requirements for transition. • Implemented the Redesign Revenue Accounting Control System (RRACS). Transactions are recorded and posted to United States Standard General Ledger (USSGL) accounts. RRACS also systemically generates the custodial financial statements and the file for Treasury Information Executive Repository (TIER) data transmissions. **Actions Planned or Underway for FY 2011 and Beyond:** • Continue CADE2 development and prepare to deploy Transition State 1 for Filing Season 2012. • Complete analysis, design and development of current CADE release to accommodate tax law changes in the 2012 filing season.

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	• Continue deploying the IT Asset Centralization Initiative, which includes realignment of hardware and personnel and developing plans to relocate IT assets to secure data center locations.

Security of the Internal Revenue Service	
Strengthening the security infrastructure and the applications that guard sensitive data.	**Actions Taken:** • Completed traceability for corrective actions in the Computer Security Material Weakness plan including: ° Document and tracking results of internal security inspections. ° Perform continuous monitoring of security controls for selected business processes. ° Provide centralized repository for test results and self-inspections. ° Issue risk levels and compliance status on a near real-time basis. • Conducted 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. • Procured equipment for the Criminal Investigation Disaster Recovery Site in Martinsburg, WV. • Identified, analyzed, and mitigated over 5,200 individual cyber incidents which could have compromised the integrity of the IRS enterprise, impacting the availability of services to employees, external partners, and constituent taxpayers. • Identified and disabled access to over 7,000 malicious or unauthorized web sites. • Produced over 450 advisories, bulletins, and alerts informing the business units and system administrators of current vulnerabilities and threats that impact IRS systems to ensure the confidentiality, integrity, and availability of systems instrumental to tax collection and processing on a large scale. • Enhanced the ability to combat increased tax administration-related online fraud against taxpayers by shutting down 4,109 phishing web sites (899 domestic and 3,210 international). • Flagged accounts of identity theft victims with “markers” that indicated to an employee that they were dealing with a substantiated case of identity theft, and to ensure that returns submitted on those accounts were filtered to verify that they were submitted by the legitimate taxpayer and not the identity theft perpetrator. ° From the inception of the identity theft program in 2008 through September 2010, more than 615,700 taxpayer accounts have received account markers related to identity theft. **Actions Planned or Underway for FY 2011 and Beyond:** • Complete the development of a Criminal Investigation Disaster Recovery Site in Martinsburg, WV. • Deploy additional account “markers” that will improve the processing of taxpayer accounts impacted by identity theft. • Expand and apply the Rational AppScan Source Edition pilot to five projects to “build security into” applications to allow developers to identify and fix security bugs early in the lifecycle, thus saving money and time. • Complete the Information Technology Security Compliance Monitoring project to enhance compliance monitoring and security controls.

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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) noncompliance.	***Individuals and Businesses*** **Actions Taken:** • Modified Examination case selection rules for cases where the First-Time Home Buyer Credit was claimed and adjusted the number of pre-refund cases selected. • Modified Automated Underreporter (AUR) case selection rules to reduce the number of "no change" closures. In FY 2010, the number of "no change" closures was reduced by 7.4%. Additionally, completed testing of soft notices to provide taxpayers the opportunity to self-correct income reporting errors. • Developed improved case selection models in ACS to leverage decision analytics and completed work on a tool to adjust inventory volumes when necessary to ensure the ACS system can better predict the outcome of cases in inventory. • Optimized collection case selection and assignment to ensure ROs are working the highest probability cases. • Utilized a risk-based scoring and selection model to select tax return preparers to receive educational and/or compliance notices. Prior to the start of the 2010 filing season, IRS mailed 2,400 notices. • Expanded participation in the Compliance Assurance Process to improve identification and resolution of tax issues for large corporations prior to the filing of tax returns. In FY 2010, the number of participants increased from 102 to 112. • Continued selection and examination of locally hired employees of foreign embassies who did not elect to participate in settlement initiatives. • Approximately 3,550 returns have been examined and closed with over $23 million in additional tax assessed. • Developed a Quality Examination Process for all new Large and Mid-Size Business examinations. • Verified refund claims on Form 1040NR and Form 1120-F tax returns by matching the recipients and withholding agent copies of the Form 1042-S withholding documents. • Conducted 100 Spanish language Small Business Tax Workshops to improve compliance. • Identified 1,576 schemes in potentially fraudulent refund claims through the Questionable Refund Program. **Actions Planned or Underway for FY 2011 and Beyond:** • Modify Examination case selection and modeling to include cases where taxpayers claim the Adoption Credit. • Adjust 2011 work plans to include examination of post-refund cases where First-Time Home Buyer Credits were claimed. • Implement improved analytics in AUR case selection and continue testing soft notices as alternatives to conducting examinations. • Identify alternative workload selection models and further refine the definition of high-wealth taxpayers. • Implement Return Preparer Strategy including requiring that all paid preparers except attorneys, certified public accountants, and enrolled agents pass a competency test and complete continuing professional education of 15 hours per year. • Build a Return Review Program to enhance IRS ability to detect fraud and other forms of noncompliance at the time of filing, before the refund is released. • Continue the matching program for Forms 1042 and 1042-S and Forms 8804 and

	8805. • Continue to develop cases for examination on high-income foreign athletes and entertainers who have been identified as nonfilers. • Establish an approach to address multiple compliance concerns during tax return preparer visitations. • Continue to expand Spanish language Small Business Tax Workshops to improve compliance. ***Tax-Exempt Entities*** **Actions Taken:** • Assisted the DOJ in fraud and conspiracy investigations related to municipal bond contracts. Work thus far has resulted in seven guilty pleas and indictments of seven former financial services executives. • Analyzed results from governmental bond questionnaires and initiated examination projects in identified areas of noncompliance. • Improved procedures and training to identify promoters of abusive transactions involving retirement plans to deter the marketing of abusive promoter schemes. • Released interim report on compliance of College and Universities for unrelated business taxable income and compensation. Based on responses IRS has opened several dozen examinations of colleges and universities focusing on unrelated business income and executive compensation. **Actions Planned or Underway for FY 2011 and Beyond:** • Complete examinations of college and university unrelated business income and compensation issues and prepare a final report. • Initiate compliance reviews of over 100 of the largest private foundations. • Continue to assist the DOJ in developing criminal cases and in preparing prosecutions on abusive tax-exempt bond transactions. • Continue to investigate potential promoters of abusive transactions involving retirement plans. • Begin the regular public listing of organizations that are revoked based on rules established by the Pension Protection Act of 2006.

Implementing Tax Law Changes	
Implementing tax law changes correctly is critical for an effective filing season. Many programs, activities and resources have to be planned and managed effectively for successful implementation.	**Actions Taken:** • Completed 52 risk assessments covering 64 ARRA provisions and ensured risk mitigation actions were identified and completed. • Modified tax forms and publications to ensure all reflected changes resulting from ARRA legislative provisions including forms for Build America Bonds and other direct pay tax credit bonds. • Delivered a successful 2010 filing season, processing 141.9 million individual returns and issuing 109.5 million refunds totaling $366 billion. • Provided more than 3.6 million responses to taxpayers calling to obtain information on ARRA and other credits available to them. • Identified erroneous and fraudulent FTHBC claims through new programming and pre-refund filters that reject returns where claims in excess of the maximum allowable credit and claims in excess of allowable amounts for taxpayers with AGI exceeded income limitations.

	• Provided an IRS.gov application that provides a PIN for use in electronically submitting a TY 2009 return.
	• Continued to provide customers with access to tax law information on IRS.gov in an easily understandable format.
	  ◦ Provided taxpayers self-service guidance to answers to tax law questions through the Interactive Tax Assistant (ITA).
	  ◦ Provided website and phone tools for taxpayers needing information on the one-time $250 Economic Recovery Payment. More than 5.6 million web and 815,300 telephone requests were completed.
	• Implemented streamlined examination closing agreement process for both walk-in and IRS initiated exempt organization closing agreements.
	• Allocated $2.4 billion of Clean Renewable Energy Bonds (CREBS) to 1,067 applicants and $1 billion of Tribal Economic Development Bonds to 76 Indian tribal governments.
	
	Actions Planned or Underway for FY 2011 and Beyond:
	
	• Prepare for the implementation of the Affordable Care Act (ACA) including the revision of more than 30 and creation of three new tax forms based on preliminary analysis of the legislation.
	• Publish new IRM provisions to clarify the processes for handling rebate refund cases for Tax-Exempt Bonds.
	• Develop new voluntary compliance procedures to resolve tax law violations related to Build America Bonds and other direct-pay bonds.
	• Develop recommendations to improve the staggered determination letter process for employee plans.
	• Continue to identify erroneous and fraudulent claims and schemes on returns claiming new tax law credits.
	• Implement a compliance approach to address the refundable Adoption Credit for TY 2010.

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:**
	
	• Provided topical information, alternative resources, and expedited routing options through the toll-free telephone system including the deployment of enhanced menu scripting, informational announcements and call routing to address taxpayer inquiries related to ARRA and other legislative changes.
	• Created a unique Economic Recovery Toll-Free line to allow taxpayers to choose from a menu of major provisions of the ARRA and WHBAA and routing to a Customer Service Representative (CSR), if necessary.
	• Continued implementation of TAB service improvements including:
	  ◦ Application to obtain a Personal Identification Number to file returns electronically.
	  ◦ Modification of IRS.gov home page to improve visitors' experiences.
	  ◦ Expanded traditional TAC services to 27 volunteer locations.
	  ◦ IRS.gov search capability for volunteer tax assistance sites.
	• Provided greater access to available services on non-workdays through events such as "Solution Saturday" and other special services like EITC awareness day.
	• Implemented new quality initiatives at Taxpayer Assistance Centers and volunteer return preparation sites using sampling reviews of prepared returns to determine the accuracy.
	• Gathered feedback from professional organizations that represent external stakeholders (i.e. Accountants, Reporting Agents, etc.) to simplify forms and the

	tax filing process. **Actions Planned or Underway for FY 2011 and Beyond:** • Provide a toll-free number for taxpayer transcript request. • Provide a system that will accommodate all levels of teletype (TTY) users. • Continue to utilize IRS partners to disseminate information and simplify forms and the tax filling process. • Increase the number of Limited English Proficiency (LEP) products. • Continue outreach efforts with advocacy groups that serve and support the visually and hearing impaired. • Continue to engage partners in support of special service days. • Engage national and local partners in providing feedback on how the tax filing process can be improved.

Human Capital	
The IRS's ability to meet expectations in personnel management area, such as recruiting, training, and retaining employees.	**Actions Taken:** • Launched a job search tool on YouTube to provide the public with information on employment opportunities with the IRS. "Working at the IRS," provides information about various career paths available and features "Day in the Life" videos in which IRS employees discuss their jobs, the diversity of the IRS workforce, and the culture of the agency. • Developed an overall strategy for improving the coaching and mentoring skills at all leadership levels, including implementation of an internal coaching certification program and core workshops for all leaders. • Implemented a streamlined hiring process that incorporates full capabilities of automated ranking and rating. • Developed an Accelerated Leadership Program pilot to test a "fast track" training program for identified high potential candidates. • Increased the emphasis on veteran hiring, with veterans comprising 11% of total hires in FY10, up from 9% in FY09 and 7% in FY08. • Launched the Schedule A website recruiting, hiring, developing, retaining, and promoting individuals with disabilities. • Completed 41 of 58 Workforce of Tomorrow recommendations that address the most significant workforce challenges facing current employees and managers. **Actions Planned or Underway for FY 2011 and Beyond:** • Implement the Accelerated Leadership Program pilot to test a "fast track" training program for identified high potential candidates. • Finalize a strategy to further IRS as the Best Place to Work in Government. • Continue to improve processes and leverage systems to streamline hiring. • Continue the use of cutting edge technologies and communication tools to increase the breadth of recruitment to better deliver a diverse applicant pool that is reflective of the IRS workforce.

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Erroneous and Improper Credits and Payments	

Reduce improper payments that include base compliance activities and redesign efforts.	**Actions Taken:**
	• Protected over $3.7 billion in revenue through EITC enforcement efforts, which includes the examination of over 474,000 original and amended returns claiming EITC, 900,000 document matching reviews, and 300,000 math error process corrections.
	• Identified more than 405,500 fraudulent returns claiming over $3.0 billion in refunds, stopped over $2.6 billion in fraudulent claims using the Electronic Fraud Detection System, with an average refund of $8,230.
	• Refined marketing for the 4th EITC Awareness Day to increase overall participation, targeting the underserved and a new population segment emerging from the economic downturn.
	  ° Provided PSA campaigns in English and Spanish, utilizing TV, radio, and print ads with 58,610 airings/insertions.
	  ° Utilized social media venues including Twitter, Facebook, and My Space
	  ° Increased free EITC return preparation by 1.2% using IRS partners.
	  ° Increased EITC dollars distributed by 17.5% over the same period in 2009.
	• Completed the following EITC Tax Return Preparer Study activities:
	  ° Improved overall program results through development of a risk-based scoring model to match preparer risk of noncompliance with an appropriate treatment.
	  ° More than tripled the number of EITC preparers treated using the new risk-based scoring model.
	  ° Improved case selection and program implementation for EITC paid tax return preparer due diligence visits resulting in a 75% increase in the number of tax return preparers penalized over 2009, with proposed penalties increasing by 550% to over $3 million.
	  ° Sent 2,400 pre-filing season letters to first-time and experienced paid preparers with education and compliance messages.
	• Identified research-based approaches to improve EITC participation and minimize taxpayer errors.
	  ° Continued partnerships with key tax software associations to identify program enhancements to help reduce EITC errors and assist tax return preparers in meeting requirements.
	  ° Refined an IRS.gov EITC Tax Return Preparer Toolkit to help tax return preparers assist taxpayers.
	  ° Expanded outreach to ensure tax return preparers were aware of their due diligence requirements on newly issued regulations.
	• Implemented the web-based EITC Preparer Due Diligence Training Module for preparers that cover requirements and standards. Over 11,000 preparers completed the training. Additionally, over 5,500 preparers viewed webinars on EITC due diligence and over 7,000 preparers attended presentations on EITC at the Nationwide Tax Forums.
	• Implemented the new EITC math error authority, systemic verification and disallowance during processing, using third party data to verify the new requirement that a child must be younger than the taxpayer unless the child is disabled.
	• Utilized AUR data to identify outreach and education opportunities for identified patterns of noncompliance that may be replicated in EITC returns.

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	Actions Planned or Underway for FY 2011 and Beyond: • Continue to hold an EITC Awareness Day as the jump start to IRS marketing and outreach efforts in underserved markets. • Develop a Spanish version of the on-line training module for tax return preparers that cover requirements and standards. • Expand partnerships with external partners to increase EITC communication channels. • Develop and refine educational and marketing material housed on EITC Central and IRS.gov. • Increase the activities associated with EITC paid preparer treatments, based on refined risk-based selections, including due diligence audits, visits by revenue and criminal investigation agents, streamlined injunctions, and educational and compliance notices to first-time and experienced preparers to influence the accuracy of EITC returns filed. • Expand education and outreach to EITC paid tax return preparers on their EITC due diligence requirements through enhancements to the on-line Tax Return Preparer Toolkit, promotion of the web-based Due Diligence Training Module including a new Spanish version, and seminars at IRS Nationwide Tax Forums. • Continue partnerships with the EITC software industry to identify and recommend enhancements to tax return preparer and consumer software and with the tax return preparer community to improve the accuracy of EITC returns.

Globalization	

International tax compliance is a key challenge as reflected by IRS's recent enforcement initiatives, as well as its prominence in the IRS Strategic Plan. The IRS has placed unprecedented focus on detecting and bringing to justice those taxpayers who hide assets overseas to avoid paying tax.	**Actions Taken:**
	• Improved the way compliance risks are identified and addressed in large, complex global businesses and high-wealth individuals.
	• Refined case identification and selection methods used in ongoing offshore investigations of promoters, facilitators and participants in abusive offshore arrangements.
	• Expanded international presence and coordination with treaty partners and international organizations to improve offshore compliance.
	• Began mining data from the 2009 Offshore Voluntary Disclosure Initiative.
	• Launched the Large Business and International Expansion including a Global High-Wealth Industry to ensure compliance with tax laws in a global tax environment.
	• Continued collaboration with Organization for Economic Cooperation and Development (OECD), the Forum on Tax Administration (FTA) and the Joint International Tax Shelter Information Center to identify and curb abusive tax avoidance transactions, arrangements and schemes and to enhance activities against cross-border transactions involving tax compliance risks including conducting joint audits.
	• Presented workshops at the National Tax Forums on "Foreign Athletes and Entertainers – Special Withholding Rules" and "Form 2555 – Foreign Earned Income Exclusion."
	• Continued to ensure that residents of Puerto Rico properly pay U.S. Self-Employment Tax on their earnings by:
	  ◦ Issuing 25,735 soft letters requesting a total of $13 million of additional tax.
	  ◦ Resolving cases with approximately 6,800 of the soft letter recipients filing tax returns and paying tax due of $3 million.

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	• Continued to address emerging compliance issues, including internationally sponsored pension plans, the movement of in-kind charitable gifts offshore, ensuring that charities adhere to requirements for foreign bank accounts, expanding coordination of employment tax compliance with foreign countries, and cross-border commerce using Indian reservations and casinos.
	• Established the Global Illicit Financial Team (GIFT) to identify and investigate large multi-national tax and financial crime cases generally perpetrated by organized crime syndicates.
	
	Actions Planned or Underway for FY 2011 and Beyond:
	
	• Focus on realigning international resources to create a more centralized organization dedicated to improving international tax compliance.
	• Implement additional rules for determining risk in the Global High-Wealth population.
	• Continue to conduct examinations of taxpayers who applied under the Offshore Voluntary Disclosure Initiative.
	• Continue developing cases for examination on high-income foreign athletes and entertainers who have been identified as nonfilers.
	  ◦ Implement procedures to require certain large business taxpayers to report uncertain tax positions on their tax returns to reduce the amount of time spent identifying issues on the taxpayer's return.
	  ◦ Create a group to develop policies, targeting criteria, and case procedures to focus on combating international illicit money networks and professional money launderers.
	• Address tax-exempt emerging compliance issues, including internationally sponsored pension plans, the movement of in-kind charitable gifts offshore, ensuring that charities adhere to requirements for foreign bank accounts, expanding coordination of employment tax compliance with foreign countries, and cross-border commerce using Indian reservations and casinos.

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:** • Continued efforts to remove or redact Social Security Numbers (SSNs) from outgoing taxpayer correspondence, eliminating or mitigating SSNs from 4.3% of notices and 22.3% of letters in FY 2010. • Completed requirements for contractor handling of taxpayer Personally Identifiable Information (PII) for all publishing contracts that utilize PII. • Developed filters to exclude taxpayers from the Federal Payment Levy Program by FY 2011 if income levels meet specified poverty level guidelines. • Developed a comprehensive set of tax return preparer recommendations and metrics to ensure uniform and high-ethical standards of conduct for tax return preparers. • Implemented the Quality Examination Process (QEP) to strengthen communication and coordination between IRS agents and large and mid-size business taxpayers reducing taxpayer burden. **Actions Planned or Underway for FY 2011 and Beyond:** • Implement plans to regulate the tax return preparer industry, including a requirement that all paid tax return preparers, with some exception, pass a

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	competency test and complete continuing professional education of 15 hours per year. • Utilize low-income filters to exclude taxpayers that meet income thresholds from in the Federal Payment Levy Program. • Continue efforts to remove or redact Social Security Numbers from outgoing correspondence. • Provide a 2-D barcode encoded with the taxpayer's SSN on notices which will provide an additional level of security to protect sensitive taxpayer information in the event of lost or misrouted notices.

Leveraging Data to Improve Program Effectiveness and Reduce Costs	
The absence of accurate and complete management information hinders the IRS's ability to produce timely, accurate and useful information needed for day-to-day decisions.	**Actions Taken:** • Continued using the managerial cost accounting system to conduct cost benefit analyses that provides timely, accurate, and useful data for decision making by business units. • Used CDDB to reconcile all revenue receipts and refunds for the FY 2010 financial audit. • Implemented RRACS to incorporate USSGL. • Developed an FY 2011 Postage and Printing cost reduction strategy. • Created a Sustainability Plan to reduce energy consumption in an effort to meet a variety of federal energy reduction requirements. • Reviewed a series of internal operations, conducting cost benefit analyses and developing performance measures to improve program evaluation and decision making. **Actions Planned or Underway for FY 2011 and Beyond:** • Implement the FY 2011 Postage and Printing cost reduction strategy by forming a cross-functional implementation team. • Continue to review internal operations, conducting additional cost benefit analyses and development of performance measures to improve program evaluation and decision making.

Financial Statements

Principal Financial Statements

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

The IRS principal financial statements for fiscal years 2010 and 2009 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, 2010 and 2009

(In Millions)

	2010	2009
Assets		
Intragovernmental:		
Fund Balance with Treasury (Note 2)	$ 2,562	$ 2,463
Due from Treasury (Note 6)	4,133	4,031
Other Assets (Note 3)	136	147
Total Intragovernmental	**6,831**	**6,641**
Cash and Other Monetary Assets (Notes 4, 6)	295	63
Federal Taxes Receivable, Net (Notes 5, 6)	35,000	29,000
Property and Equipment, Net (Note 7)	1,060	1,094
Other Assets (Note 3)	12	12
Total Assets	**$ 43,198**	**$ 36,810**
Liabilities		
Intragovernmental:		
Due to Treasury (Note 5)	$ 35,000	$ 29,000
Other Liabilities (Note 8)	235	208
Total Intragovernmental	**35,235**	**29,208**
Federal Tax Refunds Payable	4,133	4,031
Other Liabilities (Note 8)	2,003	1,659
Total Liabilities	**41,371**	**34,898**
Net Position		
Unexpended Appropriations	1,531	1,675
Cumulative Results of Operations	296	237
Total Net Position	**1,827**	**1,912**
Total Liabilities and Net Position	**$ 43,198**	**$ 36,810**

The accompanying notes are an integral part of these statements.

1

Internal Revenue Service
Statement of Net Cost
For the Years Ended September 30, 2010 and 2009

(In Millions)

	2010	2009
Program		
Taxpayer Assistance and Education		
Gross Cost	$ 793	$ 556
Earned Revenue	(7)	(5)
Net Cost of Program	**786**	**551**
Filing and Account Services		
Gross Cost	3,528	3,950
Earned Revenue	(70)	(68)
Net Cost of Program	**3,458**	**3,882**
Compliance		
Gross Cost	9,331	8,175
Earned Revenue	(378)	(295)
Net Cost of Program	**8,953**	**7,880**
Administration of Tax Credit Programs		
Gross Cost	250	190
Earned Revenue	-	-
Net Cost of Program	**250**	**190**
Net Cost of Operations (Note 11)	**$ 13,447**	**$ 12,503**

The accompanying notes are an integral part of these statements.

2

Internal Revenue Service
Statement of Changes in Net Position
For the Years Ended September 30, 2010 and 2009

(In Millions)

	2010		2009	
	Cumulative Results of Operations	Unexpended Appropriations	Cumulative Results of Operations	Unexpended Appropriations
Beginning Balances	**$ 237**	**$ 1,675**	**$ 162**	**$ 1,523**
Budgetary Financing Sources:				
Appropriations Received		12,154		11,603
Appropriations Transferred In/Out		-		130
Other Adjustments		(153)		(112)
Appropriations Used	12,145	(12,145)	11,469	(11,469)
Transfers In Without Reimbursement - Earmarked Funds	-		10	
Other Financing Sources:				
Imputed Financing	1,390		1,123	
Transfers In/Out Without Reimbursement	35		21	
Transfers to General Fund	(64)		(45)	
Total Financing Sources	**13,506**	**(144)**	**12,578**	**152**
Net Cost of Operations	**(13,447)**		**(12,503)**	
Net Change	**59**	**(144)**	**75**	**152**
Ending Balances	**$ 296**	**$ 1,531**	**$ 237**	**$ 1,675**

The accompanying notes are an integral part of these statements.

3

Internal Revenue Service
Statement of Budgetary Resources
For the Years Ended September 30, 2010 and 2009

(In Millions)

	2010	2009
Budgetary Resources:		
Unobligated Balance, Brought Forward, October 1	$ 887	$ 690
Recoveries of Prior Year Unpaid Obligations	90	94
Budget Authority		
Appropriations	12,444	11,851
Spending Authority from Offsetting Collections	151	130
Nonexpenditure Transfers, Net	-	130
Permanently Not Available	(153)	(112)
Total Budgetary Resources	**$ 13,419**	**$ 12,783**
Status of Budgetary Resources:		
Obligations Incurred (Note 12)	$ 12,603	$ 11,896
Unobligated Balance – Available (Note 2)	241	384
Unobligated Balance – Not Available (Note 2)	575	503
Total Status of Budgetary Resources	**$ 13,419**	**$ 12,783**
Change in Obligated Balance:		
Obligated Balance, Net, Brought Forward, October 1	$ 1,587	$ 1,394
Obligations Incurred	12,603	11,896
Gross Outlays	(12,324)	(11,624)
Recoveries of Prior Year Unpaid Obligations, Actual	(90)	(94)
Change in Uncollected Customer Payments from Federal Sources	(24)	15
Obligated Balance, Net, End of Period	**$ 1,752**	**$ 1,587**
Net Outlays:		
Gross Outlays	$ 12,324	$ 11,624
Offsetting Collections	(127)	(144)
Distributed Offsetting Receipts	(283)	(233)
Net Outlays	**$ 11,914**	**$ 11,247**

The accompanying notes are an integral part of these statements.

4

Internal Revenue Service
Statement of Custodial Activity
For the Years Ended September 30, 2010 and 2009

(In Billions)

	2010	2009
Revenue Activity		
Collections of Federal Tax Revenue (Note 13)		
Individual Income, FICA/SECA, and Other	$ 1,989	$ 2,036
Corporate Income	278	225
Excise	47	47
Estate and Gift	20	25
Railroad Retirement	5	5
Federal Unemployment	6	7
Total Collections of Federal Tax Revenue	**2,345**	**2,345**
Increase in Federal Taxes Receivable, Net	6	-
Total Federal Tax Revenue	**$ 2,351**	**$ 2,345**
Distribution of Federal Tax Revenue to Treasury	**$ 2,345**	**$ 2,345**
Increase in Amount Due to Treasury	6	-
Total Disposition of Federal Tax Revenue	**2,351**	**2,345**
Net Federal Revenue Activity	**$ -**	**$ -**
Federal Tax Refund Activity		
Total Refunds of Federal Taxes (Note 14)	$ 467	$ 438
Appropriations Used for Refund of Federal Taxes	(467)	(438)
Net Federal Tax Refund Activity	**$ -**	**$ -**

The accompanying notes are an integral part of these statements.

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INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2010 and 2009

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 top quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.

The organizational structure of the IRS consists of organizations and major programs which administers the nation's tax laws and annually collects 95 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. The National Taxpayer Advocate Service reports directly to Congress and the IRS Chief Counsel reports to the Secretary of the Treasury.

The eight support divisions are Modernization and Information Technology Services, Agency Wide Shared Services, Stewardship, Wage & Investment Stewardship, Executive Leadership and Direction, Human Capital Office, Human Capital Office Corporate Programs and Chief Financial Officer. These divisions provide shared services support to all 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.

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INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2010 and 2009

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

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2010 and 2009

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. 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, 2010 and 2009

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.

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

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.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2010 and 2009

H. Federal Tax Refunds Payable and Due from Treasury

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

I. Financing Sources and Revenues

Appropriations Received

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

Appropriations

- Taxpayer Services
- Enforcement
- Operations Support
- Other Appropriations

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

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

Operations Support funds the indirect costs of all programs. Activities include executive planning and direction; shared service support for facilities, rent, utilities and security; procurement, printing 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*.

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.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2010 and 2009

The *Affordable Care Act of 2010* (ACA) was enacted on March 23, 2010. There are tax provisions effective in calendar year 2010 and more to be implemented during the next several years. The role of the IRS is to administer the various tax provisions included in the new law, the largest set of tax law changes in 20 years.

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 in FY 2009 represented amounts retained from tax collections for payments to private collection agencies (PCAs) and for enforcement activities. The Private Collection Agent Program authorized 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 retained 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.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2010 and 2009

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 tax liabilities are not included in program costs.

HCTC activities are focused on implementing the health insurance tax credit program set out in the *Trade Adjustment Assistance Reform Act of 2002* (Trade Act of 2002). These costs do not encompass payments made to health insurance carriers on behalf of participants or tax credits refunded to qualifying individuals. (See Other Accompanying Information - unaudited for discussion of refundable tax credits.)

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.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2010 and 2009

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 and the Department of Health and Human Services (HHS) as a receiving entity. Obligations and outlays incurred by the IRS are charged to the allocation account as it executes the delegated activity on behalf of Transportation and HHS. Financial activity for the allocations transfers are reported in the financial statements of Transportation and HHS.

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.

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

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2010 and 2009

includes the expected liability for death, disability, medical, and miscellaneous costs for approved cases. DOL estimates the liability for future payments as a result of past events.

Employee Pension Benefits

The IRS employees participate in the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS). For employees covered by CSRS, the IRS contributes 7% of the employees' gross pay for regular and 7.5% for law enforcement officers' retirement. For employees covered by FERS, the IRS contributes 11.2% 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 the Thrift Savings Plan (TSP), a defined contribution plan. For those employees participating in the FERS, a TSP account is automatically established, and IRS makes a mandatory contribution to this plan equal to one percent of the employees' compensation as well as matching contributions ranging from one to four percent of the employees' compensation for FERS-eligible employees who contribute to their TSP. No matching contributions are made to the TSP for employees participating in the CSRS.

Employee Health and Life Insurance Benefits

Employees are eligible to participate in the Federal Employees Health Benefit Program (FEHB) and Federal Employees Group Life Insurance Program (FEGLI). Employees participating in the FEGLI program can obtain basic term life insurance, with the employee paying two-thirds of the cost and IRS paying one-third. Additional coverage is optional, to be paid fully by the employee. The basic life coverage may be continued into retirement if certain requirements are met. The IRS recognizes the full cost of providing these benefits.

P. Use of Estimates

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

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2010 and 2009

Note 2. Fund Balance with Treasury

(In Millions)	2010	2009
General Funds	$ 2,248	$ 2,300
Special Funds	310	158
Revolving Funds	6	6
Other Funds	(2)	(1)
Fund Balance with Treasury	**$ 2,562**	**$ 2,463**

(In Millions)	2010	2009
Unobligated balances:		
Available	$ 241	$ 384
Unavailable	575	503
Obligated balance not yet disbursed	1,752	1,586
Non-budgetary FBWT	(6)	(10)
Status of Fund Balance with Treasury	**$ 2,562**	**$ 2,463**

Note 3. Other Assets

(In Millions)	2010		2009	
	Intra-governmental	With the Public	Intra-governmental	With the Public
Advances	$ 83	$ 8	$ 117	$ 7
Accounts receivable, net	49	2	26	3
Forfeited property held for sale	-	2	-	2
Clearing accounts	4	-	4	-
Other Assets	**$ 136**	**$ 12**	**$ 147**	**$ 12**

Note 4. Cash and Other Monetary Assets

(In Millions)	2010	2009
Imprest Fund	$ 4	$ 4
Other monetary assets	291	59
Cash and Other Monetary Assets	**$ 295**	**$ 63**

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2010 and 2009

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

(In Billions)	2010	2009
Federal taxes receivable	$ 138	$ 128
Allowance for uncollectible taxes receivable	(103)	(99)
Federal taxes receivable, net and Due to Treasury	**$ 35**	**$ 29**

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

Note 6. Non-entity Assets

(In Millions)	2010		2009	
	Intra-governmental	With the Public	Intra-governmental	With the Public
Due from Treasury	$ 4,133	$ -	$ 4,031	$ -
Federal taxes receivable, net	-	35,000	-	29,000
Other monetary assets	-	291	-	59
Non-entity Assets	**$ 4,133**	**$ 35,291**	**$ 4,031**	**$ 29,059**

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.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2010 and 2009

Note 7. Property and Equipment

(In Millions)	Useful Life (Years)	Cost	Accumulated Depreciation	2010 Net Book Value	2009 Net Book Value
ADP assets	3 to 7	$ 1,526	$ (1,094)	$ 432	$ 411
Internal use software	3 to 7	1,073	(706)	367	429
Leasehold improvements	10	426	(263)	163	139
Major systems	7	422	(422)	-	-
Internal use software – work in process		60	-	60	75
Vehicles	5	63	(43)	20	27
Furniture and non-ADP equipment	8 to 10	43	(27)	16	12
Assets under capital lease	3 to 7	2	-	2	-
Investigative equipment	10	7	(7)	-	1
Property and Equipment		**$ 3,622**	**$ (2,562)**	**$ 1,060**	**$ 1,094**

The Cost column represents the historical cost of property and equipment, net of disposals. The cost basis for FY 2010 and FY 2009 is $3,622 million and $3,513 million, respectively. Accumulated depreciation for FY 2010 and FY 2009 is $2,562 million and $2,419 million, respectively.

The IRS has 14 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 individual taxpayer accounts.
- Customer Account Data Engine 2 (CADE 2) is leveraging existing systems and new development to implement a single, data-centric solution which provides daily processing of individual taxpayer accounts and establishes a solid data foundation for the future.
- 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.
- The Custodial Detail Database (CDDB) is the subsidiary ledger for RRACS which provides the functionality needed for custodial financial management and reporting.
- Redesign Revenue and Accounting System (RRACS) adds enhancements to financial reporting of taxpayer receipts and adds traceability between summary records and the detailed subsidiary ledger (CDDB).

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2010 and 2009

The IRS has 14 internal use software projects, continued.

- Knowledge Incident/Problem Service Asset Management (KISAM) project will replace the IRS' current asset and problem management system, Information Technology Asset Management System.
- Integrated Procurement System (IPS) is a project to re-engineer the existing procurement system, Web Requisition Tracking System/Integrated Procurement System, to meet current enterprise architecture and security standards.

Deployed Internal Use Software

(In Millions)	Cost	Accumulated Depreciation	2010 Net Book Value	2009 Net Book Value
Current CADE	$ 302	$ (165)	$ 137	$ 185
Modernized E-File	251	(145)	106	70
Integrated Financial System	147	(115)	32	53
E-Services	141	(131)	10	30
AMS	78	(8)	70	76
STIR	76	(76)	-	5
Customer Communications	25	(25)	-	-
Enterprise Systems Management	16	(16)	-	1
Internet Refund Fact of Filing	15	(15)	-	1
RRACS	6	(1)	5	-
CDDB	8	(2)	6	7
Other	8	(7)	1	1
Deployed Internal Use Software	**$ 1,073**	**$ (706)**	**$ 367**	**$ 429**

Work in Process Internal Use Software

(In Millions)	2010	2009
Modernized E File	$ 11	$ 49
Current CADE	-	23
RRACS	-	3
KISAM	5	-
IPS	4	-
CADE2	40	-
Work in Process Internal Use Software	**$ 60**	**$ 75**

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INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2010 and 2009

Note 8. Liabilities

Other Liabilities

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

	2009		
(In Millions)	Current	Non-Current	Total
Intragovernmental:			
Accrued payroll and benefits	$ 80	$ -	$ 80
Accrued FECA liability	43	55	98
Accrued expenses	30	-	30
Other Liabilities	**$ 153**	**$ 55**	**$ 208**
With the Public:			
Accrued annual leave	$ 531	$ -	$ 531
Actuarial FECA liability	-	426	426
Accrued payroll and benefits	340	-	340
Accrued expenses	215	-	215
Liability for Deposit Funds and Clearing Accounts	62	-	62
Accounts payable	85	-	85
Other Liabilities	**$ 1,233**	**$ 426**	**$ 1,659**

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INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2010 and 2009

Liabilities Not Covered by Budgetary Resources

(In Millions)	2010		2009	
	Intra-governmental	With the Public	Intra-governmental	With the Public
Accrued annual leave	$ -	$ 549	$ -	$ 531
Actuarial FECA liability	-	441	-	426
Accrued FECA liability	98	-	98	-
Liabilities Not Covered by Budgetary Resources	**$ 98**	**$ 990**	**$ 98**	**$ 957**

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

Note 9. Leases

Capital Leases

The IRS leases ADP telecommunications equipment for toll free call centers under seven year leases. The payments for the leased equipment are made at the beginning of the leases. There are no future payments due.

Operating Leases

(In Millions) Fiscal Year	Lease Payment
2011	$ 13
2012	12
2013	7
2014	1
2015	1
After 2015	3
Total Future Lease Payments	**$ 37**

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, 2010 and 2009

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, 2010 and 2009, 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, 2010 and 2009, there were three cases and two 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.

The IRS has pending refund claims and lawsuits relating to whether the FICA tax is owed on stipends paid to medical residents for their services prior to April 1, 2005. It is probable these claims and lawsuits will result in a loss to the Federal government. An estimate of the potential loss cannot be made.

As of September 30, 2010 and 2009, the IRS does not have contractual commitments for payments on obligations related to canceled appropriations.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2010 and 2009

Note 11. Cost and Earned Revenue by Programs

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

	2009				
(In Millions)	Taxpayer Assistance and Education	Filing and Account Services	Compliance	Administration of Tax Credit Programs	Total
Intragovernmental Gross Cost	$ 88	$ 1,639	$ 2,372	$ 43	$ 4,142
Gross Costs with the Public	468	2,311	5,803	147	8,729
Program Costs	556	3,950	8,175	190	12,871
Intragovernmental Earned Revenue	(2)	(12)	(41)	-	(55)
Earned Revenue from the Public	(3)	(56)	(254)	-	(313)
Program Revenues	(5)	(68)	(295)	-	(368)
Net Cost of Operations	**$ 551**	**$ 3,882**	**$ 7,880**	**$ 190**	**$ 12,503**

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2010 and 2009

Note 12. Statement of Budgetary Resources

Obligations Incurred

(In Millions)	2010	2009
Direct - Category B	$ 12,467	$ 11,782
Reimbursable - Category B	136	114
Obligations Incurred	**$ 12,603**	**$ 11,896**

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

(In Millions)	Budgetary Resources	Obligations Incurred	Distributed Offsetting Receipts	Net Outlays
Statement of Budgetary Resources (SBR)	$ 12,783	$ 11,896	$ 233	$ 11,247
Included on SBR, not in President's Budget				
Expired Funds	(386)	(38)	-	-
Distributed Offsetting Receipts	-	-	(233)	233
Allocation Transfer from Treasury	(122)	(27)		(24)
Other	(1)	3	-	(5)
Included in President's Budget, not on SBR				
Tax credits and interest refunds to taxpayers	82,373	82,373	-	82,373
Payments to informants	5	5	-	5
Budget of the United States Government	**$ 94,652**	**$ 94,212**	**$ -**	**$ 93,829**

The *FY 2012 Budget of the United States Government* (President's Budget) presenting the actual amounts for the year ended September 30, 2010 has not been published as of the issue date of these financial statements. The FY 2012 President's Budget is scheduled for publication in February 2011. A reconciliation of the FY 2009 column on the Statement of Budgetary Resources (SBR) to the actual amounts for FY 2009 in the FY 2011 President's Budget for budgetary resources, obligations incurred, distributed offsetting receipts, and net outlays is presented above.

The President's Budget includes appropriations for EITC, Child Tax Credit, HCTC, interest relating to taxpayer refunds, informant payments and additional refundable tax credits relating to the Recovery Act totaling $82.4 billion. The majority of the appropriations represent budgetary resources and outlays of payments to taxpayers for credits that exceed the taxpayer's income tax liability and interest paid on refunds of collections.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2010 and 2009

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 $1,043 million and $985 million for the periods ended September 30, 2010 and 2009, respectively.

Note 13. Collections of Federal Tax Revenue

(In Billions)	Tax Year 2010		Tax Year 2009	Tax Year 2008	Tax Year Prior Years	Collections Received FY 2010	Collections Received FY 2009
Individual income, FICA/SECA, and other	$ 1,316	*	$ 636	$ 20	$ 17	$ 1,989	$ 2,036
Corporate income	189	**	75	2	12	278	225
Excise	35		12	-	-	47	47
Estate and gift	-		8	1	11	20	25
Railroad retirement	4		1	-	-	5	5
Federal unemployment	4		2	-	-	6	7
Collections of Federal Tax Revenue	**$ 1,548**		**$ 734**	**$ 23**	**$ 40**	**$ 2,345**	**$ 2,345**

* Includes other collections of $241 million.
** Includes tax year 2011 corporate income tax receipts of $13 billion.

Note 14. Federal Tax Refund Activity

(In Billions)	Tax Year 2010	Tax Year 2009	Tax Year 2008	Tax Year Prior Years	Refunds Disbursed FY 2010	Refunds Disbursed FY 2009
Individual income, FICA/SECA, and other	$ 1	$ 312	$ 36	$ 17	$ 366	$ 340
Corporate income	3	16	17	62	98	95
Excise	1	1	-	-	2	2
Estate and gift	-	-	1	-	1	1
Federal Tax Refund Activity	**$ 5**	**$ 329**	**$ 54**	**$ 79**	**$ 467**	**$ 438**

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

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2010 and 2009

Note 15. Fiduciary Activities

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

(In Millions)	2009 20X6737	20X6738	20X6740	20X6741	Total
Fiduciary net assets, beginning of year	$ (2)	$ 11	$ -	$ -	$ 9
Contributions	47	37	635	18	737
Disbursements to and on behalf of beneficiaries	(45)	(30)	(635)	(18)	(728)
Increase (Decrease) in fiduciary net Assets	2	7	-	-	9
Fiduciary Net Assets, end of year	**$ -**	**$ 18**	**$ -**	**$ -**	**$ 18**

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

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

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

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

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

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INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2010 and 2009

Note 16. Reconciliation of Net Cost of Operations to Budget

(In Millions)	2010	2009
Resources used to finance activities:		
Obligations incurred	$ 12,603	$ 11,896
Spending authority from offsetting collections and recoveries	(241)	(224)
Distributed offsetting receipts	(283)	(233)
Transfers to General Fund	(64)	(45)
Imputed financing	1,390	1,123
Transfers in/out without reimbursement	35	21
	13,440	**12,538**
Resources that do not fund net cost of operations:		
Changes in goods, services and benefits ordered but not yet received or provided	(56)	(64)
Costs capitalized on the balance sheet	(249)	(300)
Budgetary offsetting collections and receipts	(1)	-
	(306)	**(364)**
Costs that do not require resources in current period:		
Depreciation and amortization	361	320
Increase (Decrease) in unfunded liabilities	33	(29)
Revaluation of assets and liabilities	16	42
Other	(97)	(4)
	313	**329**
Net Cost of Operations	**$ 13,447**	**$ 12,503**

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.

INTERNAL REVENUE SERVICE

Required Supplementary Information - Unaudited

For the Years Ended September 30, 2010 and 2009

Schedule of Budgetary Resources by Major Budget Accounts

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

INTERNAL REVENUE SERVICE

Required Supplementary Information - Unaudited

For the Years Ended September 30, 2010 and 2009

Schedule of Budgetary Resources by Major Budget Accounts

(In Millions)	2009 Taxpayer Service	Enforcement	Operations Support	Other Appropriations	Total
Budgetary Resources					
Unobligated Balance, Brought Forward, October 1	$ 181	$ 100	$ 184	$ 225	$ 690
Recoveries of Prior Year Unpaid Obligations	23	20	47	4	94
Budget Authority					
Appropriations	2,293	5,118	3,866	574	11,851
Spending Authority from Offsetting Collections	30	53	41	6	130
Nonexpenditure Transfers, Net	129	1	44	(44)	130
Permanently Not Available	(49)	(26)	(30)	(7)	(112)
Total Budgetary Resources	**$ 2,607**	**$ 5,266**	**$ 4,152**	**$ 758**	**$ 12,783**
Status of Budgetary Resources					
Obligations Incurred	$ 2,451	$ 5,176	$ 3,935	$ 334	$ 11,896
Unobligated Balance – Available	23	16	102	243	384
Unobligated Balance – Not Available	133	74	115	181	503
Total Status of Budgetary Resources	**$ 2,607**	**$ 5,266**	**$ 4,152**	**$ 758**	**$ 12,783**
Change in Obligated Balance:					
Obligated Balance, Net, Brought Forward, October 1	$ 224	$ 301	$ 757	$ 112	$ 1,394
Obligations Incurred	2,451	5,176	3,935	334	11,896
Gross Outlays	(2,447)	(5,049)	(3,832)	(296)	(11,624)
Recoveries of Prior Year Unpaid Obligations, Actual	(23)	(20)	(47)	(4)	(94)
Change in Uncollected Customer Payments from Federal Sources	-	2	13	-	15
Obligated Balances, Net, End of Period	**$ 205**	**$ 410**	**$ 826**	**$ 146**	**$ 1,587**
Net Outlays					
Gross Outlays	$ 2,447	$ 5,049	$ 3,832	$ 296	$ 11,624
Offsetting Collections	(30)	(55)	(53)	(6)	(144)
Distributed Offsetting Receipts	-	-	-	(233)	(233)
Net Outlays	**$ 2,417**	**$ 4,994**	**$ 3,779**	**$ 57**	**$ 11,247**

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INTERNAL REVENUE SERVICE

Required Supplementary Information - Unaudited

For the Years Ended September 30, 2010 and 2009

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 2010, the total estimated payout (including principal and interest) for claims pending judicial review by the Federal courts is $8.8 billion and by Appeals is $8.0 billion. In FY 2009, the total estimated payout (including principal and interest) for claims pending judicial review by the Federal courts was $4.7 billion and by Appeals was $6.3 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:

(In Billions)	2010	2009
Total unpaid assessments	$ 330	$ 308
Compliance assessments	(93)	(75)
Write-offs	(99)	(105)
Gross Federal taxes receivables	138	128
Allowance for uncollectible taxes receivable	(103)	(99)
Federal taxes receivable, net	**$ 35**	**$ 29**

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

To eliminate double-counting, the compliance assessments reported above exclude trust fund recovery penalties, totaling $3 billion as of September 30, 2010 and 2009, respectively, 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.

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Refundable Tax Credits and Other Outlays

To provide tax relief to targeted individuals and businesses, Congress has provided assistance in the form of tax credits. For the majority of tax credits, the economic benefit is limited to the taxpayer's tax liability. Credits limited in this manner are termed nonrefundable There is an additional class of tax credits which is 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 Additional Child Tax Credit is a special credit for taxpayers who work, have earnings below an established ceiling and have a qualifying child. The Child Tax Credit is limited to the taxpayer's tax liability and is a nonrefundable tax credit. However, certain individuals who receive less than the full amount of the Child Tax Credit may qualify for the "Additional" Child Tax Credit. Under this credit, subject to additional criteria, the taxpayer may receive the full credit amount even if such amount exceeds the taxpayer's tax liability. Consequently, the Additional Child Tax Credit is categorized as a refundable tax credit. Benefits of the credit were augmented under ARRA by increasing eligibility for the credit in 2009 and 2010.

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Health Care Tax Credit

The Health Care Tax Credit was established in 2002 to assist economically dislocated workers in acquiring or continuing critical health care coverage during periods of economic distress. Under this credit, participants can elect to take a portion of their premium as a credit on their tax return. Alternatively, participants can elect to receive direct reimbursements should they have insufficient tax liability against which to apply the credit.

Individual Alternative Minimum Tax (AMT) Credit

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

First-Time Home Buyer Credit

In 2008, Congress provided taxpayers with a refundable tax credit equivalent to an interest-free loan equal to 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 eliminated the repayment obligation for taxpayers who purchase homes after January 1, 2009, increased the maximum value of the credit to $8,000, and removed the prohibition on financing by mortgage revenue bonds. Additionally, ARRA extended the availability of the credit for homes purchased before December 1, 2009. The ARRA provision retains the credit recapture if the house is sold within three years of purchase.

Making Work Pay Credit and Credit for Certain Government Retirees

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

Build America and Recovery Zone Bonds

Build America Bonds are a financing tool for state and local governments. The bonds, which allow a new direct federal payment subsidy, are taxable bonds issued by state and local governments which will give them access to the conventional corporate debt markets. At the election of the state and local governments, the Treasury Department will make a direct payment to the state or local governmental issuer in an amount equal to 35 percent of the interest payment on the Build America Bonds. As a result of this federal subsidy payment, state and local governments will have lower net borrowing

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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-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.

American Opportunity Tax Credit

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

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The following table summarizes refundable tax credits and outlays paid in fiscal years 2010 and 2009.

(In Millions)	2010	2009
Stimulus Credit	$ 81	$ 2,024
Earned Income Tax Credit ø	54,712	42,418
Additional Child Tax Credit ø	22,659	24,284
Health Care Tax Credit ø	205	113
Individual Alternative Minimum Tax (AMT) Credit	1,034	711
First-Time Homebuyer Credit ø	8,668	9,386
Making Work Pay Credit and Credit for Certain Government Retirees Δ	13,740	663
Build America and Recovery Zone Bonds Δ	1,376	19
COBRA Credit Δ	3,857	313
American Opportunity Tax Credit	3,851	-
Corporate Alternative Minimum Tax (AMT) Credit	86	24
Refundable Tax Credits	**$ 110,269**	**$ 79,955**

ø Existing refundable credits expanded under the ARRA.
Δ New refundable credits resulting from the ARRA.

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For the Years Ended September 30, 2010 and 2009

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. 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 $639 billion and $661 billion in FY 2010 and FY 2009, respectively. Medicare taxes collected by the IRS were estimated to be approximately $182 billion and $192 billion in FY 2010 and FY 2009, respectively. Social Security taxes and Medicare taxes are included in individual income, FICA/SECA and other on the Statement of Custodial Activity.

Tax Gap

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

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

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and have not yet reached their statutory collection expiration date. Also, the tax gap includes only tax, while the collection gap includes tax, penalties, and interest.

Tax Burden and Tax Expenditures

The Internal Revenue Code provides for progressive rates of tax, whereby higher incomes are generally subject to higher rates of tax. The following graphs and charts present the latest available information on income tax and adjusted gross income (AGI) for individuals by AGI level and for corporations by size of assets. For individuals, the information illustrates, in percentage terms, the tax burden borne by varying AGI levels. For corporations, the information illustrates, in percentage terms, the tax burden borne by these entities by various sizes of their total assets. The graphs are 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 for government operations, decisions to forego Federal revenue are as important as decisions to spend Federal revenue.

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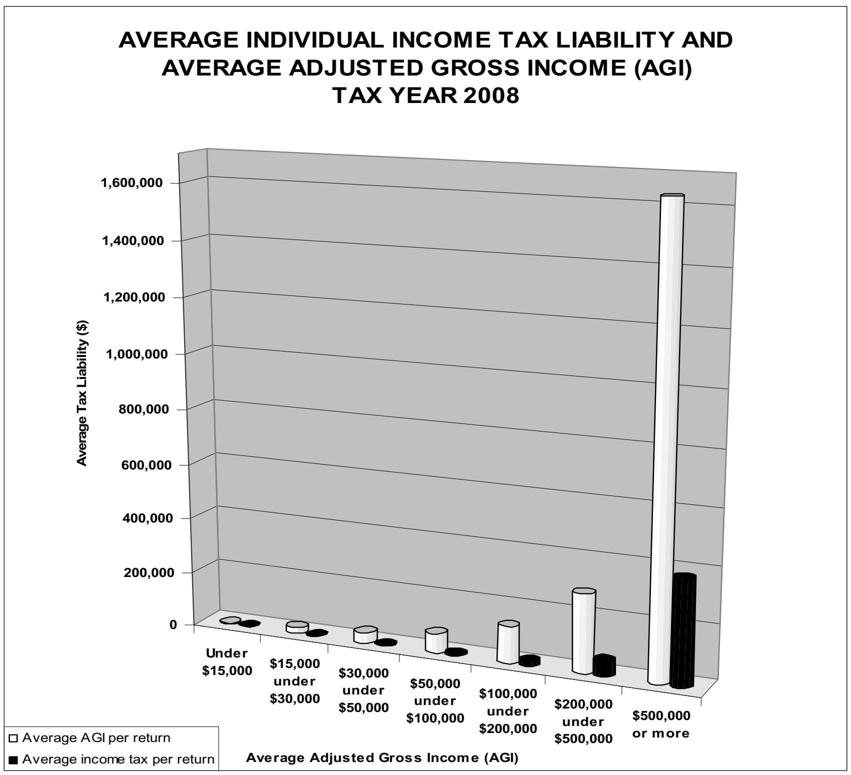
For the Years Ended September 30, 2010 and 2009



Adjusted gross income (AGI)	Number of taxable returns (in thousands)	AGI (in millions)	Total income tax (in millions)	Average AGI per return (in whole dollars)	Average income tax per return (in whole dollars)	Income tax as a percentage of AGI
Under $15,000	37,970	104,025	2,227	2,740	59	2.1%
$15,000 under $30,000	29,687	655,035	18,958	22,065	639	2.9%
$30,000 under $50,000	25,641	1,002,998	56,953	39,117	2,221	5.7%
$50,000 under $100,000	30,926	2,193,691	184,554	70,934	5,968	8.4%
$100,000 under $200,000	13,851	1,845,103	232,270	133,211	16,769	12.6%
$200,000 under $500,000	3,477	993,427	193,700	285,714	55,709	19.5%
$500,000 or more	899	1,468,581	342,919	1,633,572	381,445	23.4%
Totals	**142,451**	**8,262,860**	**1,031,581**	**-**	**-**	**-**

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

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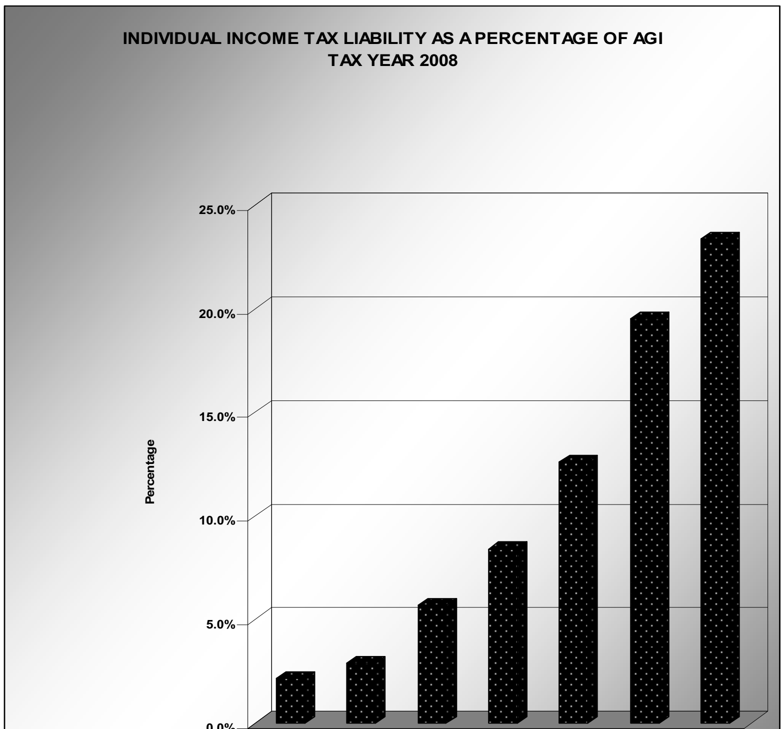

	Under $15,000	$15,000 under $30,000	$30,000 under $50,000	$50,000 under $100,000	$100,000 under $200,000	$200,000 under $500,000	$500,000 or more
Income tax as a percentage of AGI	2.1%	2.9%	5.7%	8.4%	12.6%	19.5%	23.4%

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

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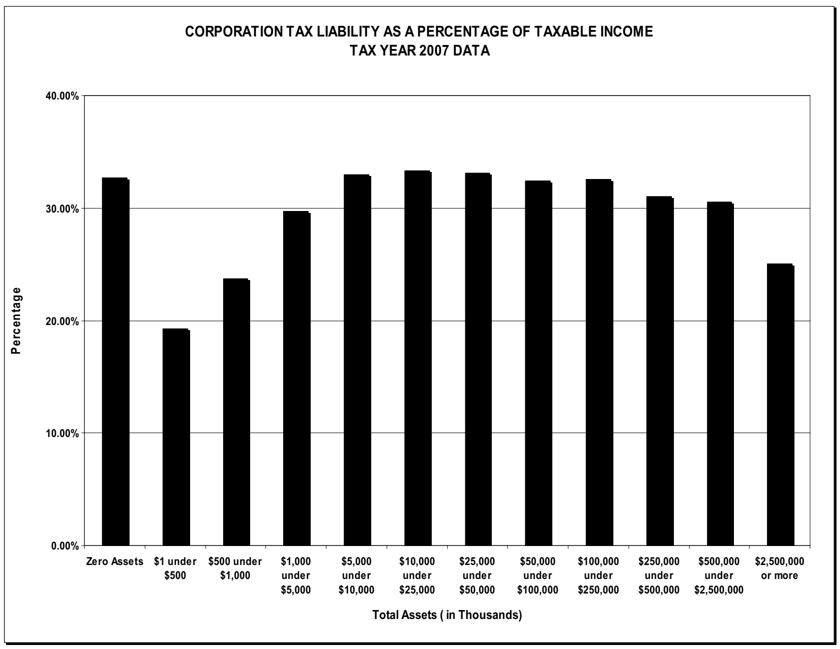

Total Assets (in thousands)	Income subject to tax (in millions)	Total income tax after credits (in millions)	Percentage of income tax after credits to taxable income
Zero Assets	26,280	8,593	32.7%
$1 under $500	8,205	1,582	19.3%
$500 under $1,000	4,292	1,017	23.7%
$1,000 under $5,000	15,577	4,628	29.7%
$5,000 under $10,000	10,008	3,299	33.0%
$10,000 under $25,000	16,650	5,547	33.3%
$25,000 under $50,000	13,139	4,347	33.1%
$50,000 under $100,000	16,621	5,392	32.4%
$100,000 under $250,000	27,977	9,100	32.5%
$250,000 under $500,000	35,046	10,876	31.0%
$500,000 under $2,500,000	145,944	44,586	30.6%
$2,500,000 or more	928,546	232,408	25.0%
Total	**1,248,285**	**331,375**	**26.5%**

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

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Material Weaknesses, Significant Deficiency, and Compliance Issues

Material Weaknesses

During our audits of the Internal Revenue Service's (IRS) fiscal years 2010 and 2009 financial statements, we identified two material weaknesses[1] in internal control. These material weaknesses represent significant management challenges and have (1) impaired management's ability to prepare its balance sheet without extensive compensating procedures, (2) limited the availability of reliable information to assist management in making well-informed decisions concerning its unpaid tax assessments[2] on an ongoing basis, (3) resulted in errors in taxpayer accounts that increased taxpayer burden, and (4) reduced assurance that data processed by IRS's information systems are reliable and that sensitive taxpayer information is appropriately protected. The deficiencies that we identified relate to IRS's internal control over (1) unpaid tax assessments and (2) information security. We reported on each of these deficiencies last year[3] and in prior audits. We highlight these deficiencies in the following sections.

Unpaid Tax Assessments

During fiscal year 2010, 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 tax assessments[4] were not traceable from its general ledger system

[1]A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis.

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

[3]GAO, *Financial Audit: IRS's Fiscal Years 2009 and 2008 Financial Statements*, GAO-10-176 (Washington, D.C.: Nov. 10, 2009).

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

for tax administration-related transactions (Redesign Revenue Accounting Control System (RRACS))[5] to individual transactions in underlying source records, (2) IRS lacked a subsidiary ledger for unpaid tax assessments that would allow it to produce reliable, useful, and timely information with which to manage and report externally, and (3) IRS experienced errors and delays in recording taxpayer information, payments, and other tax assessment-related activities.

As we reported in prior years,[6] IRS's balance for federal taxes receivable, which comprised over 80 percent of IRS's total assets as reported on its fiscal year 2010 balance sheet, is a product of a compensating statistical estimation process rather than the summation of individual account balances. IRS's financial management systems could not reliably classify and report the transaction-by-transaction unpaid tax assessments balances in accordance with federal accounting standards due to material inaccuracies. To compensate for this deficiency, IRS applied a statistical sampling and estimation process to data from its master files to estimate the year-end balances of (1) taxes receivable in its financial statements and required supplementary information and (2) compliance assessments and write-offs in its required supplementary information.

While IRS adjusts the gross taxes receivable balance in its general ledger based on the results of this estimation process, the adjusted account balance can no longer be traced back to the detailed records because it was the product of a statistical estimate. This process leaves IRS unable to identify which taxpayers owe the tax debts summarized in the gross taxes receivable balance or how much each one owes because it does not have records to trace transactions from the taxes receivable amount, through its general ledger system, and back to underlying transaction-level source documents. Such traceability is necessary to enable IRS to ensure that recorded transactions are complete, accurate, and supported by underlying records.

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

[6]GAO-10-176.

Over the years, IRS has taken a number of actions intended to improve its accounting and reporting of unpaid tax assessments. IRS began phasing in the use of the Custodial Detail Data Base (CDDB) in 2006. One key objective of CDDB was to serve as a transaction-level subsidiary ledger for unpaid tax assessments by linking and classifying taxpayer account information from IRS's master files[7] to its general ledger for tax-related transactions and activity, thus providing transactional traceability. In fiscal year 2008, IRS enhanced CDDB to analyze and record unpaid tax assessments balances from its master file on a weekly basis, including related interest and penalty accruals, to its general ledger by the various financial reporting categories (taxes receivable, compliance assessments, and write-offs). These enhancements established CDDB's capability to function as a transaction-level subsidiary ledger for unpaid tax assessments. Additionally, during fiscal year 2010, IRS implemented its RRACS general ledger, which contains *United States Standard General Ledger* (USSGL) accounts for the reporting of taxes receivable. RRACS gives IRS the ability to record the taxes receivable-related balance into USSGL accounts and use the account balances to produce the taxes receivable information in its financial statements.

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 transactions into the various financial reporting categories, the analysis and classification continues to contain material inaccuracies. Specifically, through its use of its statistical sampling and estimation process, IRS identified errors necessitating almost $10 billion in adjustments to the 2010 fiscal year-end gross taxes receivable balance produced by CDDB. Accordingly, IRS must continue to use a resource intensive statistical sampling and estimation process in order to derive reliable amounts for taxes receivable and other unpaid tax assessments categories for internal and external reporting. While the use of CDDB has refined this process, it continued to take IRS several months to complete and required multibillion-dollar adjustments to the taxes receivable balance in its general ledger. Once adjusted, the taxes receivable balance in IRS's general ledger could no longer be traced back to underlying transaction-level source documents. Consequently, the lack of

[7] 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.

an effective transaction-level subsidiary ledger continued to inhibit IRS's ability to timely develop reliable financial and management reports useful for ongoing management decisions and external reporting in accordance with federal accounting standards.

During our fiscal year 2010 audit, we continued to identify several systemic deficiencies in the programs used by CDDB that resulted in it misclassifying tax debt accounts among the three financial reporting categories—taxes receivable, compliance assessments, and write-offs. We identified instances in which CDDB did not correctly classify an account module.[8] Specifically, IRS had not written sufficient details into the CDDB classification program to allow it to sort through, identify, and analyze all the relevant transaction-level information required for proper classification, recording, and reporting. For example, when IRS records multiple tax assessments on a single account module, CDDB is currently unable to distinguish among and separately classify the various balances. In 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.[9] IRS later audited the taxpayer and assessed additional taxes against the taxpayer for the same tax period. However, IRS had no evidence that the taxpayer had agreed to the additional tax assessment. Consequently, the additional tax assessment should have been classified as a compliance assessment.[10] Instead, CDDB classified the entire outstanding balance as taxes receivable because CDDB programming did not provide for separate classification of different tax assessments recorded on the same account module into separate accounting categories.

[8]A 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.).

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

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

In another example, CDDB was unable to process and properly classify related account modules associated with unpaid payroll taxes when IRS (1) assessed a trust fund recovery penalty (TFRP) against an 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.[11] In one case we reviewed, IRS assessed a TFRP against two officers related to a defunct business's unpaid payroll taxes for a particular tax period.[12] The business 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 from the defunct business's individual officers. In this situation, CDDB should have (1) classified the outstanding TFRP against one of the officers as taxes receivable, (2) classified the outstanding TFRP against the other officer as a duplicate tax assessment that is not counted for financial reporting purposes, (3) classified a like amount of the business's outstanding payroll tax as a duplicate tax assessment that is not counted for financial reporting purposes, and (4) 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 these same individuals a TFRP related to another business for the same tax period. Because there were two separate TFRP tax assessments recorded on the individuals' master file account modules 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 taxes receivable and classifying the individual TFRP accounts as duplicate tax assessments. Since the business was defunct and the amount of the payroll tax owed by the business was more than the amount of the TFRP assessed against the individuals, the taxes receivable balance was overstated by the amount assessed against the defunct business that was in

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

[12]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.

excess of the TFRP assessment. 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 2010 audit, we again found errors in taxpayer records resulting from IRS not recording information accurately and timely. Such errors directly affect the accuracy of CDDB's tax debt classification and reporting. Additionally, such errors can cause frustration to taxpayers who either have already paid taxes owed or who owe significantly lower amounts.

For example, in one case we reviewed, IRS made a data entry error when recording information from a taxpayer's payroll tax return that resulted in a tax assessment against the taxpayer for approximately $1 million when the taxpayer had reported a tax liability of less than $50,000. IRS's error created a balance due within the account and led to IRS erroneously issuing a notice to the taxpayer requesting payment for approximately $1 million. Although IRS subsequently determined that the balance due was the result of its own error and corrected the information in the taxpayer's account module, it did so only after inconveniencing the taxpayer. In another case, IRS recorded on a taxpayer's tax account module in January of 1985 that the taxpayer was involved in litigation. When IRS recorded the litigation activity on the taxpayer's account module, this action appropriately suspended the automated countdown to the expiration date of the statutory collection period[13] for the outstanding tax debt on the master file record. However, when IRS selected and reviewed this case as part of its unpaid tax assessments statistical estimation process in fiscal year 2010, its research showed that the litigation was settled in 1991 and the taxpayer subsequently paid a portion of the total outstanding tax debt in a settlement with the government. If IRS had timely recorded the settlement of the litigation on the taxpayer's account module, the countdown of the statutory collection period would have resumed and the taxpayer's account module would likely have been removed from IRS's systems years earlier. Instead, as a result of IRS's processing delay, the taxpayer's account module balance of over $8 million was erroneously included in IRS's inventory of unpaid tax assessments during fiscal year 2010.

[13]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.

Errors involving IRS's failure to properly record payments to all related taxpayer accounts associated with unpaid payroll taxes also continued to affect the accuracy of IRS's records. As we have reported in prior years' audits,[14] IRS's systems were unable to 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. During our fiscal year 2009 audit, we tested a statistical sample of payments recorded on TFRP accounts and estimated 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 errors.[15] Although IRS has made improvements in its processes for recording trust fund recovery penalties over the last several years and continues to work towards improving these controls, it conceded that it had not made significant progress during fiscal year 2010. Consequently, with IRS's concurrence that no significant actions were taken to address the conditions found in our 2009 audit, we did not test IRS's controls in this area as part of our fiscal year 2010 audit.

Furthermore, processing delays and errors contributed to IRS's inability to timely release federal tax liens against taxpayers who fully satisfied or were otherwise relieved of their tax liability. Such delays and errors resulted not only in inaccurate tax records but also delayed IRS's release of federal tax liens and may cause undue burden to taxpayers who attempt to sell property or apply for commercial credit.[16]

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 reporting net taxes receivable and other unpaid tax assessment balances. IRS identified misclassified tax assessment records when reviewing a sample of unpaid tax assessment cases during fiscal year 2010. To address these errors, it recorded adjustments to affected accounts to reflect correct values at the point in time that IRS sampled the account information. On the basis of a statistical projection of these individual adjustments, IRS had to make multibillion dollar adjustments to the year-end balances of all three categories of unpaid tax assessments generated by CDDB in order to produce reliable amounts for external reporting on its balance sheet and required supplementary information for fiscal year 2010.

[14]GAO-10-176.

[15]We are 95 percent confident that the error rate does not exceed 15.1 percent.

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

Absent the use of this statistical estimation process, the various fiscal year 2010 unpaid tax assessment balances produced by CDDB would have been materially inaccurate.

The progress IRS has made to date with using CDDB is an important step in moving toward a fully functioning subsidiary ledger that could provide for full traceability of detailed taxes receivable transaction information to the general ledger. However, IRS has not yet fully addressed all the issues that cause material inaccuracies in the unpaid tax assessments information produced by CDDB. This will require further enhancements to CDDB to enable it to more accurately distinguish between the three categories of unpaid tax assessments, and improving controls over the recording of information in taxpayer accounts so that reliable transaction-based balances for taxes receivable can be ultimately recorded in the general ledger. Our June 2010 report discussed the existing control deficiencies in this area and contained recommendations to address those issues.[17]

Information Security

IRS 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, or 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. The absence of effective compensating procedures both increases the potential for undetected material misstatements in the agency's financial statements or other internal and external reports, and the risk that sensitive IRS and taxpayer information may be compromised.

During fiscal year 2010, IRS made progress in addressing numerous information security weaknesses we identified in previous audits. IRS corrected about 25 percent of the weaknesses that we had previously reported. For example, IRS (1) upgraded key Integrated Financial System

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

(IFS)[18] servers, decreasing the risk that known vulnerabilities may be exploited; (2) discontinued the use of unencrypted protocols on the servers supporting its procurement system, decreasing the risk that malicious users could capture sensitive information; and (3) limited access to certain key financial documents used for input into IFS, decreasing the risk that users could intentionally or unintentionally corrupt data.

Despite these actions, most of the previously identified weaknesses in internal control over information security remain unresolved and continue to place IRS systems at risk. For example, IRS continued to allow individuals more access to sensitive information contained on the network than needed to perform their assigned duties. In addition, IRS had not completed actions to address a vulnerability in its procurement system that allowed users to enter commands that bypassed normal application security controls. Further, at one data center, visitors continued to be provided unnecessary access to secured areas.

During our fiscal year 2010 audit, we identified additional deficiencies in internal control over information security that, along with previously identified deficiencies that remain unresolved, continued to jeopardize the confidentiality, integrity, and availability of information processed by IRS's key systems, and increased the risk of material misstatement for financial reporting. For example, the database associated with the online system IRS used to support and manage its computer access request, approval, and review processes was not appropriately secured. Weak control of powerful database IDs and insecure configurations reduce the confidence in the integrity of individuals' access privileges assigned to key IRS systems. In addition, IRS had not appropriately restricted permissions on the database that supported an application used for cost allocation of rent-related data, allowing database users to run operating system commands. Also, IRS used unencrypted protocols on a server supporting the Electronic Federal Tax Payment System (EFTPS)[19] and several internal routers, potentially exposing user IDs and passwords transmitted in clear text across the

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

[19]The Electronic Federal Tax Payment System (EFTPS) is a tax payment system provided free by the U.S. Department of the Treasury, through which businesses and individuals can pay federal taxes electronically via the Internet or by phone.

network to inappropriate disclosure and unauthorized use. Further, even though five updates have been released since 2006 (with the latest being released in August 2009), IRS had not updated the database software on the Microsoft Windows servers that supported RRACS, IRS's general ledger system. Such software access updates are necessary to protect against known vulnerabilities. Similarly, IRS did not install critical patch updates on several databases supporting IFS, and the operating system software supporting several network routers was out of date, increasing the risk that known information security vulnerabilities may be exploited.

An underlying reason for these deficiencies is that IRS has not yet fully implemented key components of its comprehensive information security program. Although IRS has processes in place intended to monitor and assess its internal controls, these processes were not always effective. For example, IRS did not:

- detect many of the vulnerabilities we identified during the fiscal year 2010 audit, some of which were readily identifiable.
- test RRACS application security in its current production environment. We tested access controls in the current environment and identified weaknesses in RRACS controls that compromised segregation of duties and jeopardized the integrity of the application's data.
- perform comprehensive testing within the past year of one of its key network components that it considered to be a high risk system.

In addition, IRS often did not take sufficient actions to correct known information security control deficiencies. Specifically, IRS did not always effectively validate that corrective actions taken effectively addressed previously reported weaknesses. We continued to identify weaknesses that IRS informed us it had mitigated. For example, IRS informed us that it had corrected 39 of the 88 information systems security weaknesses we had previously reported. However, we determined that 16 (41 percent) of the 39 weaknesses had not yet been fully resolved.

Until IRS takes additional steps to implement more comprehensive testing and effective validation processes, 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 new control deficiencies identified in fiscal year 2010 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 to IRS on the information security control deficiencies we identified during fiscal year 2010 and the status of previously identified deficiencies in this area.

To address its information security weaknesses, IRS has various initiatives underway. IRS has developed and documented a detailed plan to guide its efforts in addressing critical information security weaknesses. The agency is in the process of implementing this comprehensive plan to address numerous information security weaknesses, such as those associated with access controls, audit trails, contingency planning, and training. According to the plan, the last of these weaknesses is scheduled to be resolved in the first quarter of fiscal year 2014. In addition, IRS has developed metrics to measure success in complying with guides, policies, and standards in such areas as configuration management, access authorizations, auditing, and change management. As long as these efforts include the flexibility to adapt to changing technology and evolving threats, encompass the findings of GAO and the Treasury Inspector General for Tax Administration (TIGTA) in measuring success, and are fully and effectively implemented, they should improve the agency's overall information security posture.

Significant Deficiency

In addition to the material weaknesses discussed previously, during the fiscal year 2010 audit, we identified a significant deficiency[20] in IRS's internal control over tax refund disbursements.

Tax Refund Disbursements

In recent years, we have reported[21] a number of deficiencies in IRS's internal control over the processing of manual tax refunds.[22] In fiscal year 2010, we continued to identify similar deficiencies. The persistence of such deficiencies increases the risk of IRS paying erroneous tax refunds that once paid, compelled IRS to devote resources to attempting to recover, with no guarantee of success. The significance of these recurring deficiencies has grown as the magnitude of manual tax refunds has increased in recent years. As a result of these persistent internal control deficiencies, coupled with the magnitude of manual tax refunds disbursed, as well as new deficiencies we identified in internal control over manual

[20]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.

[21]GAO, *Management Report: Improvements Needed in IRS's Internal Controls*, GAO-10-565R (Washington, D.C.: June 28, 2010); *Management Report: Improvements Needed in IRS's Internal Controls*, GAO-09-513R (Washington, D.C.: June 24, 2009); *Management Report: Improvements Needed in IRS's Internal Controls*, GAO-07-689R (Washington, D.C.: May 11, 2007); and *Management Report: Improvements Needed in IRS's Internal Controls*, GAO-05-247R (Washington, D.C.: April 27, 2005).

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

tax refunds and claims associated with the First-Time Home Buyer Credit (FTHBC)[23] during our fiscal year 2010 audit, we concluded that collectively, these control deficiencies constitute a significant deficiency in IRS's internal control over tax refund disbursements. This significant deficiency increases the risk that IRS may pay out duplicate or otherwise erroneous tax refunds to which individuals or businesses are not entitled and for which IRS must spend resources attempting to recover.

The deficiencies in IRS's controls over manual tax refunds that we have reported in previous years and that continued to exist in fiscal year 2010 include the following:

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

- Employees were not effectively documenting actions to monitor tax refund processing. Appropriate documentation is necessary to provide verifiable evidence that appropriate tax refund monitoring was being conducted.

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

- Training for employees responsible for (1) processing manual tax refunds and (2) maintaining security over IRS's tax processing systems was not effective. Effective training is critical to ensure that employees responsible for these important functions are proficient in their responsibilities.

- Reviews of duplicate tax refund transcripts that identify potential duplicate tax refunds were incomplete. Because IRS did not effectively review these transcripts before these tax refunds were disbursed, it lost the opportunity to prevent erroneous tax refunds from being disbursed.

Over the years, we have made numerous recommendations for corrective actions to address these deficiencies. IRS has taken these issues seriously, has devoted significant resources to its efforts to resolve them, and has successfully implemented a number of our recommendations. Nevertheless, the underlying deficiencies have persisted. Additionally, during fiscal year 2010, we found instances where the guidance IRS provided to employees responsible for processing manual tax refunds was outdated or contradictory with other, related guidance. We also found flaws in the documentation that identified which officials were authorized to approve manual tax refunds.

At the same time, the magnitude of manual tax refunds has also increased significantly in recent years. This significant increase exacerbates the adverse impact of the unresolved and newly identified internal control deficiencies. From fiscal year 2008 to fiscal year 2010, IRS's manual tax refund payments increased from about $55 billion to over $100 billion (over 80 percent). During fiscal year 2010, about 22 percent of all tax refunds disbursed ($467 billion) were manual compared to about 13 percent in fiscal year 2008. Consequently, the significance of the persistent manual tax refund processing control deficiencies has increased the risk that IRS may pay out duplicate or otherwise erroneous tax refunds to individuals or businesses that are not entitled to them.

In fiscal year 2010, IRS prepared a corrective action plan intended to improve internal control over manual tax refunds. While this plan has much potential, IRS also recognized that it would take time for it to yield meaningful results. As of June 2010, when we conducted our testing of internal control over manual tax refund transactions, these actions had not yet had a significant effect, and as discussed earlier, we continued to find issues similar to those we identified in prior years. One reason for the persistence of these problems has been that IRS assigned responsibilities for manual tax refund initiation to large numbers of staff in many different organizational units. This wide dispersal of responsibilities made it more difficult for IRS to ensure that responsible staff understood current policies and procedures, including providing them the appropriate training needed to ensure they consistently and effectively implemented required policies and procedures in this area. The large number of staff involved also resulted in some staff processing relatively small numbers of manual tax refunds, making it more difficult for them to maintain proficiency in their related responsibilities. In July 2009, IRS centralized manual tax refund processing. Under this approach, smaller numbers of employees have been given broader responsibilities with respect to manual tax refund monitoring. If effectively implemented, this approach, coupled with the other corrective actions IRS has planned, has the potential to ultimately yield substantive progress in improving controls in this area that has thus far been elusive. However, the issues we reported in the past largely continued to exist in fiscal year 2010. At the time of our fiscal year 2010 audit testing, the employees given these broader responsibilities had not always received training commensurate with their new responsibilities, which may have impaired their ability to reduce the risk of erroneous tax refunds.

In addition to the persistent internal control issues affecting manual tax refunds, we found deficiencies in IRS's internal controls over processing FTHBC claims. As a result of these deficiencies, we found instances of erroneous tax refund disbursements. During fiscal year 2010, taxpayers filed over 2.2 million FTHBC claims totaling about $16 billion. Of these FTHBC claims, over 1.7 million (over 77 percent) resulted in tax refund payments to taxpayers totaling over $8.6 billion (over 53 percent of the amount claimed).

From the nearly 1.7 million FTHBCs allowed between October 1, 2009, and May 31, 2010, we statistically selected a random sample of 60 credits, and reviewed supporting documentation to determine whether the credit, and ultimately the resultant tax refund paid, if any, was valid to the extent this was determinable based on the limited documentary support made available to IRS.[24]

[24]We attempted to select our random sample directly from a population of tax refund disbursements during this period resulting from FTHBC claims, which would have allowed us to statistically estimate the full effect of the issues we identified upon the resultant tax refunds. However, due to limitations in its records, IRS was not able to provide the population of tax refunds due to FTHBC claims.

In testing the transactions included in this sample, we found four cases in which the FTHBCs IRS allowed were not supported by properly completed documentation. In each case, a related tax refund was disbursed to the taxpayer. However, because the supporting documentation was not properly completed, the tax refund may have been erroneous. Specifically, we found

- two cases in which an FTHBC was allowed although the taxpayer did not provide a required settlement statement documenting the cost of the home and the date of its purchase,
- one case in which the FTHBC amount IRS allowed was incorrect based on supporting documentation, and
- one case in which IRS allowed an FTHBC based on a claim in which the stated purchase date of the home was not supported by the settlement statement, which indicated a home purchase date in the future.

Based on our work, we estimated that as much as 12.9 percent[25] of FTHBCs filed during this period that IRS allowed were not supported by properly completed documentation. Therefore, we concluded that IRS's internal control over FTHBC claims was not effective in ensuring that the claims and any resultant tax refunds paid were valid.

We also identified 201 taxpayers who, based on information in IRS's database, appeared to have been allowed two FTHBCs.[26] From these 201 cases, we statistically selected a random sample of 20 taxpayers and reviewed documentation supporting their FTHBC claims to determine whether they complied with the IRC and if they did not, to determine why this had occurred and the extent of any related erroneous tax refunds.

[25] We are 90 percent confident that not more than 12.9 percent of these credits were not supported by properly completed documentation.

[26] Subsequently, we broadened this analysis to encompass FTHBCs filed between April 2009 and mid-July 2010, and identified an additional 201 taxpayers who also appeared to have been allowed multiple FTHBCs, and brought these to the attention of IRS. The procedures we used to identify these 402 suspicious cases were only able to detect instances where IRS allowed FTHBCs totaling more than $8,000, which is the dollar limit under the law. However, it would not detect instances where IRS allowed multiple FTHBCs totaling less than $8,000. Consequently, the actual number of taxpayers who were allowed multiple FTHBCs may be larger.

Based on our testing, we determined that IRS paid an erroneous tax refund to 19 of these taxpayers.[27]

- In 18 cases, IRS allowed an FTHBC in both tax year 2008 and tax year 2009. In each case, the taxpayer had filed an amended 2008 tax return claiming an FTHBC. When they subsequently submitted their 2009 tax return, they again claimed an FTHBC. Because IRS did not effectively review these taxpayers' accounts when the second claim was filed, it did not detect the fact that a previous claim had already been filed. In each case, IRS allowed both claims and consequently, paid an erroneous tax refund.

- In 2 cases, IRS recorded a 2009 FTHBC in the taxpayer's account and initiated a tax refund payment, although the taxpayer had not filed a claim. In each case, the taxpayer had previously filed an FTHBC claim on his or her amended 2008 tax return, based on which IRS also paid a related tax refund. In one of these cases, IRS detected the erroneous duplicate refund and prevented its disbursement. However, in the other case, a duplicate refund was disbursed to the taxpayer.

We brought all 201 cases to the attention of IRS officials so that they could follow up, determine the facts, and initiate any appropriate corrective action.

These errors in FTHBC processing occurred primarily because IRS's internal control over tax refunds processing were not updated in time to provide for effective review of the new tax form and supporting documentation needed to implement certain provisions of the laws that created the FTHBC, which allow taxpayers to claim an FTHBC for calendar 2009 on their tax return for calendar year 2008.

The deficiencies in internal control over tax refund disbursements we identified resulted in IRS disbursing duplicate erroneous tax refunds and increase the risk of duplicate or otherwise erroneous tax refund payments beyond those we have identified.

[27]We are 90 percent confident that 99.5 percent of the FTHBCs we identified as potential duplicate FTHBCs, were actual duplicate FTHBCs that IRS had recorded in the taxpayers' accounts, and that as a result, 99 percent of the taxpayers in whose accounts IRS recorded these duplicate FTHBCs had also been paid an erroneous tax refund.

Compliance Issues

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).

Release of Federal Tax Liens

The Internal Revenue Code grants IRS the authority 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.[28] The lien serves to protect the interest of the federal government and as a public notice to current and potential creditors of the government's interest in the taxpayer's property. For example, federal tax liens are disclosed in individuals' credit reports. Under section 6325 of the Internal Revenue Code, IRS is required to release federal tax liens within 30 days after the date the tax liability is satisfied or has become legally unenforceable or the Secretary of the Treasury has accepted a bond for the assessed tax.

In our prior audits, we found that IRS did not always release the applicable federal tax lien within 30 days after a tax liability is satisfied, either through payment or abatement, as required by the Internal Revenue Code.[29] In response, IRS has taken a number of actions over the years to improve its lien release 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 release 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 2010 and IRS's own testing continued to find that it did not always release all tax liens within 30 days after taxpayers paid or were otherwise relieved of a tax liability. Prior to fiscal year 2006, as

[28] 26 U.S.C. §§ 6321, 6323.

[29] GAO-10-176.

part of our annual 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[30] 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 2010, we noted that IRS's testing identified nine instances in which it did not release the applicable federal tax lien within the statutorily mandated 30 days. The time between satisfaction of the liability and release of the lien ranged from 33 days to 97 days. On the basis of the sample of unpaid tax assessment cases resolved in the first 6 months of fiscal year 2010 for which it had filed a tax lien, IRS did not release liens within 30 days[31] for an estimated 15 percent of the cases.

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.[32] We previously issued a report discussing the continued delays IRS was experiencing in releasing tax liens and recommended that IRS analyze the cause of delays in releasing liens and implement procedures to ensure their timely release.[33] IRS has not yet completed actions to fully address this recommendation. Until IRS addresses the deficiencies we previously reported, as well as those it has identified through its own testing, IRS will

[30]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.

[31]IRS reported that it is 95 percent confident that the percentage of cases in which the lien was not released within 30 days does not exceed 25 percent.

[32]GAO, *Financial Audit: IRS's Fiscal Years 2008 and 2007 Financial Statements*, GAO-09-119 (Washington, D.C.: Nov. 10, 2008).

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

not be able to ensure that it releases liens in accordance with the 30-day limit mandated by the Internal Revenue Code. Further, the continued failure to promptly release tax liens could cause undue hardship and burden to taxpayers who are attempting to sell property or apply for commercial credit.

Financial Management Systems' Noncompliance with FFMIA

In fiscal year 2010, we found that IRS's financial management systems did not substantially comply with the requirements of FFMIA. Specifically, IRS's systems did not substantially comply with *Federal Financial Management Systems Requirements* (FFMSR)[34] or federal accounting standards (U.S. generally accepted accounting principles). However, we did find that IRS's systems substantially complied with the *United States Standard General Ledger* at the transaction level. In its fiscal year 2010 Federal Managers' Financial Integrity Act of 1982 assurance statement to the Department of the Treasury, IRS reported the same conclusion.

In fiscal year 2010, IRS's systems did not substantially comply with FFMSR because of the existence of material weaknesses in IRS's internal control over unpaid tax assessments and information security, as discussed earlier in this report. As a result of these material weaknesses, IRS's internal control over financial reporting was not effective as of September 30, 2010.

IRS's financial management systems also did not substantially comply with federal accounting standards, specifically Statement of Federal Financial Accounting Standards No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*.[35] IRS's automated systems for tax related transactions did not support the net federal taxes receivable amount on IRS's balance sheet and other required supplemental information related to uncollected taxes—compliance assessments, and write-offs—as required by the standard.

[34]The Office of Management and Budget (OMB) Circular No. A-127, *Financial Management Systems*, prescribes FFMSR for the executive agencies of the Federal Government. On January 9, 2009, OMB issued a revised Circular No. A-127, which superseded previous versions of this Circular and which became effective beginning with fiscal year 2010.

[35]FASAB Statement of Federal Financial Accounting Standards 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, as codified in FASAB Pronouncements as Amended, Version 9 (Washington, D.C.: June 30, 2010).

In previous years, we also reported that IRS's financial system for reporting tax related activities, then known as the Interim Revenue Accounting Control System (IRACS), did not conform to the USSGL at the transaction level because (1) IRS lacked transaction traceability for taxes receivable, which was the product of a complex statistical estimation process and was not recorded in IRACS, and (2) IRACS did not post transactions in conformance with USSGL posting models. However, during fiscal year 2010, IRS implemented RRACS—a significant enhancement to IRACS, which brought IRS's system into conformance with the requirements of the USSGL.

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

IRS has established a remediation plan to address the conditions that lead to its systems' substantial noncompliance with the FFMIA requirements. This plan outlines the actions to be taken to resolve these issues and defines related resources and responsible organizational units. Many of the actions detailed in the plan are long-term in nature and are tied to IRS's systems modernization efforts.[36]

[36]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.

Management's Report on Internal Revenue Control over Financial Reporting

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

COMMISSIONER

November 5, 2010

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, 2010, 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, 2010, IRS internal control over financial reporting was effective.

Douglas H. Shulman
Commissioner

November 5, 2010
Date

Gregory E. Kane
Acting Chief Financial Officer

November 5, 2010
Date

Comments from the Internal Revenue Service

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

COMMISSIONER

November 5, 2010

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 2010 and 2009 Financial Statements.* We are pleased that the Internal Revenue Service (IRS) received an unqualified opinion on the combined financial statements for the eleventh consecutive year. The unqualified opinion demonstrates that the IRS accurately accounts for approximately $2.3 trillion in tax revenue receipts, $467 billion in tax refunds, and $12 billion in IRS appropriated funds.

We are pleased the Government Accountability Office (GAO) determined that the Redesign Revenue Accounting Control System (RRACS) we implemented in January 2010 complies with the United States Standard General Ledger (USSGL), and that the taxes receivable balance we recorded in RRACS for the first time also substantially complies with the USSGL, addressing this component of the material weakness on unpaid tax assessments.

The IRS continued to make improving information security a top priority during FY 2010, and we made notable improvements again this year:

- Completed corrective actions in network access controls and the Enterprise Security Audit Trail (ESAT) program.
- Implemented standard security configurations and established metrics in the areas of inventory management and configuration management, auditing, access authorization, and change management for network access systems and devices.
- Implemented auditing capability through ArcSight that identifies auditable events and event content consistent with IRS policy to include monitoring, collection analysis, storage, and reporting.

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- Transferred RRACS to the Martinsburg Computing Center (MCC) to resolve the auditor concerns with the mainframe operations in Detroit.
- Upgraded the Integrated Financial System (IFS) servers and the UNIX operating system to Solaris 10.
- Deployed Internet Protocol Security (IPSec) to address the auditor concerns with controls that affect the key IRS financial systems.

While we agree with GAO that there are identified weaknesses that continue to exist, we view their materiality to have decreased. The IRS believes that the improvements we made have significantly reduced the overall risk, and we look forward to working with GAO to develop testing of the IT security controls and the compensating processes and procedures during the FY 2011 audit to demonstrate that the overall risk has been reduced to below a material weakness.

During FY 2010, the IRS took significant steps to strengthen controls and reduce risks of duplicate, erroneous, or fraudulent refunds associated with the manual refund process. As GAO acknowledged in the report, the IRS developed a corrective action plan to improve the controls over manual refunds in FY 2010, but due to the timing of when GAO conducted the testing of these controls, there was not sufficient time for the corrective actions to have been fully implemented and tested. As a result, the GAO concluded that significant progress had not been made and declared this a significant deficiency. The IRS is already seeing positive improvements as a result of the actions we have taken. While the number of manual refunds issued on individual accounts increased by over 15,000 between 2009 and 2010, the number of erroneous refunds issued decreased by 46 percent. The IRS expects to see continued improvement once all business areas implement the new established process. The IRS is committed to implementing all of the corrective actions we shared with GAO, and are confident that GAO will find significant progress has been made during the FY 2011 audit.

GAO also provided in the report examples of where the IRS had issued erroneous refunds related to the First-Time Home Buyers Credit (FTHBC). During FY 2010, the IRS took many corrective actions to substantially minimize the number of erroneous claims paid out. Through the compliance filter process alone, we have identified and audited approximately 300,000 claims in FY 2010 and prevented these erroneous refunds being issued. Additionally, the IRS has more than 130,000 claims in review with statuses yet to be determined. Given the complexity of tax administration and the time constraints the IRS faced implementing this legislation, it was impossible to either stop or address every potentially erroneous claim. The IRS will continue its aggressive approach to ensure the accuracy and legitimacy of FTHBC claims and continue to consider high risk claims that were not addressed during our pre-refund compliance and enforcement activities in our post-refund work selection. We will also rely on our comprehensive Recapture and Repayment Strategy using third party data to identify instances of non-compliance including and in addition to those identified in this report. We are confident that GAO will find significant progress has been made during the FY 2011 audit.

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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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