United States Government Accountability Office

GAO

Report to the Secretary of the Treasury

November 2008

FINANCIAL AUDIT

IRS's Fiscal Years 2008 and 2007 Financial Statements

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GAO-09-119

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Highlights

Highlights of GAO-09-119, a report to the Secretary of the Treasury

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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. 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 2008. GAO will continue to monitor IRS's progress in implementing the 147 recommendations that remain open as of the date of this report, of which 66 relate to the material weakness in information security.

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

To view the full product, including the scope and methodology, click on GAO-09-119. 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 2008 and 2007 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 rely on 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 or compliance with laws and regulations, and thus did not provide reasonable assurance that losses, misstatements, and noncompliance with laws and regulations material in relation to the financial statements would be prevented or detected on a timely basis.

IRS continued to make significant strides in addressing its financial management challenges and material weaknesses in internal control. Specifically, IRS's progress to address control deficiencies over the collection of unpaid taxes and the issuance of improper refunds is such that GAO no longer considers the remaining control deficiencies in this area to constitute a material weakness. Furthermore, during fiscal year 2008, IRS significantly improved internal controls that safeguard hard-copy taxpayer receipts and data at primary submission processing locations. These improvements, combined with prior years' progress, enabled GAO to conclude that remaining issues related to this activity no longer constitute a significant deficiency. IRS also continued to make progress in developing cost accounting information to capture the full cost of its operating activities, and in establishing a framework for implementing a subsidiary ledger for its tax administration activities. However, continued management commitment and sustained efforts are necessary to build on the significant progress made to date and to fully address remaining financial management challenges. These remaining challenges pertain to material weaknesses in IRS's control over financial reporting, management of unpaid tax assessments, and information security. Also, while GAO recognized improvements in controls over revenue collection and refund issuance, remaining issues over IRS's enforcement collection activities constituted a significant deficiency. Furthermore, GAO found that IRS was not always in compliance with the law concerning the timely release of tax liens.

IRS management faces serious challenges from its continued use of obsolete financial management systems that do not conform to the requirements of FFMIA. These challenges adversely affect IRS's ability to fulfill its responsibilities as the nation's tax collector because it is unable to routinely obtain comprehensive, timely, accurate, and useful information for day-to-day decision making. As IRS continues to progress toward ever more automated financial management processes, the presence of material weaknesses in controls over these systems, especially in the area of information security, could have serious implications for our future ability to determine whether IRS's financial statements are fairly stated.

Contents

Abbreviations

AMS	Account Management Services
ATFR	Automated Trust Fund Recovery
AUR	Automated Underreporter Program
CADE	Customer Account Data Engine
CDDB	Custodial Detail Data Base
CFO Act	Chief Financial Officers Act of 1990
EFTPS	Electronic Federal Tax Payment System
FFMIA	Federal Financial Management Improvement Act of 1966
FFMSR	*Federal Financial Management System Requirements*
FIA	Federal Managers' Financial Integrity Act of 1982
FISMA	Federal Information Security Management Act of 2002
IFS	Integrated Financial System
IRACS	Interim Revenue Accounting Control System
IRS	Internal Revenue Service
JFMIP	Joint Financial Management Improvement Program
OIC	Offers in Compromise
OMB	Office of Management and Budget
SGL	*U.S. Government Standard General Ledger*
TIGTA	Treasury Inspector General for Tax Administration

G A O

Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

November 10, 2008

The Honorable Henry M. Paulson, Jr.
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, 2008, and 2007. We performed our audits in accordance with the Chief Financial Officers (CFO) Act of 1990, as expanded by the Government Management Reform Act of 1994. This report contains our (1) unqualified opinions on IRS's financial statements, (2) opinion that IRS's internal controls were not effective as of September 30, 2008, (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, 2008.

Our unqualified opinions on IRS's fiscal years 2008 and 2007 financial statements were made possible in part by the continued extraordinary efforts of IRS senior management and staff to compensate for serious internal control and financial management systems deficiencies. IRS is currently in the midst of a major business systems modernization that is ultimately intended to resolve its most serious financial systems challenges. However, it is unclear when this effort will be completed or if it will be fully successful. In the interim, preparing reliable financial statements will continue to be a difficult challenge for IRS, requiring continued reliance on extraordinary compensating measures. To date, these measures have proved successful: for the ninth consecutive year, we have been able to render an unqualified opinion on IRS's financial statements.

IRS has made great strides over the last several years in addressing its financial management challenges and has resolved or substantially mitigated several material weaknesses and other less significant weaknesses in its internal control. This progress continued in fiscal year 2008. For example, in past years, we have reported a material weakness in IRS's internal control over tax revenue and refunds because IRS's controls were not fully effective in providing management the essential information it needs to make informed decisions on how best to optimize the use of the federal government's resources to collect tax revenues owed and minimize the risk of paying improper tax refunds. Over the last several years, IRS has taken significant steps to address the deficiencies comprising this material weakness. Specifically, IRS has (1) made substantial progress in enhancing its cost accounting capabilities with a goal to determine the full cost of its activities at the program level, (2) further enhanced its performance measures and developed return on investment information for the Earned Income Tax Credit program that includes full costs, (3) established corporate governance bodies that collectively represent significant progress in establishing an agencywide approach to managing its tax collection efforts, and (4) continued to implement sophisticated computer analysis and modeling techniques to assist its tax collection efforts. IRS's progress in addressing these issues has been such that we no longer consider the remaining internal control deficiencies related to revenue and refunds to constitute a material weakness.

However, the deficiencies that remain do constitute a significant deficiency in internal control over revenue and refunds that continues to hamper IRS's ability to optimize the use of its resources to collect unpaid taxes and minimize payment of improper refunds. Specifically, IRS has not developed performance metrics and goals on the cost of, and the revenue collected from, IRS's enforcement programs and activities, and IRS has not established and implemented the financial management structure and processes to provide it with key financial management data on costs and enforcement revenue.[1] Successfully addressing these issues is fundamental to IRS's ability to determine how it will ultimately apply cost and enforcement revenue information to the management of its various enforcement functions, especially the collection of unpaid taxes.

During our fiscal year 2008 audit, we also found that IRS significantly improved the internal control it relies on to safeguard hard-copy taxpayer receipts and data processed at its primary submission processing locations-service center campuses and lockbox banks. For example, IRS (1) strictly enforced its prohibition against employees bringing personal belongings into restricted receipt processing areas and strengthened controls to prevent unauthorized access to taxpayer receipts and

[1]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.

information, (2) better enforced and revised its operating procedures for processing hard-copy taxpayer receipts and data, and (3) verified that couriers transporting taxpayer deposits to depository institutions were on approved access lists and used appropriate vehicles. These improvements, combined with the progress we reported in previous audits,[2] enabled us to conclude that remaining issues related to safeguarding hard-copy taxpayer receipts and data no longer constitute a significant deficiency.

IRS has also made notable progress in addressing internal control issues related to other material weaknesses we have reported in past audits. For example, based on a series of cost pilot projects it completed during fiscal year 2008, IRS concluded that it has the capability to use the cost data within its Integrated Financial System (IFS) and the associated workload and production data from its business unit systems to calculate the full costs of its products, services, and programs. IRS produced cost information for three of its programs and plans to expand the availability of cost accounting information to other programs in future years. In fiscal year 2009, IRS plans to prioritize its products and services for which cost information is needed and develop the necessary processes to systematically produce full cost information to support management decision making. We commend IRS for the positive steps it has taken in developing a practical approach to use the cost information within IFS to systematically produce managerial cost accounting data. Moving expeditiously to determine its cost accounting priorities and develop the processes to routinely produce the associated cost accounting data will allow IRS to realize the full potential of its cost accounting capabilities.

IRS continued to make progress in its efforts to develop detailed subsidiary records for its tax activities, but much remains to be done on this multiyear effort. During fiscal year 2008, IRS instituted the use of trace identification numbers (trace ID) for revenue and refund transactions to provide detail transaction traceability for these activities. Such traceability is necessary to enable IRS to better ensure that its records are accurate, complete, and fully supported. We were able to verify the effectiveness of these trace IDs for refunds and for revenue processed through the Electronic Federal Tax Payment System (EFTPS). However, controls over trace IDs on non-EFTPS revenue transactions were not yet in place, and IRS continues to lack transaction traceability or effective subsidiary

[2]GAO, *Financial Audit: IRS's Fiscal Years 2007 and 2006 Financial Statements*, GAO-08-166 (Washington, D.C.: Nov. 9, 2007).

records for taxes receivable, which comprised over 81 percent of the assets and liabilities reported in its fiscal year 2008 balance sheet.

Among the most serious financial management issues still remaining to be addressed is the continued material weakness in IRS's information security. As IRS continues its efforts to modernize its financial and operational systems, it is critical that IRS take actions to establish and maintain effective information security controls on a continuing basis, through an ongoing cycle of risk management activities, to protect the processing, storage, and transmission of financial and sensitive data. Until IRS successfully manages its information security risks, management will not have adequate assurance of the integrity and reliability of the information generated from its financial management systems or its ability to effectively safeguard sensitive taxpayer information. In addition, as IRS continues to progress toward ever more automated financial management processes, options for alternate procedures to verify the accuracy of the information contained in these systems without relying on automated controls within them diminish. If IRS does not resolve this issue before these options are exhausted, it could have serious implications for our ability to determine whether IRS's financial statements are fairly stated.

IRS will need to fully address the remaining financial management issues caused by the limitations of its automated financial management systems. In formulating its strategy for dealing with these issues, IRS will need to address how it will apply cost information to its tax administration functions, including collection of taxes, payment of tax refunds, and management of unpaid tax assessments, which are accounted for in automated systems that are physically separate from the IFS that encompasses IRS's cost accounting capability. IRS has completed several pilot projects intended to explore ways of addressing this issue. In 1995, we designated financial management and systems modernization at IRS as high-risk areas.[3] We continue to consider these issues as high risk and include them in our Business Systems Modernization high-risk area.[4]

We commend IRS for the improvements it has continued to make in its financial processes and operations. The agency has made substantial progress in improving its financial management since our first attempt to

[3]GAO, *High-Risk Series: An Overview*, GAO/HR-95-1 (Washington, D.C.: Feb. 1995).

[4]GAO, *High-Risk Series: An Update*, GAO-07-310 (Washington, D.C.: Jan. 2007).

audit its financial statements in fiscal year 1992.[5] It is important that its financial management initiatives continue in order to achieve comprehensive and lasting financial management reform.

IRS also continues to face a significant challenge in strengthening its enforcement of the nation's tax laws, another challenge that we have designated as high risk.[6] As we have previously reported, the resources IRS has been able to dedicate to enforcing the tax laws have not kept pace with the increases it has seen in its enforcement workload. At the same time, IRS continues to face significant compliance-related issues, including combating abusive tax shelters and tax schemes, on which it is placing a high priority. Critical to IRS's efforts to improve enforcement and, ultimately, taxpayer compliance, is the need to have current and reliable information on the rate of compliance, both overall and by type of taxpayer. IRS is in the process of completing a new study of the rate of compliance with the nation's tax laws by individual taxpayers for tax years 2006 and 2007, and is conducting a similar study of S-Corporations.[7] IRS expects initial compliance rate estimates from the S-Corporation and tax year 2006 individual reporting study during fiscal year 2009. Additionally, although IRS has made significant progress as discussed above, the continued lack of readily available cost benefit information for most programs and activities, will hamper IRS's ability to make the most effective use of the information ultimately acquired from these studies to enable IRS to better fulfill its mission.

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.

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

[5]GAO, *Financial Audit: Examination of IRS' Fiscal Year 1992 Financial Statements*, GAO/AIMD-93-2 (Washington, D.C.: June 30, 1993).

[6]GAO-07-310.

[7]An S-corporation is a corporation with a limited number of stockholders (100 or fewer) that elects not to be taxed as a regular corporation and meets certain other requirements.

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, 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, DC 20548

To the Commissioner of Internal Revenue

In accordance with the Chief Financial Officers (CFO) Act of 1990, as expanded by the Government Management Reform Act of 1994,[1] this report presents the results of our audits of the financial statements of the Internal Revenue Service (IRS) for fiscal years 2008 and 2007. The financial statements report the assets, liabilities, net position, net costs, changes in net position, budgetary resources, and custodial activity related to IRS's administration of its responsibilities for implementing federal tax legislation. The financial statements do not include an estimate of the amount of taxes that are owed the federal government but have not been paid by taxpayers, often referred to as the tax gap,[2] nor do they include information on tax expenditures.[3]

Based on our audits, we found that

- IRS's financial statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles,
- IRS's internal controls were not effective as of September 30, 2008,
- IRS did not comply with one of the legal provisions we tested, and
- IRS's financial management systems were not in substantial compliance with the requirements of the Federal Financial Management Improvement Act of 1996 as of September 30, 2008.

In its role as the nation's tax collector, IRS has a demanding responsibility in collecting taxes, processing tax returns, and enforcing the nation's tax laws. IRS is a large and complex organization, posing unique operational challenges for management. IRS employs tens of thousands of people in its

[1] CFO Act of 1990, Pub. L. No. 101-576, 104 Stat. 2838 (Nov. 15, 1990); Government Management Reform Act of 1994, Pub. L. No. 103-356, 108 Stat. 3410 (Oct. 13, 1994).

[2] IRS includes an estimate of the tax gap in its Management Discussion and Analysis and 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.

Washington, D.C., headquarters, 10 service center campuses, 3 computing centers, and numerous other field offices throughout the United States. In fiscal years 2008 and 2007, IRS collected about $2.7 trillion in tax payments, processed hundreds of millions of tax and information returns; and paid about $426 billion and $292 billion, respectively, in refunds to taxpayers.

One of the more significant challenges continuing to face IRS is the ability to routinely provide management the appropriate information it needs to make fully informed day-to-day decisions and ensure accountability, which is a primary objective of the CFO Act. During fiscal year 2008, IRS continued to make progress in modernizing its financial management capabilities, and continued to make strides in addressing its financial management challenges. IRS nonetheless continued to confront many of the internal control weaknesses that we have reported in prior audits. In fiscal year 2008, for the ninth consecutive year, IRS was able to produce financial statements covering its tax administration and nontax administrative activities that are fairly stated in all material respects. However, until IRS resolves the issues affecting the automated systems it relies on to process tax-related transactions, it will continue to be challenged to sustain the level of effort needed to produce reliable financial statements in a timely manner.

During fiscal year 2008, IRS continued to make significant progress in its efforts to address long-standing weaknesses in control over several critical areas, including collections of unpaid taxes and disbursements of improper tax refunds, security over hard-copy taxpayer receipts and data, management of unpaid tax assessments, and reliability of financial reporting.

For example, in past years, we have reported a material weakness[4] in IRS's internal control over tax revenue and refunds because IRS's controls were not fully effective in providing management the essential information it needs to make informed decisions on how best to maximize the federal

[4]A material weakness is a significant deficiency, or a combination of significant deficiencies, that result in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected.

government's ability to collect tax revenues owed and minimize the risk of paying improper tax refunds. We reported that IRS did not have agencywide cost-benefit information; related cost-based performance measures; or an agencywide, systematic approach to ensure it was maximizing the use of its tax collection resources. To address these issues, IRS has in recent years (1) made significant progress in cost accounting by developing a cost accounting policy that provides guidance on managerial cost concepts for the agency, establishing an Office of Cost Accounting within the Chief Financial Officer's organization to implement IRS's cost accounting policy throughout the agency, and completing several cost pilot projects to demonstrate the viability of its methodology for determining full cost at the program level, (2) further enhanced its performance measures and completed development of return on investment information for the Earned Income Tax Credit program that includes full costs, (3) established corporate governance bodies that collectively represent significant progress in establishing an agencywide approach to managing its tax collection efforts, and (4) improved its management of tax collection efforts by continuing to implement sophisticated computer analysis and modeling to prioritize and focus its collection activities. IRS's progress in further addressing these issues during fiscal year 2008 has been such that we no longer consider the remaining internal control deficiencies to constitute a material weakness.

However, the deficiencies that remain constitute a significant deficiency in internal control over revenue and refunds that continues to hamper IRS's ability to optimize the use of its resources to collect unpaid taxes and minimize payment of improper refunds. IRS has not developed performance metrics or goals on the cost and benefits, including enforcement tax revenue collected from IRS's enforcement programs and activities,[5] and IRS has not established the financial management structures and processes to provide it with key financial management data on costs and enforcement revenue. Addressing these issues successfully is fundamental to IRS's ability to determine how it will ultimately apply cost and enforcement revenue information to its various tax law enforcement functions, especially the collection of unpaid taxes.

In addition, during our fiscal year 2008 audit, we found that IRS significantly improved its internal control to safeguard hard-copy taxpayer

[5]One exception is the Earned Income Tax Credit program for which IRS has developed such metrics.

receipts and data processed at its primary submission processing locations–service center campuses and lockbox banks.[6] For example, IRS (1) strictly enforced its prohibition against employees bringing personal belongings into restricted receipt processing areas and strengthened control to prevent unauthorized access to taxpayer receipts and information, (2) better enforced and revised its operating procedures for processing hard-copy taxpayer receipts and data, and (3) ensured that couriers transporting taxpayer deposits to depository institutions were on approved access lists and used appropriate vehicles. These improvements, combined with the progress we reported in previous audits, enabled us to conclude that remaining issues related to internal control over hard-copy taxpayer receipts and data no longer constitute a significant deficiency.

However, although levels of electronic filing of returns have been steadily increasing, IRS nevertheless continues to receive and process millions of hard-copy tax returns each year, along with hundreds of billions of dollars of associated payments. As long as IRS continues to receive such large volumes of hard-copy taxpayer receipts and data, there will continue to be a significant risk to the government and taxpayers alike that loss of receipts or inappropriate disclosure 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 those internal controls to verify that they do not deteriorate over time.

During fiscal year 2008, IRS continued to enhance the capabilities of its Custodial Detail Data Base (CDDB), which is ultimately intended to serve as a subsidiary ledger for IRS's tax administration activities, including tax revenue receipts, tax refund disbursements, and unpaid tax debt. An effective detailed subsidiary ledger is an important tool to help insure that reported balances are accurate, complete, and supported by underlying detailed records. IRS plans to achieve this goal through CDDB by

[6]Lockbox banks are commercial banks that operate under contract with the Financial Management Service to provide tax receipt processing and deposit services on behalf of IRS.

analyzing and linking account information in IRS's master files[7] to its general ledger for tax administration activities. In fiscal year 2008, IRS enhanced CDDB to begin regularly recording unpaid assessments, including accrued penalties and interest, from its master files to its general ledger by the various financial reporting categories (taxes receivable, compliance assessments, and write-offs).[8] These enhancements established CDDB's capability to function as a subsidiary ledger for unpaid tax debt. However, due to inherent limitations in CDDB programs for classifying unpaid assessments into the correct financial reporting categories and inaccuracies in taxpayer records, IRS is still unable to use CDDB as its subsidiary ledger for external reporting of its unpaid assessments, and must continue to use a labor-intensive, manual compensating process to estimate the year-end balances of the various categories of unpaid tax assessments to avoid material misstatements to its financial statements. For example, IRS had to make over $28 billion in adjustments to the fiscal year-end 2008 gross taxes receivable balance produced by CDDB as a result of its manual estimation process for financial reporting. Full operational capability of CDDB depends on the successful implementation of future system releases planned through 2009 and the ability of these releases to address current limitations in accurately classifying all of IRS's unpaid assessments.

In addition, IRS devoted significant resources to addressing the lack of adequate audit trails we reported in prior years for its most material tax-related balances, including tax revenue, tax refunds, and taxes receivable. To address this issue, during fiscal year 2008, IRS instituted the use of trace identification numbers (trace ID) for revenue and refund transactions in order to provide this traceability from its general ledger for

[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. There are several master files, the most significant of which are the individual master file, which contains tax records of individual taxpayers, and the business master file, which contains tax records of corporations and other businesses.

[8]On the basis of federal accounting standards, unpaid tax assessments are classified into one of the following three categories: (1) federal taxes receivable, which are taxes due from taxpayers for which IRS can support the existence of a receivable through taxpayer agreement or a favorable court ruling; (2) compliance assessments where neither the taxpayer nor the court has affirmed that the amounts are owed; and (3) write-offs, which 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 accounts, are reported on the financial statements.

tax transactions back to source documentation and throughout IRS's financial management system. For tax refunds, as well as for tax revenue transactions processed through the Electronic Federal Tax Payment System (EFTPS),[9] we were able to verify that these trace IDs were effective in providing transaction traceability. However, we also found that for tax revenue transactions processed outside of EFTPS, the transactions required manual transcription of the trace IDs by IRS employees for input to the general ledger, which entailed a significant inherent risk of human error. As of September 30, 2008, IRS had not instituted controls to prevent or detect and correct such transcription and input errors. In addition, as noted above, IRS's reported balance for federal taxes receivable on its balance sheet was based on statistical sampling and thus was not recorded in the general ledger. As a result, IRS's general ledger for tax transactions continues to lack traceability for material tax transactions reported in its financial statements.

During fiscal year 2008, IRS continued to expand its processing capabilities of individual tax returns through its Customer Account Data Engine (CADE), the system IRS is implementing to replace its master files. Two updates to CADE released in January and July 2008 added several new tax forms and schedules to its functionality. However, longer term challenges to CADE's success remain, including the ability to access historical taxpayer account information currently residing on the master files, as well as the ability to handle processing capacity and data storage requirements to meet future operational needs. During fiscal year 2008, CADE processed 30.6 million tax returns, including 29 million returns that generated tax refunds totaling $62.3 billion, of which $18.2 billion were disbursed under the Economic Stimulus Act of 2008.[10] However, for fiscal year 2008, this still represented only about 15 percent of the total refunds disbursed, and CADE did not process any of the over $2.7 trillion in tax

[9]EFTPS is an automated tax payment system that allows taxpayers to make federal tax payments electronically, and processes deposit data related to payroll and other taxes paid by federal agencies through the Federal Agency Tax Payments and Returns II System. By law, businesses with employment or other depository taxes that exceed $200,000 annually are required to use EFTPS. 26 U.S.C. § 6302(h), 26 C.F.R. § 1-6302(h).

[10]Pub. L. No. 110-185, § 101, 122 Stat. 613, 613-17 (Feb. 13, 2008)(*codified at* 26 U.S.C. § 6428). The act included provisions to help stimulate the economy, such as the 2008 disbursement to eligible taxpayers of recovery rebates (i.e., tax refunds) of up to $600 for individuals and $1,200 for couples, with an additional $300 for each child. Pursuant to the act, IRS disbursed refunds totaling about $94 billion, or about 22 percent of all refunds disbursed by IRS during fiscal year 2008.

revenue IRS collected. It is unclear when IRS will be able to rely on CADE to process all tax collections and related tax refunds.

While IRS has made notable improvements throughout fiscal year 2008, control deficiencies over financial reporting and management of unpaid tax assessments continued to represent material weaknesses. These weaknesses are caused primarily by IRS's continued reliance on outdated automated systems to provide the financial information that management needs to make well-informed decisions, and similar weaknesses and problems will continue to exist until these legacy systems are replaced. In addition, we continue to consider issues related to information security to be a material weakness. The persistent, serious deficiencies in information security increase the risk that confidential IRS and taxpayer information will be compromised, and have serious implications related to the reliability of financial management information produced by IRS's systems. 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 we, as IRS's auditors, will continue to be unable to rely on the automated controls built into these systems to obtain assurance that the reported balances generated by them are reliable. Opportunities for us to use the types of alternate audit procedures we have applied in the past to compensate for this condition, such as reviewing comparisons between automated systems and utilizing remaining hard-copy records, are diminishing as IRS's modernization efforts progress. If IRS does not resolve its information security material weakness before these options disappear, it could have serious implications for our ability to determine whether IRS's financial statements are fairly stated.

In addition, as IRS continues to implement the modernization of its computer-based administrative processes, care is needed to ensure that paperless transactions using electronic signatures are appropriately implemented. As part of the Office of Management and Budget's (OMB) implementation of the Government Paperwork Elimination Act, OMB has issued procedures and guidance cautioning agencies to carefully control access to electronic data associated with paperless transactions. [11]

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, net position, net costs, changes in net position, budgetary resources, and custodial activity as of, and for the fiscal years ended, September 30, 2008, and September 30, 2007.

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

IRS's financial statements include tax revenues collected during the fiscal year as well as the total unpaid taxes for which IRS and the taxpayers or courts agree on the amounts owed. Cumulative unpaid tax assessments for which there is no future collection potential or for which there is no agreement on the amounts owed are not reported in the financial statements. Rather, they are reported as write-offs and compliance assessments, respectively, in required supplemental information to IRS's financial statements. Also, in conformity with U.S. generally accepted accounting principles, to the extent that taxes owed in accordance with the nation's tax laws are not reported by taxpayers and are not identified through IRS's various enforcement programs, they are not reported in the financial statements nor in required supplemental information to the financial statements. Additionally, in conformity with U.S. generally accepted accounting principles, tax expenditures, which represent the amount of revenue the government forgoes resulting from federal tax law provisions that (1) allow a special exclusion, exemption, or deduction from gross income, or (2) provide a special credit, preferential rate, or deferred tax liability, are not reported in the financial statements but rather are presented as other accompanying information.

[11]See Government Paperwork Elimination Act, Pub. L. No. 105-277, div. C, tit. XVII, 112 Stat. 2681, 2681-749 (Oct. 21, 1998)(*codified at* 44 U.S.C. § 3504); see also 65 Fed. Reg. 25,508 (May 2, 2000), and OMB procedures and guidance to implement the Government Paperwork Elimination Act.

Opinion on Internal Control

Because of the material weaknesses in internal control discussed below, IRS did not maintain effective internal control over financial reporting (including safeguarding of assets) or compliance with laws and regulations, and thus did not provide reasonable assurance that losses, misstatements, and noncompliance with laws material in relation to the financial statements would be prevented or detected on a timely basis. Our opinion is based on criteria established under 31 U.S.C. § 3512 (c), (d), commonly referred to as the Federal Managers' Financial Integrity Act of 1982 (FIA), and OMB Circular No. A-123, *Management's Responsibility for Internal Control.*

Despite its material weaknesses in internal control and its systems deficiencies, IRS was able to prepare financial statements that were fairly stated in all material respects for fiscal years 2008 and 2007. Nonetheless, IRS continues to face the following key issues that represent material weaknesses in internal control:

- weaknesses in controls over the financial reporting process, resulting in IRS not (1) being able to prepare its balance sheet without extensive compensating procedures and (2) having current and reliable ongoing cost information to support management decision making and to prepare cost-based performance measures;

- weaknesses in controls over unpaid tax assessments, resulting in IRS's inability to properly manage unpaid tax assessments and leading to increased taxpayer burden; and

- weaknesses in information security controls, resulting in increased risk of unauthorized individuals accessing, altering, or abusing proprietary IRS programs and electronic data and taxpayer information.

These material weaknesses in internal control may adversely affect any decision by IRS's management that is based, in whole or in part, on information that is inaccurate because of these deficiencies. In addition, unaudited financial information reported by IRS, including budget information, may also contain misstatements resulting from these deficiencies. The issues encompassed by these material weaknesses were reflected in the material weaknesses reported by IRS in its fiscal year 2008 FIA assurance statement to the Department of the Treasury.

In addition to the material weaknesses discussed above, we identified one internal control deficiency that although not a material weakness, represents 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. This deficiency entails weaknesses in IRS's control over tax revenue and refunds. IRS's controls were not fully effective in providing IRS management information to assist it in making more informed decisions on how best to maximize the federal government's ability to collect tax revenues owed and minimize the risk of paying improper tax refunds. IRS encompassed the issues comprising this significant deficiency in its fiscal year 2008 FIA assurance statement to the Treasury.

We have reported on these material weaknesses and the significant deficiency in prior audits and have provided IRS recommendations to address these issues.[12] One hundred and forty-seven recommendations were still open as of the date of this report, of which 66 relate to the material weakness in information security. IRS continues to make strides in resolving these matters. We will follow up in future audits to monitor IRS's progress in implementing these recommendations. For more details on these issues, see appendix I.

We also identified less significant weaknesses in IRS's system of internal control and its operations. We will be reporting on these matters to IRS separately.

Compliance with Laws and Regulations

Our tests of compliance with selected provisions of laws and regulations disclosed one area of noncompliance that is reportable under U.S. generally accepted government auditing standards and OMB guidance. This area relates to IRS not releasing federal tax liens against taxpayers' property on time.[13] 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 or OMB audit guidance. 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. For more details on these issues, see appendix I.

[12]GAO, *Internal Revenue Service: Status of GAO Financial Audit and Related Financial Management Report Recommendations*, GAO-08-693 (Washington, D.C.: July 2, 2008).

[13]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).

Systems Compliance with the Requirements of FFMIA

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, 2008.[14] Specifically, IRS's systems did not substantially comply with *Federal Financial Management System Requirements* (FFMSR), federal accounting standards (U.S. generally accepted accounting principles), and the *U.S. Government Standard General Ledger* (SGL) at the transaction level. Our conclusion is based on criteria established under FFMIA; OMB Circular No. A-127, *Financial Management Systems*[15] (which includes the Joint Financial Management Improvement Program (JFMIP)/OMB series of system requirements documents); U.S. generally accepted accounting principles; and the SGL.[16]

The issues resulting in IRS's lack of substantial compliance with the requirements of FFMIA relate to the material weaknesses discussed above, and were reflected in the material weaknesses reported in IRS's fiscal year 2008 FIA assurance statement to Treasury. IRS's FFMIA remediation plan details its planned corrective actions for the weaknesses that render its financial management systems noncompliant with the requirements of FFMIA. For more details on these issues, see appendix I.

Consistency of Other Information

IRS's Management Discussion and Analysis and other required supplementary and other accompanying information contain a wide range of data, some of which are 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

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

[15]OMB, Circular No. A-127, *Financial Management Systems* (Washington, D.C.: Dec. 1, 2004). FFMSR require application of the SGL at the transaction level and state that conformance requires, among other items, that transaction detail for SGL accounts be readily available in the financial management systems and directly traceable to specific SGL account codes.

[16]JFMIP was originally formed under the authority of the Budget and Accounting Procedures Act of 1950 as a cooperative undertaking of OMB, Treasury, Office of Personnel Management, and GAO, working in cooperation with each other and with operating agencies to improve financial management practices in the federal government. On December 1, 2004, JFMIP ceased to exist as a separate organization, with OMB's Office of Federal Financial Management assuming many JFMIP functions.

inconsistencies with the financial statements, U.S. generally accepted accounting principles, or OMB guidance.

Objectives, Scope, and Methodology

Management is responsible for (1) preparing the annual financial statements in conformity with U.S. generally accepted accounting principles; (2) establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of 31 U.S.C. § 3512 (c), (d) (FIA) are met; (3) complying with applicable laws and regulations; and (4) ensuring that IRS's financial management systems substantially comply with the requirements of FFMIA.

We are responsible for obtaining reasonable assurance about whether (1) the financial statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, and (2) management maintained effective internal controls, the objectives of which are the following:

- Financial reporting—transactions are properly recorded, processed, and summarized to permit the preparation of financial statements in conformity with U.S. generally accepted accounting principles and assets are safeguarded against loss from unauthorized acquisition, use, and disposition.
- Compliance with laws and regulations—transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements and any other laws, regulations, and governmentwide policies identified by OMB audit guidance.

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 laws for which OMB audit guidance requires testing, (2) testing whether IRS's financial management systems substantially comply with the three requirements of FFMIA, and (3) performing limited procedures with respect to certain other information appearing in these annual financial statements. For more details on our methodology and the laws and regulations we tested, see appendix II.

We did not evaluate all internal control relevant to operating objectives as broadly defined by FIA, such as controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to testing controls over financial reporting and compliance with laws and regulations. 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 had a direct and material effect on the financial statements or that were required to be tested by OMB audit guidance that we deemed applicable to IRS's financial statements for the fiscal year ended September 30, 2008. We considered the material weaknesses identified above in determining the nature, timing, and extent of our audit procedures on IRS's fiscal years 2008 and 2007 financial statements. We caution that noncompliance may occur and not be detected by these tests and that such testing may not be sufficient for other purposes. We performed our work in accordance with U.S. generally accepted government auditing standards and OMB audit guidance.

Agency Comments and Our Evaluation

In responding to this report, IRS stated that it was dedicated to improving financial management, and noted its significant accomplishments in addressing related challenges, including (1) completing required Federal Information Security Management Act activities, including contingency plan testing on 247 applications and systems and live disaster recovery tests for all major applications, (2) achieving a 35 percent reduction in Trust Fund Recovery Penalty cross reference errors using CDDB reports, and classifying $27 billion (77 percent) of the $35 billion in TFRP inventory, and (3) implementing a 20 digit trace-ID in all payment systems which enables CDDB to identify each individual tax revenue payment to support traceability to IRACS.

IRS also recognized that information security continues to be a significant issue, and noted that it established an Office of Online Fraud Detection and Prevention to address evolving online threats affecting IRS and taxpayers. IRS also noted that it developed a corrective action plan to address information technology security training, systems auditing, access controls, system security configuration control, and systems disaster recovery. Additionally, IRS noted that it is continuing its assessments of business processes to address identity protection and that it analyzed the use of social security numbers for reduction and elimination where possible.

Finally, IRS recognized that challenges remain, but noted that it has a solid management team that is dedicated to promoting the highest standards of financial management, and continues to increase the focus on information security and internal control while improving financial reporting.

The complete text of IRS's response is included in appendix III.

Steven J. Sebastian
Director
Financial Management and Assurance

November 5, 2008

Management Discussion and Analysis

The Internal Revenue Service
FY 2008 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 approximately $2.74 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…" The roots of the IRS go back to the Civil War when President Lincoln and the Congress, in 1862, 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
The IRS will fund America's future by strengthening our system of voluntary tax compliance.

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 business related taxes, examination of returns, taxpayer assistance, as well as oversight of the tax-exempt organization and the Earned Income Tax Credit program, one of the nations largest federally administered means-tested benefits programs.

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 2008 Statistics	
Total Revenue Collected	$2.74 trillion
Total Enforcement Revenue Collected	$56.4 billion
Total Refunds	$426 billion
Economic Stimulus Payments Facts	
• Number of Payments Issued	116.2 million
• Total Payments	$94.3 billion
• Number of Assistor Calls Answered	5.5 million
• Number of Automated Calls Answered	21.9 million
• "Where's My Stimulus Payment?" Usage	38.7 million
Number of Hits on IRS.gov	2.2 billion
Number of Returns Filed	249.8 million
"Where's My Refund?" Usage	39.2 million
Number of Taxpayers Assisted	99.3 million
Number of Returns Filed Electronically	98.8 million

Financial Resources
The IRS FY 2008 budget was $10.9 billion in direct appropriations, supplemented by $196.1 million in user fee revenue and $140.2 million in reimbursable resources for a total operating level of $11.2 billion. The IRS also received $202 million in FY 2008 supplemental funding to execute the Economic Stimulus Program.

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
Department of the Treasury
Internal Revenue Service

SERVING THE NATION'S TAXPAYERS
STRATEGIC PLAN FRAMEWORK

Mission

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

GOALS AND OBJECTIVES

IMPROVE TAXPAYER SERVICE

- Improve service options for the tax paying public
- Facilitate participation in the tax system by all sectors of the public
- Simplify the tax process

ENHANCE ENFORCEMENT OF THE TAX LAW

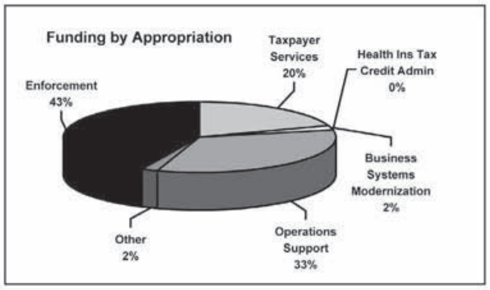
- Discourage and deter non-compliance with emphasis on corrosive activity by corporations, high-income individual taxpayers and other contributors to the tax gap
- Ensure that attorneys, accountants and other tax practitioners adhere to professional standards and follow the law
- Detect and deter domestic and off-shore based tax and financial criminal activity
- Deter abuse within tax-exempt and governmental entities and misuse of such entities by third parties for tax avoidance or other unintended purposes

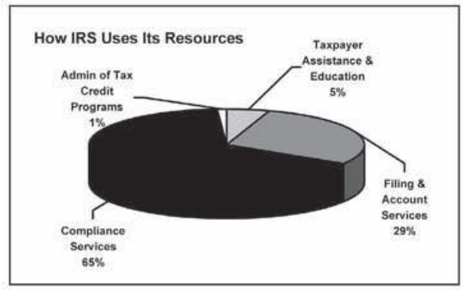
MODERNIZE THE IRS THROUGH ITS PEOPLE, PROCESSES, AND TECHNOLOGY

- Increase organizational capacity to enable full engagement and maximum productivity of employees
- Modernize information systems to improve service and enforcement
- Ensure the safety and security of people, facilities and information systems
- Modernize business processes and align the infrastructure support to maximize resources devoted to frontline operations

Service + Enforcement = Compliance

IRS RESOURCES





Funding by Appropriations ($ thousands)

In FY 2008, the three core operating appropriations were allocated as shown below:

- **Taxpayer Services** *[$2,140,365]* funds processing tax returns and related documents, assistance for taxpayers in filing returns and paying taxes due.
- **Enforcement** *[$4,780,000]* 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** *[$3,689,694]* 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** *[$267,090]* funds capital asset acquisitions of information technology systems to modernize key tax administration systems.
- **Health Insurance Tax Credit Administration** *[$15,235]* funds the administration of the Health Coverage Tax Credit (HCTC).
- **Other: Mandatory Appropriation (Special Funds): User Fees** *[$196,145]* financed by payment for goods and services provided and **Private Collection Agency** *[$13,428]* collection fees.

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 costs 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 Services** activities include pre-filing agreements, document matching, examination, collection, and criminal investigation activities.
- **Administration of Tax Credit Programs** includes costs for EITC and HCTC program activities.

The following table shows comparative data on the use of IRS resources by major programs:

Use of Resources ($ thousands)		
Program	FY 2008	FY 2007
Taxpayer Assistance and Education	$622,852	$478,663
Filing and Account Services	$3,601,581	$3,640,565
Compliance Services	$8,136,464	$7,701,812
Administration of Tax Credit Programs	$184,344	$190,881

3

2009-2013 Strategic Plan Update

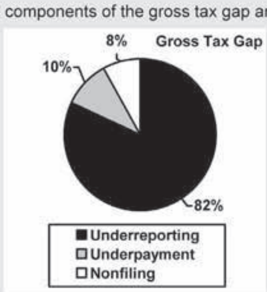
In FY 2008, the IRS updated its Strategic Plan to identify the goals and objectives to guide the agency from FY 2009 through FY 2013. The plan incorporates key trends shaping tax administration, including increasing international activities, and continues to focus on the goals of improving taxpayer service and enforcing the tax laws. The goals are supported by a strategic foundation that includes the critical areas of human capital management and information technology. The new strategic plan will guide the agency in its mission to provide America's taxpayers top-quality services by helping them understand and meet their tax responsibilities and enforce the law and with integrity and fairness to all.

The Tax Gap

The gross tax gap is the difference between the total tax imposed on taxpayers by law for a given tax year and the amount of that tax liability that is paid on time. The IRS estimates the gross tax gap is $345 billion for 2001. The net tax gap estimate is:

Net Tax Gap	
Gross Tax Gap	$345 billion
Enforced and Other Late Payments	$55 billion
Net Tax Gap	**$290 billion**

The components of the gross tax gap are:

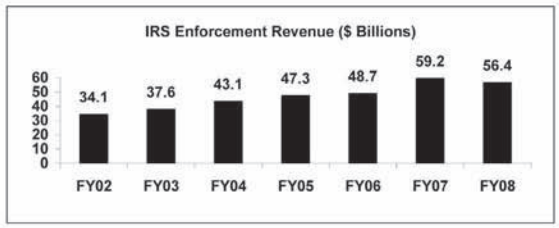


The IRS remains committed to finding ways to increase compliance and reduce the tax gap, while minimizing the burden on the vast majority of taxpayers who pay their taxes accurately and on time.

Fiscal Year (FY) 2008 Performance

For FY 2008, the IRS achieved an overall success rate of 75% in meeting or exceeding the targets for 24 of its 32 performance measures. This is an improvement over the 62% success rate achieved in FY 2007. In FY 2008, 67% of the Taxpayer Service targets (8 of 12), 78% (14 of 18) of the Enforcement targets and 100% (2 of 2) of its Business System Modernization targets were achieved. Detailed information on performance is contained in Appendix B, Performance Data; and Appendix C, Explanation of Shortfalls.

Collections related to enforcement activities totaled $56.4 billion, a 65% increase over FY 2002.



In FY 2008, the IRS expanded its ongoing research studies of filing, payment and reporting compliance, including the National Research Program, to provide a comprehensive picture of overall taxpayer compliance levels. Research allows the IRS to target specific areas of noncompliance to improve voluntary compliance and allocate resources more effectively to reduce the tax gap. Improved research data also refine the workload selection models to reduce audits of compliant taxpayers and ultimately help the IRS achieve high rates of return from its enforcement programs. The reporting compliance study for individual taxpayers that will provide updated and more accurate audit selection tools was launched in 2007 and continued in 2008. It is the first of an ongoing series of individual studies using a multi-year rolling methodology. The study examined more than 13,000 randomly selected tax year 2006 individual audits. Similar sample sizes will be used in subsequent tax years. This new method will allow the IRS to combine results over rolling three-year periods to make annual updates to its voluntary compliance estimates after the initial three annual studies.

As part of its continuing effort to measure the burden associated with meeting Federal tax obligations, the IRS surveyed both individual and self-employed taxpayers to measure time and expense in meeting filing requirements for small-business taxpayers who file both income and employment tax returns. Results of the surveys will be used to develop updated burden estimate models for release in FY 2009.

Strategic Goal
Improve Taxpayer Service

OBJECTIVES

- ***Improve Service Options for the Tax Paying Public***
- ***Facilitate Participation in the Tax System by All Sectors of the Public***
- ***Simplify the Tax Process***

Taxpayer Assistance Facts

The IRS continued to improve services through automation, outreach, and education of taxpayers. In FY 2008, taxpayers used the IRS website, IRS.gov, in record numbers to get current information. Changes to the Alternative Minimum Tax (AMT) provisions and passage of the Economic Stimulus Act of 2008 required the IRS to develop new web applications, including Economic Stimulus Payment calculators and "Where's My Stimulus Payment?," to provide timely information to taxpayers. IRS.gov usage increased significantly in FY 2008 from FY 2007:

- Nearly 2.2 billion web pages were viewed, an increase of 63%;
- More than 39.2 million taxpayers used "Where's My Refund?," an increase of 22% and over 317,000 used the new Spanish version;
- Over 38.7 million taxpayers used "Where's My Stimulus Payment?" to check on the status of their payment;
- Released tax publications in more languages, including Chinese, Russian, Korean, and Vietnamese;
- Implemented an automated message to inform taxpayers about the estimated wait time to reach a telephone assistor;
- Launched an electronic Publication 17, *Your Federal Income Tax*, on IRS.gov; and,
- Implemented "My IRS Account," a self-service internet application that allows taxpayers access to information about their past filings.

Improve Taxpayer Service

Helping taxpayers understand their tax reporting and payment obligations is the cornerstone of taxpayer compliance. In FY 2008, the IRS met or exceeded 67% (8 of 12) of the Taxpayer Service performance targets.

In FY 2008, the IRS continued to improve taxpayer service, including efforts to increase the number of taxpayers using electronic filing. New forms and schedules were added to the business electronic portfolio; the number and use of volunteers to assist taxpayers in meeting filing requirements increased; communication with external stakeholder organizations improved with the introduction of feedback loops; and, the IRS continued to conduct national phone forums with practitioners to discuss important tax issues affecting taxpayer groups.

Highlights of the 2008 Filing Season

The 2008 filing season was challenging because of late enactment of the AMT legislation and implementation of the Economic Stimulus Payment program. Despite these challenges, the IRS delivered another successful filing season. Results of the 2008 filing season include:

- Processed 155.6 million individual returns including returns filed solely to claim an economic stimulus payment, an increase of 11% and issued 107.6 million refunds totaling $369 billion;
- Answered over 40.4 million calls, an increase of 21% because of a large number of taxpayer inquiries about the economic stimulus checks;
- Completed 52 million automated calls, an increase of over 123%;
- Maintained Account and Tax Law Accuracy rates of over 90%;
- Expanded partnerships with nonprofit and community organizations, opening approximately 12,000 free tax preparation sites nationwide. Volunteers at these sites prepared 3.5 million returns for low-income and elderly taxpayers, an increase of 33%; and,
- Expanded return preparation at the IRS Taxpayer Assistance Centers preparing over 575,000 returns, a 42% increase over last year.

Increased electronic filing over 2007:

- Individual returns electronically filed surpassed 63% (excluding taxpayers who filed solely to claim a stimulus payment);
- Total number of individual returns filed electronically reached 89.6 million, up 12%;
- Business returns electronically filed reached 19.4%;
- Home-computer filing increased to 26.8 million returns, a 20% increase over 2007; and,
- Tax professional use of e-file increased to 61.8 million returns, an increase of 8% over last year.

Over 4.7 million tax returns were prepared and submitted through the IRS Free File in FY 2008, a 23% increase over FY 2007. Free file continues to be a popular option for taxpayers who qualify. A recent survey showed 96% of those who used the program found it "easy to

Economic Stimulus Payment (ESP)

In January 2008, the Economic Stimulus Act of 2008 provided economic stimulus payments to over 130 million American households. Taxpayers were entitled to payment of up to $600 ($1,200 if filing a joint return) plus an additional $300 for each qualifying child. The IRS sent notices to 132.9 million taxpayers to alert them of their potential eligibility and generated publicity to ensure stimulus payments reached the widest possible audience. The IRS implemented ESP soon after its enactment in February 2008, allowing Treasury to begin depositing payments in taxpayer bank accounts and mailing checks to taxpayers beginning **55** workdays after passage of the legislation.

Taxpayers filed a 2007 tax return to claim the payment, and the IRS used that information to determine eligibility and calculate the amount of the stimulus payment.

To ensure taxpayers understood the legislation and received their payments as quickly as possible, the IRS:

- Developed announcements, self-service telephone and web applications, and a stimulus telephone hotline taxpayers could use to ascertain the status of their payment; and,
- Launched an information center on IRS.gov dedicated to the stimulus payments that included features such as a frequently asked questions section, a stimulus payment calculator, and a "Where's My Stimulus Payment?" application.

To reach those taxpayers who did not have a filing requirement, the IRS mailed over 25.6 million information packages to inform social security recipients and disabled veterans about the payments.

On March 29, 2008 the IRS held "Super Saturday," a day devoted to getting the word out about the program and assisting people in filing for the stimulus payment. Super Saturday successes include:

- Assisted over 22,600 taxpayers
- Prepared more than 11,000 returns, including over 8,900 returns solely to claim a stimulus payment
- Answered 24,000 telephone calls

use;" 98% said they would recommend Free File to a friend or family member; and 95% said they would use it again.

Taxpayer Education and Outreach

The IRS enhanced its outreach and educational services through partnerships with the public to increase understanding and compliance with the tax law. Free tax seminars were offered to groups of people sharing common tax interests.

The IRS partners with organizations such as state taxing authorities and volunteer groups to serve taxpayer needs. Through its 4,991 Volunteer Income Tax Assistance and 6,849 Tax Counseling for the Elderly sites, the IRS provided free tax assistance to the elderly, disabled, and limited English proficient individuals and families. The over 78,000 volunteers located at these sites filed over 3.5 million returns, a 33% increase over FY 2007.

The IRS also reached out to those taxpayers eligible for the Earned Income Tax Credit (EITC), implementing a vigorous multi-dimensional outreach strategy that included:

- Creating EITC products and services designed to target underserved groups such as rural taxpayers, childless workers, and the limited English proficient filers;
- Conducting a second EITC Awareness Day that generated extensive national and local media coverage designed to expand education of the public on EITC and increase the participation of eligible taxpayers; and,
- Increasing free EITC return preparation by 25%. As a result, electronic filing of EITC returns increased by almost 18% over 2007.

The IRS launched its new Facilitated Self-Assistance Research Project (FSRP) in FY 2008. The project allows taxpayers to access IRS.gov at Taxpayer Assistance Centers. Approximately 2,401 customers used FSRP at the 15 pilot sites. An additional 35 sites will be launched during FY 2009.

Through its Low Income Taxpayer Clinic (LITC) grant program, the IRS awarded matching grants of up to $100,000 per year to develop, expand or maintain low income taxpayer clinics. In FY 2008, the IRS awarded almost $9 million LITC grants to over 150 organizations in 50 states, the District of Columbia, Puerto Rico, and Guam.

Taxpayer Burden Reduction

Throughout FY 2008, the IRS pursued initiatives to reduce taxpayer burden, the time and out-of-pocket expense taxpayers incur in meeting their tax responsibilities. The IRS continued its partnerships with external stakeholders including practitioners, citizen groups, software

Alternative Minimum Tax (AMT)

The AMT "patch" was signed into law late in December 2007. For the vast majority of taxpayers, the FY 2008 filing season began on-time. The AMT and AMT-related tax calculations affected several major tax processing systems which required update. The IRS performed the necessary updates and processed a majority of returns, including many AMT-affected returns, without any processing delays.

To lessen the impact of the late legislation, the IRS and the return preparer industry developed a communication and outreach strategy to alert taxpayers to the AMT law changes and the effect on filing requirements and processing. Approximately 13.5 million AMT taxpayers began filing on February 11, 2008.

developers, and state/federal agencies to solicit suggestions to reduce taxpayer burden and to design forms more suitable for computer usage. In FY 2008, the IRS:

- Improved IRS.gov to help taxpayers find answers to tax questions quickly and, prepare returns accurately and on time. Also, the first version of "My IRS Account" was implemented, a self-service application that provides taxpayers access to their past filings.
- Provided a more efficient process to permit taxpayers to file Form 1120S, *U.S. Income Tax Return for an S Corporation*, and Form 2553, *S Corporation Election*, simultaneously. The change reduces corporate taxpayer burden by allowing the IRS to process completed tax returns and corresponding elections without delays or additional contacts.
- Launched Form 990-N, *Electronic Notice for Tax-Exempt Organizations Not Required to File Form 990 or 990-Z (E-Postcard)*, for small tax-exempt organizations to electronically file an annual information notice. Approximately 170,000 e-Postcards were filed in FY 2008.
- Redesigned Form 990, *Return of Organization Exempt from Income Tax*, the annual return required to be filed by tax-exempt organizations to report information about their operations. The redesigned form (the first redesign in 25 years) enhances transparency, promotes compliance, and minimizes taxpayer burden.
- Redesigned Form 8857, *Request for Innocent Spouse Relief*. The revised form is easier for taxpayers to complete and speeds IRS processing, easing the burden for taxpayers and reducing government costs.

Strategic Goal
Enhance Enforcement of The Tax Law

OBJECTIVES

- ***Discourage and Deter Non-Compliance with Emphasis on Corrosive Activity by Corporations, High-Income Individual Taxpayers and Other Contributors to the Tax Gap***
- ***Ensure that Attorneys, Accountants and Other Tax Practitioners Adhere to Professional Standards and Follow the Law***
- ***Detect and Deter Domestic and Off-Shore Based Tax and Financial Criminal Activity***
- ***Deter Abuse within Tax-Exempt and Governmental Entities and Misuse of such Entities by Third Parties for Tax Avoidance or Other Unintended Purposes***

Enforcement Facts

- In FY 2008, the IRS collected $2.74 trillion in revenue, including $56.4 billion collected through examination and collection enforcement activities.
- From FY 2002 to FY 2008, the IRS increased revenue from its enforcement programs 65%, yielding a 5 to 1 return on investment in 2008 based on the $56.4 billion in enforcement revenue with a budget of $10.9 billion.
- In FY 2008, the IRS continued to place greater emphasis on examination of returns for flow-through entities, partnerships and S Corporations, and an increased focus on examining the returns of large corporations – those with assets greater than $250 million.

Operation Malicious Mortgage highlights the partnership between the IRS and the Department of Justice to combat the threat mortgage fraud poses to the housing industry and worldwide credit markets. In FY 2008, 144 mortgage fraud cases were investigated, and 406 defendants were charged with fraud. An estimated $1 billion in losses across the nation were attributed to the charged individuals.

Enhance Enforcement of the Tax Law

Enforcement of the tax laws is an integral component of the IRS effort to enhance voluntary compliance. IRS enforcement activities, such as examination and collection, target elements of the tax gap and remained a high priority in FY 2008. In FY 2008, the IRS initiated additional information reporting requirements for large partnerships and foreign corporations, soft notices, and self-correction to improve compliance.

Highlights of Enforcement Performance

The IRS showed consistent improvement in its enforcement results, meeting or exceeding 78% (14 of 18) of its program targets.

The improvements in enforcement performance resulted primarily from the focus on corrosive activities of corporations, high income taxpayers, and other major violators of the tax code. Targeting these high-risk categories improves IRS efficiency, reduces the burden on compliant taxpayers, and focuses enforcement presence where it is most needed.

In FY 2008, the IRS enhanced analytics in critical programs, improved workload identification and selection methods, and implemented systems that target high-risk cases. As a result, in FY 2008 the IRS made improvements over FY 2007 in the following key program areas:

- Increased high-income taxpayer audits almost 16%;
- Increased small business audits 3%;
- Audited over 13,000 large corporations for the fourth consecutive year, a significant achievement given the size (assets greater than $10 million) and complexity of the corporate entities;
- Increased collection case closures 1.4%;
- Increased tax-exempt and government entities compliance contacts 6%; and,
- Increased automated underreporter (AUR) contact closures by almost 4% and dollars collected through AUR and information return processing by 22%.

The IRS also continued reengineering the examination and collection processes to expand coverage, reduce processing time, and increase yield. The IRS implemented technological enhancements to legacy systems to augment productivity and efficiency gains. Significant improvements made in FY 2008 include:

- Expansion of the Reasonable Cause Assistant (RCA) for collection field employees to improve the accuracy and consistency of penalty-relief determinations for individual and business taxpayers. RCA expedites the reasonable cause determination process by creating an automated request and approval process.
- Upgraded the Issue Management System (IMS) to provide a central repository for issue identification and tracking and allows data collection that can be used to develop and evaluate performance measures. The upgrade supported more than 5,000 revenue agents.

Backdated Stock Options

The IRS made significant progress in resolving Backdated Stock Options issues. Backdating stock options is a tax avoidance strategy to reduce tax liabilities from the higher income tax rate of 35% to the lower capital gains rate of 15%.

The practice of backdating stock options received high-level Congressional interest and nationwide coverage since changes in the law reduced the reporting requirement from 45 days to 2 days to minimize future occurrences of the practice.

The IRS collaborated with the Securities and Exchange Commission to identify corporations with potential backdating, generating sizable tax and penalty assessments. The IRS launched an initiative in 2008 to allow employers to voluntarily pay taxes and interest for their employees who exercised certain discounted stock options and stock appreciation in 2006. The initiative generated more than $1.65 billion in tax and penalty assessments and closure of 1,329 return examinations.

Increasing International Tax Activities

The number and complexity of international tax issues is increasing dramatically each year. Actions taken in FY 2008 include:

- Improved alignment of resources to address international challenges;
- Issued guidance to address offshore and cross-border compliance risks and expanded relationships and collaboration with foreign tax administrators;
- Expanded the Joint International Tax Shelter Information Centre (JITSIC) with the addition of the Japanese National Agency and opened a second office in London. The JITSIC was created by the IRS and the tax agencies of the United Kingdom, Canada, and Australia to identify and curb cross-border abusive transactions and schemes; and,
- In conjunction with the Department of State, reached agreement to open an office at the U.S. Embassy in Beijing. The post will open in early FY 2009.

- Productivity increases in the AUR notice process produced a 26% increase in assessments from $5.1 billion to $6.4 billion, and a 21% increase in assessment dollars per case compared to last year.
- Enhanced the identification and predictability of productive assessments in the Correspondence Examination Program (CEP) that contributed to a 41% increase in assessments to $2.6 billion.
- Automated the Questionable Refund Program (QRP) processes, producing a 16% labor savings through centralization, reducing the 10 Fraud Detection Centers to three centers. FY 2008 QRP performance accomplishments include:
  - Identification of more than 337,000 potentially fraudulent returns claiming more than $1.7 billion in total refunds;
  - Stopping more than $1.5 billion in fraudulent claims with an average refund of $5,303; and,
  - Initiating 230 QRP investigations.
- Implemented an Industry Issue Focus (IIF) process that places compliance issues into three tiers based on strategic impact and importance to respond to changes in business practices that create compliance risks resulting in $6.7 billion in additional taxable income not previously reported; for Top Tier issue cases currently under examination, there is potential for an additional $4.6 billion in unreported taxable income.

Questionable employment tax practices are employment schemes which have no basis other than to evade state or federal employment or unemployment taxes. The Questionable Employment Tax Program (QETP) is a collaborative program with the U.S. Department of Labor, the National Association of State Work Force Agencies, the Federation of Tax Administrators, and state agencies. In its first full year of implementation, QETP has an agreed case rate of 65%, where the taxpayer agrees to treat the worker as an employee, taking responsibility for applicable taxes (FICA and FUTA). Through FY 2008, the IRS has secured memorandums-of-understanding to conduct data sharing with 32 states.

The IRS continued to vigorously investigate 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 successful prosecution of taxpayers involved in significant abusive tax schemes, high-income non-filer, 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 criminal investigation program remained high in FY 2008:

- Completed 4,044 criminal investigations;
- Achieved a conviction rate of 92.3%;

Abusive Tax Avoidance Transactions

Abusive tax avoidance transactions can appear on many types of tax returns and range from complex structured corporate transactions that utilize multiple entities to individual scams and schemes. Use of offshore entities and accounts is also common and organized promotion of tax shelters makes them available to all types of taxpayers. The variety, size and nature of tax shelters require an organized approach to detection, deterrence and enforcement so that the use of abusive transactions can be stopped.

Lease-In/Lease-Out, Sale-in/Sale-Out Settlement Initiative

As part of the effort to detect and deter aggressive tax shelters, the IRS launched a settlement initiative for both Lease-In/Lease-Out (LILO) and Sale-In/Lease-Out (SILO) transactions in FY 2008.

SILO and LILO transactions involve corporations leasing or purchasing large assets such as rail systems, sewer systems and other large infrastructure, mostly overseas, and re-leasing them to their original owners or operators.

- Corporations, many of which are in the Fortune 500 and include many of the nation's top banks, use these transactions to bolster their balance sheets, gaining millions of dollars in tax deferrals.
- The IRS entered into a settlement offer to shut down transactions IRS has long considered abusive, offering taxpayers up to 60 days to accept the terms:
  - Companies who agree to use best efforts to shut down these shelters by 2010 will be allowed to keep 20% of the deductions claimed through 2007.

The potential for additional tax revenue resulting from the settlements lies in the recovery of billions of dollars in tax deferrals.

- Maintained a Department of Justice acceptance rate of 93.6%, with a U.S Attorney acceptance rate of 89.2%, which compares favorably with other Federal Law enforcement agencies; and,
- Obtained 2,144 convictions, exceeding the FY 2008 target.

The IRS also faced ongoing challenges in assisting tax-exempt and government entities comply with the complicated rules for maintaining their special tax status. The IRS continues to ensure that charitable organizations are not used for non-charitable or illegal purposes, including financing terrorist activities. In FY 2008, the IRS helped meet the special needs of pension plans, exempt organizations, and government entities in complying with the tax laws, taking the following actions:

- Launched an e-Postcard (Form 990N) for small tax-exempt organizations to electronically file an annual information notice and redesigned the form used by tax-exempt entities to report information about their operations;
- Developed a pre-screening process to identify employee plan applications that have deficiencies so the taxpayer can fix items timely; and,
- Increased small employer awareness of Pension Plan Correction Programs via new fix-it guides and an educational workshop.

Strategic Goal
Modernize the IRS through its People, Processes, and Technology

OBJECTIVES

- ***Increase Organizational Capacity to Enable Full Engagement and Maximum Productivity of Employees***
- ***Modernize Information Systems to Improve Service and Enforcement***
- ***Ensure the Safety and Security of People, Facilities and Information Systems***
- ***Modernize Business Processes and Align the Infrastructure Support to Maximize Resources Devoted to Front-line Operations***

Of the major BSM project releases, 92% were within cost and 92% were within acceptable variance of project schedule milestones (+/- 10%) goals.

Modernization Facts

- The IRS handles billions of transactions, processes more than 249.8 million tax returns and over 1.8 billion information returns, collects $2.74 trillion in revenue and makes over 200 million customer contacts per year.

Modernize the IRS through its People, Processes, and Technology

In FY 2008, the Business System Modernization Program met cost and schedule estimates for most releases and delivered significant business value.

FY 2008 successes include:

Business Systems Modernization

- Customer Account Data Engine (CADE). The 2008 CADE release was delivered on time for the filing season and processed 30.6 million returns, a substantial increase from the 2007 posting of 11.2 million returns, and issued over 28.9 million refunds, totaling more than $44.1 billion exclusive of stimulus payments. CADE settles daily, allowing CADE to process refunds on average five days faster than the legacy system and to update taxpayer account information immediately for customer service personnel, rather than weekly in the legacy system.

- Modernized e-File (MeF). MeF provides e-Filing capability for large corporations, small businesses, partnerships, and non-profit organizations. MeF benefits both taxpayers and the IRS by enabling taxpayers to file all of their tax forms electronically, eliminating the need for the IRS to match paper documents to electronic returns. Additionally, MeF allows more robust error checking and data validation before returns are processed, reducing the number of returns that need manual intervention and correction.

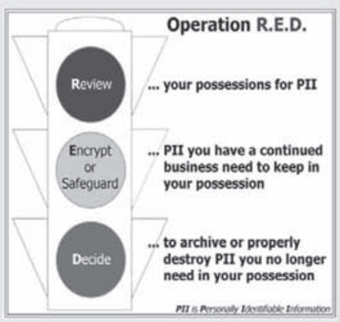
  MeF has processed over 6 million business tax returns. The fifth release of MeF went into production as planned early in 2008 providing the ability to file electronically Form 1120F (tax returns for foreign corporations) and Form 990N (also known as the electronic postcard for small tax-exempt organizations to meet their filing requirement). In 2008, MeF accepted over 3.7 million returns, a 55% increase over last year.

- Account Management Services (AMS). AMS is designed to improve support and functionality by bridging the gap between modernization initiatives like CADE and existing legacy systems. AMS allows on demand real-time access, validation, and update of taxpayer accounts. AMS provided on-line address change capability for CADE accounts completing 1,064,000 address changes. The 2008 releases of AMS provided automated inventory and workflow capabilities distributing over 733,000 electronic transcript cases to IRS campuses, increasing functionality for customer service representatives.

Operation Review, Encrypt, and Decide (R.E.D.)

In FY 2008, the IRS conducted Operation R.E.D. to focus employee awareness on existing policies and procedures regarding safeguarding of sensitive information. During this event, employees were given time to:

- **R**eview their electronic files and paper holdings for sensitive information that is required to be secured;
- **E**ncrypt (electronic) and/or safeguard (paper) all sensitive information that is required to be secured; and,
- **D**ecide whether information that they no longer have a need to know should be archived or destroyed.



Employee Engagement

Employee engagement is the degree of employee motivation, commitment, and involvement in the mission of the organization. The IRS considers employee engagement fundamental to the overall success of the organization and believes that employee engagement is an ongoing process.

The IRS conducts an annual survey to assess the level of engagement of employees. Overall satisfaction showed steady improvement from a score of 3.48 in 2002 to a score of 3.79 in 2008, on a scale of 1 to 5, with 5 being the most satisfied.

Survey results showed:

- Cooperation among people in the workgroup
- Recognition of the importance of the work
- Good relationships between employees and supervisors

IRS job satisfaction is higher than most other Federal agencies according to the Office of Personnel Management's Federal Human Capital Survey.

IT Security

The IRS is entrusted with a tremendous amount of sensitive information. Protecting this information is vital to maintaining the public trust that encourages voluntary compliance with the tax law and enables the IRS to conduct business effectively. The IRS protects taxpayer personally identifiable information, including Social Security numbers. In addition, the IRS actively ensures the security of its infrastructure and IT systems.

In FY 2008, the IRS took the following actions to protect the tax administration systems from unauthorized access, disruption and modification:

- Established the Office of Online Fraud Detection and Prevention to address increasing and evolving threats online affecting the IRS and taxpayers;
- Continued risk assessments of business processes to address identity protection and analyzed the use of social security numbers for reduction and elimination where possible;
- Updated the IRS Identity Protection Strategy, a comprehensive strategy to protect personal information and provide services to identity theft victims;
- Completed corrective action plan to address IT Security Training, systems auditing, access controls, system security configuration control, and IT systems disaster recovery; and,
- Established agency-wide security policies and standards.

Human Capital

The IRS continues to ensure the workforce is prepared to carry out the IRS mission and to address the issues of increasing numbers of retirements and competition for skilled candidates to fill positions. In FY 2008, the IRS:

- Developed recruitment strategies to improve candidate selection and expanded the use of recruitment incentives to attract highly qualified candidates;
- Conducted analysis of turnover rates by using a cost model index to determine the cost and reasons for turnover;
- Increased the accessibility of the application process for mission critical positions through automation, simplification, and the use of hiring incentives; and,
- Expanded the Succession Management Program and the Leadership Succession Review tool to levels below senior executive.

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

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

In FY 2008, the IRS conducted the following A-123 activities:

- Streamlined the testing process without compromising the validity of A-123 reviews by implementing a 3-year Rotational Testing Schedule for transactions determined to be low risk. High risk and/or material transactions are tested annually.
- Tested 17 transaction processes material to Treasury's Consolidated Financial Statements compared to 35 tests conducted in FY 2007.
  - 12 administrative processes related to $10 billion in administrative transactions.
  - 5 custodial tax-related processes related to $2.74 trillion in tax revenues.

Based upon the results of the evaluation, the IRS provided qualified assurance that its internal controls were operating effectively.

The qualified assurance was based on the three material weaknesses, reported by GAO in its audit of the IRS FY 2008 and 2007 financial statements.

Systems Controls and Legal Compliance

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

Federal Managers' Financial Integrity Act (FMFIA)

During FY 2008, the IRS adhered to the internal control requirements of FMFIA, the Office of Management and Budget (OMB) Circular A-123, and the Reports Consolidation Act of 2000.

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

- Programs achieve their intended results;
- Resources are consistent with the overall mission;
- Programs and resources are protected from waste, fraud, abuse, mismanagement, and misappropriation of funds;
- Laws and regulations are followed;
- Controls are sufficient to minimize improper and erroneous payment;
- Performance information is reliable;
- System security is in substantial compliance with all relevant requirements;
- Continuity of operations planning in critical areas is sufficient to reduce risk to reasonable levels; and,
- Financial management standards are in compliance with Federal financial systems standards, i.e., FMFIA Section 4 and Federal Financial Management Improvement Act (FFMIA).

Because the IRS has outstanding material weaknesses and the custodial 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 2008. This assurance is provided relative to Sections 2 and 4 of FMFIA. The FMFIA material weaknesses are:

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

Federal Financial Management Improvement Act (FFMIA)

The IRS made significant progress bringing the custodial financial management systems into compliance with FFMIA. In FY 2008, the IRS implemented two additional releases of the Custodial Detailed Database (CDDB), thus creating the subsidiary ledgers for revenue receipts and refunds with traceability between CDDB and the Interim Revenue Accounting and Control System (IRACS). The IRS also established traceability of revenue and refunds from the electronic payment systems.

Federal Information Security Management Act (FISMA)

In accordance with the requirements of FISMA, the IRS took actions to establish a stronger agency-wide information security program due to the IRS Computer Security Material Weakness:

Actions	Status
Certification and Testing of Systems	100%
Systems Accreditation	98%
Specialized training	99% of Employees
Annual Awareness Training	99% of Employees and Contractors
Contractor Systems Reviews	100%
Annual Security Controls Testing	100%
Annual IT Contingency Plan Testing	100%
Privacy Impact Assessment	100%
System of Record Notice	100% compliance

- The IRS certification program completed the third year of a three year cycle to certify all IRS reported systems. As of the end of the 2008 FISMA reporting period, there were a total of 247 systems (applications and General Support Systems) in the FISMA inventory: 243 had full Authority To Operate (ATO) and 4 had Interim Authority To Operate (IATO). For all ATO and IATO systems, weaknesses identified during Security Test and Evaluations, Privacy Impact Assessments, and Security Risk Assessments are documented in a Plan of Action and Milestones.
- Maintained the 24 X 7 incident response center to monitor IRS computer and network security, and created a second center to provide back-up capabilities.
- Completed all required FISMA activities contingency plan testing on all of the 247 applications/systems on the master inventory and live disaster recovery tests for all major applications.

The IRS's strategy is to implement an enterprise-wide risk management approach that cost-effectively focuses resources on major systems and assets supporting tax administration.

Lien Release Non-Compliance Issue

As of September 30, 2008, the IRS did not consistently comply with section 6325 of the Internal Revenue Code regarding the timely release of federal tax liens. The IRS Financial and Management Controls Executive Steering Committee (FMC ESC) continues to monitor the action plan which addresses lien release issues identified by the IRS, Government Accountability Office (GAO), and the Treasury Inspector General for Tax Administration (TIGTA).

Reports Consolidation Act of 2000

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

Continuity of Operations (COOP)

IRS leaders practiced scenarios during the annual COOP exercise to make sure the IRS could sustain operations after a catastrophic event. Scenarios included: workplace violence; weather disasters; international, domestic, and cyberterrorism; and blackouts.

Months of intricate planning and extensive logistical coordination were conducted to prepare for the realistic, one to two-day drills. Practice scenarios involved computer hackers penetrating information systems, bombs, explosions or shootings at offices, and floods or weather-related destruction. IRS executives reviewed the results of each exercise to learn where the IRS could make necessary changes to strengthen its overall plan. Other important practice activities like simulation exercises and tests of individual business resumption plans took place on a smaller scale.

Major Management Challenges and High-Risk Areas

The GAO, TIGTA, and the OIG for Treasury identified several Management Challenges and High-Risk Areas facing the IRS. The IRS is addressing these issues through its existing program activities. Measures of these program activities serve to show progress in addressing the management challenges and high-risk areas. The following are the most serious management and performance challenges identified by GAO, TIGTA, and the OIG in order of priority:

- Modernization of the Internal Revenue Service (Computerized Systems and Business Structure) and IRS Business Systems
- Tax Compliance Initiatives
- Security of the Internal Revenue Service
- Providing Quality Taxpayer Service Operations
- Complexity of the Tax Law

Progress Made on Earned Income Tax Credit (EITC) FMFIA Material Weakness

In FY 2008, the IRS completed the necessary actions to support a downgrade of the FMFIA Material Weakness for EITC. Actions taken in support of the downgrade include:

- Closure of 38 milestones associated with corrective actions.
- Establishment of measures and diagnostics for those functions that deliver EITC related compliance, outreach and support activities.
- Accountability through the centralization of activities under a single executive.
- Development of full cost computation for the key EITC compliance activities; and, improved service, fairness Compliance with EITC under the Commissioner's five point initiative.

Impressive results from these actions include:

- Increases in revenue protected in the EITC underreporter program (190%) and base compliance activities (35%).
- Reductions in the "no change" rate (59%) on EITC examination cases.
- Improvements in the full cost Return On Investment for compliance activities (12:1 for EITC examinations and 67:1 for EITC underreporter cases).

The GAO reviewed the IRS progress and agreed they will not oppose a downgrade. The EITC FMFIA Material Weakness was downgraded September 30, 2008.

- Human Capital
- Erroneous and Improper Payments
- Taxpayer Protection and Rights
- Processing Returns and Implementing Tax Law Changes During the Tax Filing Season
- Using Performance and Financial Information for Program and Budget Decisions

Limitations of Financial Statements

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

Overview of Revenue and Administrative Accounts

The IRS FY 2008 financial statements received an unqualified audit opinion for the ninth consecutive year.

The Balance Sheet reflects total assets of $36 billion of which $29 billion (81%) are Federal Taxes Receivable, which represents amounts expected to be collected from past due accounts. The $4 billion increase in total assets is primarily attributable to the increase in Federal taxes receivable. The majority of IRS's liabilities consist of amounts due to Treasury related to Federal taxes receivable.

The Statement of Custodial Activity shows that IRS programs collected $2.74 trillion in federal tax receipts.

Financing Sources

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

Financial Highlights

Revenue and Refund Trend Information

FY 2008 revenue receipts collected by IRS, $2.74 trillion, increased by approximately 2% from FY 2007. Federal tax revenues are collected through six major classifications: individual income FICA/SECA, corporate income, excise taxes, estate and gift taxes, railroad retirement, and federal unemployment taxes.

The FY 2008 tax refund activity of $425.7 billion includes the Economic Stimulus payments of $94.3 billion. This is an increase of approximately 46% from FY 2007. Refund activity without the stimulus amount is $331.4 billion and represents an increase of approximately 13% over FY 2007. Federal tax refunds include payments for tax, interest, and Earned Income Tax Credit and Child Care Tax Credit in excess of the tax liability. In FY 2008, the IRS issued payments of $51.8 million for Advanced Earned Income Tax Credit.

Excise Taxes

The Quarterly Federal Excise Tax Return, Form 720, reports 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 2005 through September 2007. The Treasury Department's Financial Management Service and the Bureau of Public Debt prepare the warrants and allocations to the various Trust Funds.

	Liability Quarter Ended	
	December 2005 – September 2006	December 2006 – September 2007
Airport & Airway Trust Fund	$10,183,465,000	$11,531,893,000
Black Lung Disability Trust Fund	607,881,000	651,394,000
Highway Trust Fund	41,019,915,000	39,891,934,000
Total	$51,811,261,000	$52,075,221,000

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 2008 Financial Statements, the unpaid assessment balance was approximately $278 billion as of September 30, 2008. Under federal accounting standards, unpaid assessments require tax-payer or court agreement to be considered federal taxes receivable. Assessments not agreed to by taxpayers or the courts are

Custodial Detail Database (CDDB)

CDDB was developed by the IRS to comply with the Federal Financial Management Improvement Act and to resolve a material weakness in financial systems relating to accounting for duplicate Trust Fund Recovery Penalty (TFRP) assessments and the lack of a subsidiary ledger. During FY 2008, noteworthy accomplishments for CDDB include:

- Achieved a 35% reduction in TFRP cross reference errors using CDDB reports.
- Classified $27 billion (77%) of the $35 billion TFRP inventory.
- Implemented a 20 digit trace-ID in all payment systems which enabled CDDB to capture 100% of the pre-posted and posted revenue (Electronic Federal Tax Payment System (EFTPS) was implemented in FY 2007). CDDB is now able to identify each individual payment.

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 $112 billion (39%) of unpaid assessments and increased $14 billion (14%) from $98 billion as of September 30, 2008. About $83 billion (74%) of this balance is estimated to be uncollectible. Except for bankruptcy situations, the IRS may continue collection actions for 10 years after the assessment. About $29 billion (26%) of taxes receivable is estimated to be collectible.

- Compliance assessments of $67 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.

- About $159 billion (57%) of the unpaid assessment balance as of September 30, 2008, consists of interest and penalties and is largely uncollectible.

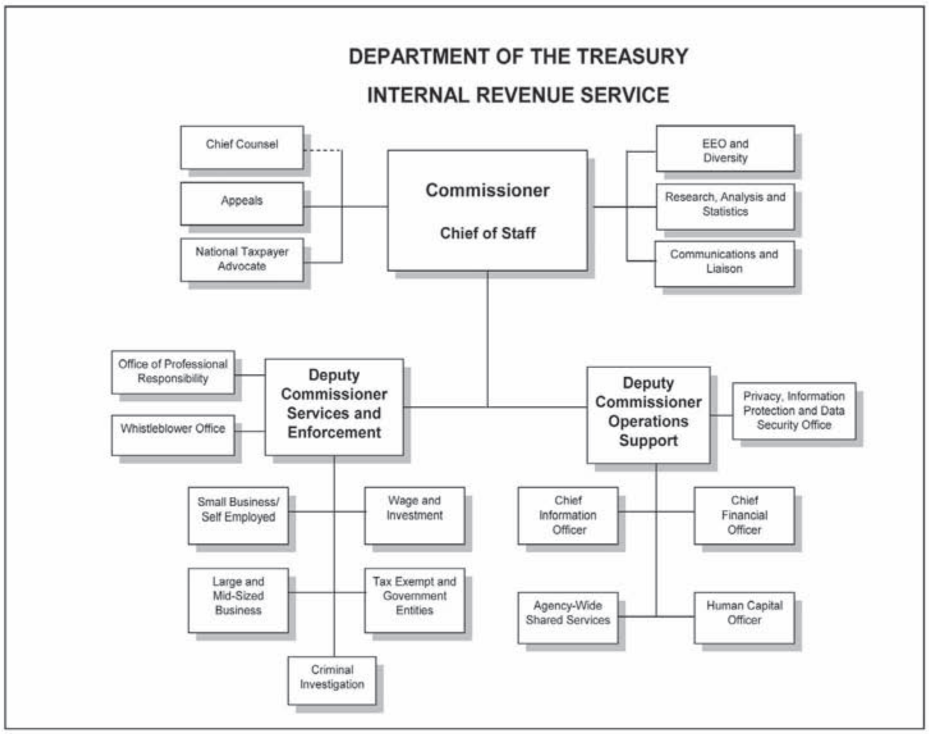
The Integrated Financial System (IFS)

IFS 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 is available for authorized users. Significant accomplishments for FY 2008 include:

- Successfully migrated all interfaces to a secure protocol
- Integrated eGov data for travel payment and postings
- Enhanced the HCTC interface to support anticipated increases based on legislative changes

Appendix A

Organization Chart



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Appendix B
Performance Measurement Data

Measure	2005	2006	2007	2008	
				Target	Actual
Goal 1: Improve Taxpayer Service					
Customer Service Representative (CSR) Level of Service	82.6%	82.0%	82.1%	82.0%	52.8%
Customer Contacts Resolved per Staff Year	7,585	7,414	7,648	8,000	12,634
Percent of Eligible Taxpayers Who File for EITC (CY)	80.0%	*	*	75%-80%	*
Customer Accuracy – Tax Law Phones	89.0%	90.9%	91.2%	91.0%	91.2%
Customer Accuracy – Customer Accounts (Phones)	91.5%	93.2%	93.4%	93.5%	93.7%
Timeliness of Critical Filing Season Tax Products to the Public	91.4%	83.0%	83.5%	86.0%	92.4%
Timeliness of Critical Other Tax Products to the Public	80.0%	61.2%	84.0%	86.0%	89.5%
Percent Individual Returns Processed Electronically	51.1%	54.1%	57.1%	61.8%	57.6%
Cost per Taxpayer Served ($) (HCTC)	N/A	$13.71	$14.90	$14.25	$16.94
Sign-Up Time (Days) – Customer Engagement (HCTC)	98.1	98.7	93.3	97.0	94.0
Percent Business Returns Processed Electronically	17.8%	16.6%	19.1%	20.8%	19.4%
Refund Timeliness – Individual (Paper)	99.2%	99.3%	98.9%	98.4%	99.1%
Taxpayer Self Assistance Rate	42.5%	46.8%	49.5%	51.5%	66.8%
Goal 2: Enforcement of the Tax Law					
Examination Coverage – Individual	0.9%	1.0%	1.0%	1.0%	1.0%
Field Examination Embedded Quality	N/A	85.9%	85.9%	87.0%	86.0%
Office Examination Embedded Quality	N/A	88.2%	89.4%	90.0%	90.0%
Examination Quality – Industry	77.0%	85.0%	87.0%	88.0%	88.0%
Examination Quality – Coordinated Industry	89.0%	96.0%	96.0%	96.0%	97.0%
Examination Coverage – Business (Corps. >$10M)	7.8%	7.3%	6.8%	6.6%	6.1%
Examination Efficiency – Individual (1040)	121	128	137	133	138
Automated Underreporter (AUR) Efficiency	1,701	1,832	1,956	1,961	1,982
Automated Underreporter (AUR) Coverage	2.2%	2.4%	2.5%	2.5%	2.55%
Collection Coverage – Units	53.0%	54.0%	54.0%	53.0%	55.2%
Collection Efficiency – Units	1,514	1,677	1,828	1,835	1,926
Field Collection Embedded Quality	N/A	84.2%	84.0%	86.0%	79.0%
Automated Collection System (ACS) Accuracy	88.5%	91.0%	92.9%	92.0%	95.3%
Criminal Investigations Completed	4,104	4,157	4,269	4,000	4,044
Number of Convictions	2,151	2,019	2,155	2,135	2,144
Conviction Rate	91.2%	91.5%	90.2%	92.0%	92.3%
Conviction Efficiency Rate ($)	295,316	328,750	301,788	317,625	315,751
TE/GE Determination Case Closures	126,481	108,462	109,408	100,600	100,050
Goal 3: Modernize the IRS through its People, Processes, and Technology					
Percent of BSM Projects within +/- 10% Cost Variance	N/A	N/A	**	Baseline	92.0%
Percent of BSM Projects within +/- 10% Schedule Variance	N/A	N/A	**	Baseline	92.0%

*The methodology for estimating the eligibility rate is being revised.
**Cost and Schedule variance is based on +/- 10% and was reported separately for each project release/subrelease. 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.

Appendix C

Explanation of Shortfalls

Customer Service Representative (CSR) Level of Service: For FY 2008, the CSR Level of Service (LOS) was 52.8%, roughly 29 percentage points below the target of 82%. The shortfall was caused by the high call volume from the Economic Stimulus Payment (ESP) issuance. Assistor Services were 119% of plan and Calls Answered were 123% of plan as a result of ESP demand. The IRS realigned resources to answer calls and seasonal employees were kept on board longer.

Percent Individual Returns Processed Electronically: For FY 2008, the Percent of Individual Returns Processed Electronically was 57.6% which is 4.2 percentage points below the target of 61.8%. Excluding taxpayers who filed solely to claim an economic stimulus payment, the percentage of e-file returns would have been 63%.

Cost per Taxpayer Served ($) (HCTC): For FY 2008, the cumulative cost per taxpayer served was $16.94, 19% above the target of $14.25. A decrease in the number of taxpayers eligible and enrolled for the credit, fewer taxpayers conducting business through the HCTC call center, and increased contractor rates are among the reasons for the increase in the Cost Per Taxpayer Served.

Percent Business Returns Processed Electronically: For FY 2008, the Percent of Business Returns Processed Electronically was 19.4% which is 1.4 percentage points below the target of 20.8%. A significant decrease (nearly 28.5%) in projected volume of electronically filed Forms 1041, primarily due to a regulation change allowing certain grantor trusts to be reported on Form 1099 instead of Form 1041, contributed to the decline.

Field Examination Embedded Quality: For FY 2008, the quality score was 86%, 1 percentage point below the target of 87%. During FY 2008, a quality action plan was implemented to address weaknesses identified within the Timeliness, Income Probe and Multi-year Pick Up attributes. In addition, area quality improvement teams were established to address area specific quality weaknesses. As a result of these efforts, significant improvements within the quality score were realized during the second half of FY 2008.

Examination Coverage – Business (Corps. >$10M): IRS exceeded its large business return closures goal of 13,059 returns, closing 13,186 returns. However, the coverage percentage dropped to 6.1% due to higher than estimated return filings. The IRS emphasis on streamlining and improving the examination process, coupled with better risk analysis, will continue to provide for early resolution of post-filing examination issues and enhance large business examination coverage.

Field Collection Embedded Quality: For FY 2008, the quality score was 79%, 7 percentage points below the target of 86%. Effort to reduce the number of aged cases in the quality inventory, coupled with the overall quality of the older cases had an impact on the cumulative quality score. Improvements to job aids, continuation of quarterly reviews and an annual "Quality Summit" focusing on specific quality attributes in need of improvement are ongoing to focus attention on case quality.

TE/GE Determination Case Closures: The IRS was within 1% of its target. The shortfall resulted from the increasing number of applications that are subject to an in-depth review for potential abuses in the Exempt Organizations determination program. These applications, along with others identified for potential promoter or fraud issues during the screening process, required more extensive development and coordination than the traditional determination workload, resulting in higher hours per case. The shortfall was minimized due to the increase in merit closures, which required fewer hours to complete.

Appendix D

Performance Measures Descriptions

Goal 1: Improve Taxpayer Service	
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 expressed in staff years where a staff year is equivalent to a position filled full time every paid day of the year, including holidays.
Percent of Eligible Taxpayers Who File for EITC	The number of taxpayers who claim the Earned Income Tax Credit (EITC) on a tax return compared to the number of taxpayers who appear to be eligible for the credit based on Census Bureau data.
Customer Accuracy – Tax Law Phones	The percentage of correct tax law answers given by a call center assistor on the IRS Toll-free lines.
Customer Accuracy – Customer Accounts (Phones)	The percentage of correct account answers given by a call center assistor on the IRS Toll-free lines.
Timeliness of Critical Filing Season Tax Products to the Public	The percentage of filing season critical tax products made available, paper or electronically, to individual taxpayers by early January. (Critical tax products include the forms, schedules, instructions and publications that a large number of taxpayers need to prepare a complete and accurate individual income tax return by April 15.)
Timeliness of Critical Other Tax Products to the Public	The percentage of filing season critical tax products made available, paper or electronically, to businesses, tax-exempt organizations, and government entities in a timely fashion. (Critical tax products include the forms, schedules, instructions and publications that a large number of taxpayers need to prepare a complete and accurate return/form by the scheduled due date.)
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 eligible for the Health Coverage Tax Credit (HCTC). (Costs include correspondence, registration, and program participation.)
Sign-Up Time (Days) – Customer Engagement (HCTC)	The length of time between mailing of the HCTC registration kit and when the participant receives the first payment.
Percent Business Returns Processed Electronically	The number of electronically filed business tax returns divided by the total business tax returns filed.
Refund Timeliness – Individual (Paper)	The percentage of refunds issued within 40 days of receipt for individual income tax returns submitted on paper.
Taxpayer Self Assistance Rate	The percentage of all taxpayer assistance requests resolved using self-assisted automated services (includes automated calls answered and Internet services completed).
Goal 2: Enforcement of the Tax Law	
Examination Coverage – Individual (1040)	The sum of all 1040 audits completed in the current fiscal year divided by the total individual income tax return filed the prior calendar year.
Field Examination Embedded Quality	The number of quality elements (important steps in resolution of an examination case assigned to a revenue agent in the field) that are scored as "met" by an independent reviewer divided by the total number of quality elements (met and not met). Sample is comprised of closed cases and all quality elements are considered equally.
Office Examination Embedded Quality	The number of quality elements (important steps in resolution of an office examination case assigned to a tax compliance officer) that are scored as "met" by an independent reviewer divided by the total number of quality elements (met and not met). Sample is comprised of closed cases and all quality elements are considered equally.

Appendix D

Performance Measures Descriptions (Continued)

Goal 2: Enforcement of the Tax Law (Continued)	
Examination Quality – Industry	The number of quality elements (important steps in the examination of Industry cases (corporations and partnerships with assets over $10 million)) scored as "met" by an independent quality reviewer. Quality elements include technical standards and administrative procedures, which respectively account for 80 percent and 20 percent of the quality score.
Examination Quality – Coordinated Industry	The number of quality elements (important steps in the examination of Coordinated Industry cases (the 900 largest corporations) scored as "met" by an independent quality reviewer. Quality elements include technical standards and administrative procedures, which respectively account for 80 percent and 20 percent of the quality score.
Examination Coverage – Business (Corps. >$10M)	The sum of all corporate returns (with assets over $10 million) and partnership returns audited during the current fiscal year divided by the number of returns filed the prior calendar year.
Examination Efficiency – Individual (1040)	The sum of all individual 1040 individual income tax returns closed by the Field and Correspondence Examination programs during the current fiscal year divided by the total number of full-time staff utilized during the current fiscal year.
Automated Underreporter (AUR) Efficiency	The total number of closed cases during the current fiscal year in the document matching program (where a taxpayer responded to the notice) divided by the total full-time staff utilized.
Automated Underreporter (AUR) Coverage	The total number of closed cases during the current fiscal year in the document matching program (where a taxpayer responded to the notice) divided by the total number of 1040 individual income tax returns filed the prior calendar year.
Collection Coverage – Units	The number of collection cases closed during the current fiscal year compared to the number of collection cases available for assignment.
Collection Efficiency – Units	The total number of cases closed during the current fiscal year (delinquent accounts and delinquent returns) divided by the total number of full-time staff utilized.
Field Collection Embedded Quality	The number of quality elements (important steps in the resolution of a collection case assigned to a revenue officer in the field) that are scored as "met" by an independent reviewer divided by the total number of quality elements (met and not met). Sample is comprised of closed cases during the current fiscal year and all quality elements are considered equally.
Automated Collection System (ACS) Accuracy	The percentage of taxpayers that received the correct answer to their question and/or had their case resolved correctly based on all available information.
Criminal Investigations Completed	The total number of criminal investigations completed during the fiscal year. (Includes both cases recommended for prosecution and cases discontinued for lack of prosecution potential.)
Number of Convictions	The number of criminal convictions.
Conviction Rate	The percentage of judicially decided criminal cases resulting in a conviction.
Conviction Efficiency Rate ($)	The cost of the IRS Criminal Investigation program divided by the number of convictions.
TE/GE Determination Case Closures	The number of cases closed where the IRS has made a decision on requests for tax exempt status or employee plan qualification.
Goal 3: Modernize the IRS through its People, Processes, and Technology	
Percent of BSM Projects within +/-10% Cost Variance	The percentage of 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 BSM projects that are within the +/-10% threshold for schedule. The schedule variance is measured from the initial schedule estimate to the current schedule estimate.

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 2008 accomplishments, actions identified for completion in FY 2009 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 2008 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, in its FY 2005 High Risk series, has consolidated IRS Business Systems Modernization and IRS Financial Management into one Business Systems Modernization high-risk area.	**Actions Taken:** • Customer Accounts Data Engine (CADE). The newest CADE Release was delivered on time for the filing season and processed 30.6 million returns, an increase from the 2007 posting of 11.2 million returns. CADE not only stores the taxpayer data on a modernized data base, but also settles daily, so CADE processes refunds on average five days faster than the IRS master file. For 2008, CADE issued over 28.9 million refunds, in excess of $44.1 billion exclusive of stimulus payments. CADE settles daily, allowing CADE to process refunds on average five days faster than the legacy system and to update taxpayer account information immediately for customer service personnel, rather than weekly in the legacy system. • Delivered the Economic Stimulus Package (ESP) checks to taxpayers ahead of schedule, a direct result of CADE daily processing capabilities, in contrast to the legacy system's weekly processing. • Modernized e-File (MeF). In 2008, MeF accepted over 3.7 million returns, a 55% increase over last year. Overall, MeF has processed over 6 million tax returns. The fifth release of MeF went into production as planned early in 2008 providing the ability to file electronically Form 1120F (tax returns for foreign corporations) and Form 990N (also known as the electronic postcard for small tax-exempt organizations to meet their filing requirement). • Account Management Services (AMS). AMS is designed to improve support and functionality by bridging the gap between modernization initiatives like CADE and existing legacy systems. AMS allows on demand real-time access, validation, and update of taxpayer accounts. AMS provided on-line address change capability for CADE accounts completing 1,064,000 address changes. The 2008 releases of AMS provided automated inventory and workflow capabilities that distributed over 733,000 electronic transcript cases to IRS campuses and increased functionality for the customer service representatives. • Delivered the majority of Modernization project releases within cost and on schedule. • Expanded the research data base for the expanded Collection Data Warehouse including additional information from the Individual and Business Master Files and combining it with the Automated Collection System information to provide the ability to conduct quantitative analysis to improve workload identification, case selection, and prioritization. Results include improved inventory modeling and increased productivity. • Expanded the Reasonable Cause Assistant (RCA) to improve the accuracy and consistency of individual taxpayer and business taxpayer penalty relief determinations. • Piloted web-based criminal investigation knowledge management systems allowing employees in the field to gain immediate, nationwide access to training materials, best practices, discussion threads, and guidance to assist them in their investiga-tions. Also piloted an e-Library, a centralized repository for all nationwide interim

	policy and procedural memoranda, providing employees "one-stop shopping" for National Meeting Minutes, Official Handbooks, and historical documents. • Upgraded the Issue Management System (IMS) to provide a central repository for issue identification and tracking and allow data collection that can be used to develop and evaluate performance measures. The upgrade supported more than 5,000 revenue agents. • Developed a Data Access Strategy to consolidate data from multiple applications and produce a data repository for issue detection and case selection. Integrated data solutions allow the IRS to retire duplicative and costly data extracts from multiple systems. • Established a Program/Project Health Assessment, to examine the "health" of all IT projects to provide independent early-warning indicators to managers and governance organizations concerning projects facing unusual challenges that can influence the filing season or other critical IRS functions. **Actions Planned or Underway for FY 2009 and Beyond:** • Deliver production pilot for CADE Release 4 adding capabilities to process other types of returns such as decedent, prior-year returns, extension requests, and refund hold capability, along with additional notices for child tax credits and direct deposit math error. • Complete delivery of AMS Release 1 to provide additional real-time transaction updates to CADE, new inventory and workflow capabilities and closure capabilities for account transcript functionality. • Identify additional functionality for the Issue Management System including incorporating a multi-year planning tool to enable analysts to create "what-if" scenarios and perform multi-year comparisons.

Tax Compliance Initiatives	
Administer programs to deal with tax gap issues, especially those resulting from corporate and high-income individual taxpayers, as well as domestic and off-shore tax and financial criminal activity. Address the evolving challenge of unpaid taxes and continuing Earned Income Tax Credit (EITC) non-compliance.	***Individuals and Businesses*** **Actions Taken:** • Collected $56.4 billion in enforcement revenue, a 65% increase since 2002. • Increased examination closures for taxpayers with income over $200,000 by almost 16%. Maintained audits of corporations and flow-throughs with assets under $10 million in FY 2008. • Targeted preparers and promoters whose tax work indicated questionable return preparation practices and assessed over $103 million in penalties. • Used new enforcement tools to improve the quality and reliability of real property appraisals submitted by taxpayers, which increased the number of penalties assessed against appraisers and referrals to the Office of Professional Responsibility. • Established the Industry Issue Focus approach to concentrate on high risk tax issues and ensure that the IRS employs a strategic approach to managing them. This tiered process significantly reduces the amount of time and resources to examine cases, reduces taxpayer burden, and improves productivity. • Assessed $21.1 million in tax and penalties against employees of foreign embassies, consulates, and international organizations as a result of an Embassy Settlement Initiative. • Partnered with SEC to identify corporations with potential backdating of stock options, generated more than $1.65 billion in tax and penalty assessments and closure of 1,329 return examinations. • Implemented enhancements to the Automated Underreporter inventory selection process. Enhancements resulted in increases in overall assessment dollars 26% and assessment dollars per case 21%.

- Improvements in training of fraud examiners resulted in a 6.9% increase in fraud development cases and increases of more than 21% in civil fraud penalty recommendations over 2007 levels.
- Continued focus on resolving abusive transactions through the Global Settlement Initiative resulted in the securing of more than 1,605 delinquent returns and recommending for assessment over $3.04 billion in taxes.
- Continued analysis of National Research Program (NRP) results from Forms 1040 and 1120S studies to identify where and why compliance problems occur. Conclusions translated into modifications to return classification and selection routines as well as development of Tax Gap Fact sheets to address issues identified.
- Identified through the Electronic Fraud Detection System more than 337,000 potentially fraudulent returns claiming more than $1.7 billion in refunds and stopped over $1.5 billion in fraudulent claims with an average refund of $5,303.
- Initiated 230 new Questionable Refund Program investigations resulting in a 92.3% conviction rate, an 83.5% incarceration rate, and an 88.5% publicity rate on adjudicated cases.
- Expanded Suspicious Activity Report (SAR) Review Teams at ten locations across the country. These task forces allow federal, state, and local law enforcement agencies to combine their unique skills to identify and investigate individuals and organizations engaged in a wide-range of criminal activity. These task forces disrupt and dismantle criminal enterprises by seizing and forfeiting the assets.
- Deployed Operation Malicious Mortgage to combat mortgage fraud, resulting in 144 mortgage fraud cases in which 406 defendants were charged.
- Completed EITC return preparer due diligence audits, reviewing paid preparers' compliance with EITC due diligence requirements, and recommended over $570,000 in due diligence penalties.
- Developed an yK1 Link Analysis prototype, which uses K-1 data from corporations, flow-through returns, and high income individuals to identify relationships and income/loss flow between payers and payees. This helps examiners determine if a taxpayer has engaged in potentially abusive tax schemes. The project was recognized as a Top 20 finalist for the 2008 Excellence.Gov Award.

Actions Planned or Underway for FY 2009 and Beyond:

- Identify and test alternative methods of workload selection for offshore cases.
- Update Audit Technique Guides which serve as reference material to both internal users and external stakeholders.
- Implement an updated Discriminant Analysis System (DAS) to identify corporate returns that are likely to have significant reporting noncompliance.
- Continue compiling and testing business rules for identifying reporting noncompliance as part of the rollout of the new Selection, Workload, and Classification system.
- Introduce new M-3 for Form 1120F to gather information on foreign controlled corporations.
- Address offshore and cross-border compliance risks through enforcement and by issuing guidance and expanding relationships and collaboration with foreign tax administrations to increase informal and formal communications on international tax administration matters.
- Litigate cases and work settlements and design large scale resolution initiatives for tax shelter transactions to deter noncompliance.
- Increase industry and global issues focus by aligning resources to cases and issues with the highest compliance risk.
- Test new EITC paid preparer treatments to determine the effect of early education and intervention on the accuracy of EITC returns prepared by first-time paid preparers, including first-time EITC paid preparer education and compliance notices and telephone contacts.

	• Implement corporate non-filer measures and align activity consistent with those measures. • Continue to enhance Examination and AUR case selection and modeling. • Test an Automated Under-Reporter Soft Notice program that provides the taxpayer the opportunity to self-correct income reporting errors. • Deliver a training program for Campus Fraud Coordinators in the first quarter of FY 2009. ***Tax-Exempt and Government Entities*** **Actions Taken:** • Increased examinations by 3.4% and overall compliance contacts 6%. • Conducted compliance checks of executive compensation practices among tax-exempt organizations to assess compliance risk of officers and executives and initiated a new phase to address loans to officers. • Launched Form 990-N, Electronic Notice for Tax-Exempt Organizations Not Required to file Form 990 or 990-Z (e-Postcard), for small tax-exempt organizations to electronically file an annual information notice. Approximately 170,000 e-Postcards were filed in fiscal year 2008. Failure to file the e-Postcard for three consecutive years will result in loss of tax exemption. • Implemented post-bond issuance policies and procedures for issuers and borrowers of tax-exempt bond proceeds. Initiative included conducting several outreach presentations to encourage improved compliance procedures after bond issuance. • Increased awareness of IRS Pension Plan Correction Programs via new fix-it guides and an educational workshop marketed for small business practitioners and encouraged them to use online IRS "Fix-It Guides" to help their clients find, fix, and avoid common retirement plan mistakes. • Completed analysis of data from the first phase of a Risk Modeling program. Initial phase involved the examination of 200 organizations with 940 returns, of which, 234 delinquent returns were secured during the examinations. • Terminated or revoked the exempt status of 92 tax-exempt organizations as a result of targeted Abusive Tax Avoidance Transactions compliance projects. • Continued compliance initiatives to address tribal gaming and banking issues. **Actions Planned or Underway for FY 2009 and Beyond:** • Expand the use of risk modeling results for cases selection and test new models for other categories of examinations including exempt organizations that report gaming activities on Form 990. • Identify promoters who use retirement plans as parties to abusive transactions. • Continue the Combined Annual Wage Reporting project which deals with tax-gap implications of employment taxes for exempt organizations. • Continue to assist Criminal Investigation and the Department of Justice in developing criminal cases and preparing their prosecutions on abusive tax-exempt bond situations.

Security of the Internal Revenue Service	
Strengthening the security infrastructure and the applications that guard sensitive data.	**Actions Taken:** • Implemented Enterprise Disk Encryption Phase 2, encrypting all removable storage devices and media used with desktop and laptop computers. • Established the Office of Online Fraud Detection and Prevention to address the threat of online fraud affecting the IRS and taxpayers.

	• Continued risk assessments of business processes to address identity protection vulnerabilities and analyzed the use of social security numbers for reduction and elimination where possible. • Implemented Operation RED, the first phase of a comprehensive Data Loss Prevention Action Plan, to enhance awareness of data protection. • Updated the IRS Identity Protection Strategy, a comprehensive strategy for protecting personal information and providing services to identity theft victims. • Implemented an entirely new security code review against several IRS.gov applications. • Developed a Manager's Toolkit for performing security and after-hours reviews to assist managers in adhering to the Security Assurance Certification process. The toolkit provides instructions for completing the functional security reviews to ensure that existing security procedures and requirements are in place on a day-to-day basis. **Actions Planned or Underway for FY 2009 and Beyond:** • Implement the IT Asset Centralization initiative. • Complete strategic security initiatives necessary to close the IRS Computer Security Material Weakness.

	Providing Quality Taxpayer Service Operations
Providing top quality service to every taxpayer in every transaction is an integral part of the IRS's strategic and modernization plans.	**Actions Taken:** • Implemented the Economic Stimulus Payment (ESP) initiative, issuing 116.2 million payments totaling $94.3 billion with the first payments issued 55 workdays after passage of legislation. • Launched the Economic Stimulus Payments Information Center on IRS.gov, including areas for Frequently Asked Questions (FAQs), an Economic Stimulus Calculator, and "Where's My Stimulus Payment?" • Launched a data-driven outreach campaign targeting qualified individuals who normally do not have a filing requirement to claim their economic stimulus payment. • Implemented Taxpayer Assistance Blueprint (TAB) service improvement initiatives, including establishment of the Taxpayer Services Program Management Office and Services Committee to provide senior executive coordination and governance to TAB implementation. • Delivered a successful filing season, implementing all late legislation, including AMT changes by February 2008. • Delivered Spanish interactive tax applications, including the Spanish version of "Where's My Refund?" • Released tax publications in more languages, including Chinese, Russian, Korean, and Vietnamese. • Redesigned Form 990, *Return of Organization Exempt from Income Tax*. The instructions contain tools to facilitate understanding and ease preparation, including multiple reporting examples and illustrations. A three-year phase-in period will allow organizations, based on their gross receipts and assets, to file the Form 990-EZ, in lieu of the more complex Form 990. • Designed a new determination pre-screening process that quickly identifies employee plan applications that have deficiencies. By returning deficient cases to taxpayers in a timely manner, they can resolve the identified deficiencies and re-apply for a determination letter rather than waiting for a full review, which would result in a returned application at a much later date. • Created a streamlined Voluntary Closing Agreement Program (VCAP) for Tax Exempt Bonds intended to lessen burdens on issuers who desire to resolve, on a voluntary basis, infractions with respect to their bonds.

	• Allowed taxpayers to use statistical sampling to claim deductions and credits they might not be able to claim otherwise. This program advances compliance goals, improves quality, and reduces costs while minimizing undue burden on taxpayers. **Actions Planned or Underway for FY 2009 and Beyond:** • Continue to implement TAB service improvement initiatives, including recommending a set of measures to serve as the basis for a taxpayer scorecard to measure service improvements. • Provide taxpayers who did not receive an Economic Stimulus Payment or received less than the maximum amount with information to claim the Recovery Rebate Credit. • Identify optimal Taxpayer Assistance Center locations to improve geographic coverage.

Complexity of the Tax Law	
Simplifying the tax process within current laws while at the same time modernize IRS systems and processes to reduce tax complexity for individual and business taxpayers.	**Actions Taken:** • As part of the effort to complete the Study of Universal Use of Advanced Payment of Earned Income Credit (AEITC) mandated by Congress, interviewed employers to gain their insight into the benefits, costs, risks, and barriers if the advance earned income tax credit program were expanded. • Continued to develop guidance in response to The Pension Protection Act of 2006. • Developed a simplified employee plan application process for small employers. • Presented Retirement Plan Pitfalls workshops to employers and plan representatives unfamiliar with the employee benefits practice. • Addressed potential compliance issues for small businesses and individuals with limited English proficiency through the translation of chapters in Publication 17, "Your Federal Income Tax," and Publication 334, "Tax Guide for Businesses." • Initiated compliance checks for up to 5,000 locally hired employees of foreign embassies, consulates, and international organizations. As a result, 2,100 individuals from 134 countries and international organizations participated in a settlement resulting in assessments of $21.1 million in tax and penalties. • Enabled Modernized e-File (MeF) to electronically file Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*. In FY 2008, MeF accepted over 3.7 million returns, a 55% increase over FY 2007. **Actions Planned or Underway for FY 2009 and Beyond:** • Develop and implement multi-faceted treatments that will address underlying behavior that contributes to non-compliance, including a more comprehensive measurement approach. • Create additional employee plans Fix-It Guides to help employers find, fix, and avoid common plan mistakes. • Streamline the determination approval process for certain public charities. • Implement a Voluntary Compliance program to allow exempt organizations to fill delinquent returns and pay all taxes and applicable interest without penalty in order to avoid loss of their exempt status under new requirements imposed by the Pension Protection Act of 2006. • Implement procedures to simplify and clarify processes for handling rebate refund cases for Tax-Exempt Bonds. • Continue enforcement activities against the approximately 2,500 noncompliant taxpayers who did not elect to participate in the hired settlement initiative.

Human Capital	
The IRS's ability to meet expectations outlined by the President's Management Agenda in personnel management area, such as recruiting, training, and retaining employees.	**Actions Taken:** • Implemented a pilot using coaches to strengthen management skills and increase employee engagement. • Developed a Veterans Hiring Initiative. In FY 2008, the IRS exceeded its goal to hire 1,000 military veterans with the hiring of 1,203 veterans. • Achieved 87.2% of filing season hiring (a 5% improvement over FY 2007); 4 out of 10 campus locations met or exceeded 90% of FY 2008 filing season hiring. • Delivered a $2.2 million multi-media advertising and marketing plan that supported national recruitment events and partnerships with national advocacy and support groups. • Expanded the external HR *Career Connector* recruitment effort, addressing 60 occupations, and began the roll out of the internal merit promotion process. • Streamlined and automated the Candidate Development Program recruitment and selection process, successfully recruiting over 250 qualified applicants. • Redesigned the Tuition Assistance Program, spending $10.1 million on a total of 4,200 participants. • Implemented an "Anchoring Change" strategy for employees in the Large and Mid-Size Division to strengthen the linkage between front line employees and all levels of management to improve communications, relationships, business processes, and business performance. **Actions Planned or Underway for FY 2009 and Beyond:** • Complete analysis of turnover rates, causes and costs. • Develop a cost-index model to quantify turnover, with rollout to all business units. • Simplify the application process and the use of hiring incentives. • Implement a Corporate Incentive Strategy to recognize and retain managers. • Continue efforts to quickly replace key leaders lost to retirement by expanding the Succession Management Program and expanding use of the Leadership Succession Review tool to levels below the senior executive. • Implement applicable "Workforce of Tomorrow" provisions related to: ○ Valuing and retaining people ○ Planning a dynamic hiring strategy ○ Attracting the best candidates internally and externally - Developing enhanced recruiting and career progression strategies ○ Streamlining ○ Growing future leaders ○ Enhancing the role of managers

Erroneous and Improper Payments	
Reduce improper payments that include base compliance activities and redesign efforts.	**Actions Taken:** • Protected approximately $3.2 billion in revenue through EITC enforcement efforts, which included the examination of 500,000 returns and 30,000 amended returns claiming EITC, 375,000 document matching reviews, and 425,000 math error process corrections. • Identified more than 337,000 potentially fraudulent returns claiming over $1.7 billion in refunds, stopped over $1.5 billion in fraudulent claims using the Electronic Fraud Detection System, with an average refund of $5,303. • Developed EITC outreach products and services, found innovative ways to market them to the vast stakeholder segments, and targeted underserved groups, such as rural taxpayers, childless workers, and the limited English proficient. • Held a second IRS EITC Day, which generated extensive national and local media coverage. Conducted a national news conference, which was web cast with 18

	reporters representing 7 television stations. More than 90 partners held news conferences. Over 80 organizations issued news releases, and more than 1,100 radio stations were reached via statewide radio networks. The IRS conducted 23 interviews with Spanish print and radio reporters and 24 satellite media tours throughout the country. • Analyzed the results from the first year of the multi-year National Research Program study and updated error rate estimates based on TY 2001 compliance study data to meet the Improper Payments Improvement Act annual requirement. • Assessed results of FY 2008 enterprise research strategy and developed FY 2009 strategy in partnership with internal organizations to better focus EITC compliance and outreach activities using research data. • Educated paid preparers on EITC due diligence requirements during EITC seminars in several Nationwide Tax Forums. • Published and distributed new paid preparer due diligence flyer to educate paid preparers on their EITC diligence requirements. • Completed development of an updated EITC Concept of Operations (CONOPs), including the EITC Preparer Strategy, which targets effecting EITC error through progressive compliance treatments and outreach and education aimed at preparers. **Actions Planned or Underway for FY 2009 and Beyond:** • Refine campaigns and expand publicity for EITC Awareness Day based on focus group and internal feedback and coverage data to increase overall participation and improve compliance. • Complete activities associated with the fourth year of the EITC Return Preparer Study and analyze short-term outcomes, including penalties and accuracy of returns and outcomes from due diligence visits and education/compliance notices and phone calls to first-time EITC preparers. • Continue to identify and investigate high-impact EITC fraud and tax scheme promoters. • Actively explore research-based cost-effective approaches to improve EITC participation and minimize errors.

Taxpayer Protection and Rights	
The IRS has made significant progress in complying with the Internal Revenue Service Restructuring and Reform Act of 1998, and most provisions pertaining to taxpayer protection and rights have been implemented. Significant management attention is still required to ensure that remaining issues have been addressed.	**Actions Taken:** • Completed Federal Tax Levy Payment Program (FPLP) research project to determine an approach to ensure levies processed against Social Security (SSA) and Railroad Retirement (RRB) benefits protect low income taxpayers. Results need further examination. • Continued to enhance and refine the overall examination process through increased managerial involvement in all phases of the audit, encouraging examiners to address matters of substance as part of the audit and ensuring the impact on the taxpayer or representative is minimal. • Completed the development of an updated Concept of Operations to address paid preparer non-compliance and establish treatment alternatives that align intensity of the efforts with the level of paid-preparer behaviors. • Completed the Service-wide Return Preparer Strategy and initiated implementation. • Established an enterprise approach to examine questionable claims and protect revenue before issuing refunds, focusing on identifying and releasing legitimate claims quickly. **Actions Planned or Underway for FY 2009 and Beyond:** • Establish oversight review/approval process for preparer penalties to ensure

	uniform and consistent application of penalties. • Develop metrics for the return preparer program. • Continue efforts to remove or redact SSN from outgoing correspondence. • Determine impact of excluding all SSA recipients below certain income levels from FPLP. Meet with TAS to identify reliable indicators of ability to pay.

Processing Returns and Implementing Tax Law Changes During the Tax Filing Season	
The filing season remains a critical IRS program that impacts every American taxpayer. Many programs, activities and resources have to be planned and managed effectively for the filing season to be successful.	**Actions Taken:** • Delivered a successful filing season, while mitigating the impact of the late passage of the Alternative Minimum Tax legislation and administration of the provisions of the Economic Stimulus Act: ○ Processed 155.6 million individual returns, an increase of 11%, and issued 107.6 million refunds totaling $369 billion; ○ Answered over 40.4 million calls, a 21% increase, because of a large number of taxpayer inquiries about the economic stimulus checks; ○ Completed 52 million automated calls, an increase of over 123%; ○ Maintained Account and Tax Law Accuracy rates of over 90%; ○ Expanded partnerships with nonprofit and community organizations, offering approximately 12,000 free tax preparation sites nationwide. Volunteers at these sites prepared 3.5 million returns for low-income and elderly taxpayers, an increase of 33%; and ○ Expanded return preparation at the IRS Taxpayer Assistance Centers preparing over 575,000 returns, a 42% increase over last year. • Processed over 116.2 million Economic Stimulus Payments, distributing $94.3 billion dollars. Provided free help preparing the 1040A for people who were filing solely to receive their stimulus payment at approximately 320 IRS offices on Super Saturday, March 29, 2008. • Developed Telephone Excise Tax Refund insert for individual income tax packages for TY 2007, to advise eligible taxpayers who did not claim a refund on their original TY 2006 returns to file amended returns. **Actions Planned or Underway for FY 2009 and Beyond**: • Ensure 2009 filing season readiness through executive oversight. • Ensure that legislative provisions are accurately reflected in filing season forms and publications. • Provide an online web application and automated telephone service to allow taxpayers to research the amount of Economic Stimulus Payment received in 2008 for use in completing their TY 2008 tax returns. • Reduce the size and age of adjustment inventories before the filing season.

Using Performance and Financial Information for Program and Budget Decisions	
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:** • Deployed CDDB Release 3 in January 2008, adding pre-posted revenue receipt transactions classified as "other" such as federal tax deposits, lockbox, integrated submission and remittance processing. It also created a refund transactions subsidiary ledger. • Finalized the business compatibility definitions for the first two releases of Redesign Revenue Accounting Control System (RRACS). RRACS is an initiative that provides new functionality to address GAO material weaknesses, reduce the risk of failure to sustain future clean audit opinions, and streamline financial reporting. It also incorporates the United States standard general ledger (US SGL) as required by the Core Financial Systems Requirements of the Federal Financial Management System Requirements (FFMSR)/Joint Financial Management

	Improvement Act of 1996 (FFMIA). o Completed Release 1 business requirements March 2008. o Completed Project Charter, Project Management Plan, and Tailoring Plan (Milestone 1 August 2008). o Complete of the Business System Architecture Report, System Deployment Plan, and Business Systems Concept Report (Milestone 2 November 2008). • Used detailed allocation methodology to provide full cost accounting to the five operating business units and three complete years of fully allocated cost data in Integrated Financial System (IFS). • Produced the Statement of Net Cost from the IFS Cost Accounting Module. • Developed and provided a full cost Return On Investment (ROI) calculation for the EITC program that was a key factor in enabling EITC to reduce the FMFIA Material Weakness. **Actions Planned or Underway for FY 2009 and Beyond:** • Use CDDB to audit revenue and refunds in the FY 2009 audit. • Expand use of CDDB for pre-posted revenue receipts using TRACE ID numbers. • Complete the Business System Architecture Report, System Deployment Plan, and Business Systems Concept Report (Release 1, Milestone 2) for RRACS. • Complete preliminary design of RRACS Release 1. • Complete Detailed Design for RRACS Release 1. • Begin system development and testing for RRACS Release 1. • Continue use of managerial cost accounting system for cost analysis and cost estimation.

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*, revised June 3, 2008. The responsibility for the integrity of the financial information included in these statements rests with the management of IRS. The audit of IRS's principal financial statements was performed by the Government Accountability Office (GAO).

IRS's principal financial statements for fiscal years 2008 and 2007 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 Activities** presents the sources and disposition of non-exchange federal tax revenues collected.

Internal Revenue Service
Balance Sheet
As of September 30, 2008 and 2007

(In Millions)

	2008	2007
Assets		
Intragovernmental:		
Fund Balance with Treasury (Note 2)	$ 2,072	$ 2,074
Due from Treasury (Note 6)	3,064	1,675
Other Assets (Note 3)	186	187
Total Intragovernmental	**5,322**	**3,936**
Cash and Other Monetary Assets (Note 4, 6)	133	165
Federal Taxes Receivable, Net (Notes 5, 6)	29,000	26,000
Property and Equipment, Net (Note 7)	1,159	1,194
Other Assets (Note 3)	17	14
Total Assets	**$ 35,631**	**$ 31,309**
Liabilities		
Intragovernmental:		
Due to Treasury (Note 5)	$ 29,000	$ 26,000
Other Liabilities (Note 8)	197	176
Total Intragovernmental	**29,197**	**26,176**
Federal Tax Refunds Payable	3,064	1,675
Other Liabilities (Notes 8, 9)	1,685	1,692
Total Liabilities	**33,946**	**29,543**
Net Position		
Unexpended Appropriations	1,523	1,482
Cumulative Results of Operations	162	284
Total Net Position	**1,685**	**1,766**
Total Liabilities and Net Position	**$ 35,631**	**$ 31,309**

The accompanying notes are an integral part of these statements.

1

Internal Revenue Service
Statement of Net Cost
For the Years Ended September 30, 2008 and 2007

(In Millions)

	2008	2007
Program		
Taxpayer Assistance and Education		
Gross Cost	$ 623	$ 479
Earned Revenue	(6)	(3)
Net Cost of Program	**617**	**476**
Filing and Account Services		
Gross Cost	3,602	3,640
Earned Revenue	(61)	(43)
Net Cost of Program	**3,541**	**3,597**
Compliance		
Gross Cost	8,136	7,702
Earned Revenue	(285)	(231)
Net Cost of Program	**7,851**	**7,471**
Administration of Tax Credit Programs		
Gross Cost	184	191
Earned Revenue	-	-
Net Cost of Program	**184**	**191**
Net Cost of Operations (Note 11)	**$ 12,193**	**$ 11,735**

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, 2008 and 2007

(In Millions)

	2008 Cumulative Results of Operations	2008 Unexpended Appropriations	2007 Cumulative Results of Operations	2007 Unexpended Appropriations
Beginning Balances	**$ 284**	**$ 1,482**	**$ 324**	**$ 1,575**
Budgetary Financing Sources:				
Appropriations Received		11,095		10,597
Appropriations Transferred In/Out		18		4
Other Adjustments		(68)		(73)
Appropriations Used	11,004	(11,004)	10,621	(10,621)
Transfers In Without Reimbursement - Earmarked Funds	13		11	
Other Financing Sources:				
Imputed Financing	1,067		1,094	
Transfers In Without Reimbursement	30		13	
Transfers to General Fund	(43)		(44)	
Total Financing Sources	**12,071**	**41**	**11,695**	**(93)**
Net Cost of Operations	**(12,193)**		**(11,735)**	
Net Change	**(122)**	**41**	**(40)**	**(93)**
Ending Balances	**$ 162**	**$ 1,523**	**$ 284**	**$ 1,482**

The accompanying notes are an integral part of these statements.

3

Internal Revenue Service
Statement of Budgetary Resources
For the Years Ended September 30, 2008 and 2007

(In Millions)

		2008		2007
Budgetary Resources:				
Unobligated Balance, Brought Forward, October 1	$	664	$	552
Recoveries of Prior Year Unpaid Obligations		106		183
Budget Authority				
Appropriations		11,296		10,776
Spending Authority from Offsetting Collections		158		119
Nonexpenditure Transfers, Net		18		4
Permanently Not Available		(68)		(73)
Total Budgetary Resources	**$**	**12,174**	**$**	**11,561**
Status of Budgetary Resources:				
Obligations Incurred	$	11,484	$	10,897
Unobligated Balance – Available (Note 2)		224		171
Unobligated Balance – Not Available (Note 2)		466		493
Total Status of Budgetary Resources	**$**	**12,174**	**$**	**11,561**
Change in Obligated Balance:				
Obligated Balance, Net, Brought Forward, October 1	$	1,427	$	1,522
Obligations Incurred		11,484		10,897
Gross Outlays		(11,388)		(10,800)
Recoveries of Prior Year Unpaid Obligations, Actual		(106)		(183)
Change in Uncollected Customer Payments from Federal Sources		(23)		(9)
Obligated Balance, Net, End of Period	**$**	**1,394**	**$**	**1,427**
Net Outlays:				
Gross Outlays	$	11,388	$	10,800
Offsetting Collections		(136)		(110)
Distributed Offsetting Receipts		(201)		(164)
Net Outlays	**$**	**11,051**	**$**	**10,526**

The accompanying notes are an integral part of these statements.

4

Internal Revenue Service
Statement of Custodial Activity
For the Years Ended September 30, 2008 and 2007

(In Billions)

	2008	2007
Revenue Activity		
Collections of Federal Tax Revenue (Note 13)		
Individual Income, FICA/SECA, and Other	$ 2,295	$ 2,202
Corporate Income	354	395
Excise	52	53
Estate and Gift	30	27
Railroad Retirement	5	5
Federal Unemployment	7	7
Total Collections of Federal Tax Revenue	**2,743**	**2,689**
Increase in Federal Taxes Receivable, Net	3	5
Total Federal Tax Revenue	**$ 2,746**	**$ 2,694**
Distribution of Federal Tax Revenue to Treasury	**$ 2,743**	**$ 2,689**
Increase in Amount Due to Treasury	3	5
Total Disposition of Federal Tax Revenue	**2,746**	**2,694**
Net Federal Revenue Activity	**$ -**	**$ -**
Federal Tax Refund Activity		
Total Refunds of Federal Taxes (Note 14)	$ 426	$ 292
Appropriations Used for Refund of Federal Taxes	(426)	(292)
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, 2008 and 2007

Note 1. Summary of Significant Accounting Policies

A. Reporting Entity

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

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

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

Organizations

- Operating Divisions
- Functional Divisions
- National Headquarters
- Cross-Servicing Organizations

There are four operating divisions. Wage and Investment (W&I) is responsible for individuals with wage and investment income only. In addition, W&I manages submission processing for all taxpayers. 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) is in charge of employee plans, tax exempt organizations, and government entities. Large and Mid-Size Business (LMSB) is responsible for corporations, subchapter S corporations, and partnerships with assets greater than $10 million.

The functional divisions are Appeals, Criminal Investigation, Taxpayer Advocate and Chief Counsel. They are independent of the operating divisions and other units of the IRS. Taxpayer Advocate reports directly to Congress and Chief Counsel reports to the Secretary of the Treasury.

National Headquarters fills the role of setting broad policy, providing executive oversight, reviewing plans and goals of the operating units, and developing major improvement initiatives.

Two cross-servicing organizations, Modernization and Information Technology Services (MITS) and Agency Wide Shared Services (AWSS), provide central support to all areas of the IRS.

Major Programs

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

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

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2008 and 2007

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*, revised June 3, 2008. 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 IRS's accounts, primarily appropriated funds, from which the IRS is authorized to make expenditures and pay liabilities.

Obligated balances not yet disbursed include accounts payable and other accrued liabilities net of receivables, and undelivered orders. Unobligated balances may be further broken into available and unavailable components. Available unobligated balances represent amounts in unexpired appropriations as of the end of the current fiscal year. Unavailable unobligated balances 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) and the Department of Interior GovWorks (GovWorks). Centralized services funded through the WCF consist primarily of telecommunications services, payroll processing, and depreciation of property and equipment owned by the WCF. Activities funded through GovWorks consist of the

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2008 and 2007

acquisition of furniture. Advances to the public are cash outlays for criminal investigations and employee travel.

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

E. Cash and Other Monetary Assets

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

F. Federal Taxes Receivable, Net and Due to Treasury

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

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

Compliance assessments are unpaid assessments 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 and Abatements

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 but 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 IRS's enforcement programs, 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, 2008 and 2007

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, 2008 and 2007

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. IRS records Due from Treasury to designate approved funding to pay year-end tax refund liabilities. The liability account represents the Federal tax refunds to taxpayers.

I. Financing Sources and Revenues

Appropriations Received

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.

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), the largest of these funds, and Health and Insurance Tax Credit Administration. BSM provides resources for the planning and capital asset acquisition of information technology to modernize IRS's business systems. Additionally, BSM is obligated pursuant to an expenditure plan approved by Congress. Health and Insurance Tax Credit Administration provides funding for health insurance and refundable tax credits to qualified individuals.

Exchange Revenues

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

Non-exchange Revenues – Earmarked Funds

Non-exchange revenues represent amounts retained from tax collections for payments to private collection agencies (PCAs) and for enforcement activities. The Private Collection Agent Program

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2008 and 2007

authorizes contracts with PCAs to collect delinquent taxes on behalf of IRS not to exceed 25 percent of the total taxes collected. Additionally, IRS retains 25 percent of the total taxes collected to fund enforcement activities.

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 IRS. The imputed costs are pension and other retirement benefit costs administered by the Office of Personnel Management, costs of processing payments and collections by the Financial Management Service and legal judgments paid by the Treasury Judgment Fund.

J. Program Costs

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

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

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

Administration of Tax Credit Programs oversees the Earned Income Tax Credit (EITC) and Health Coverage Tax Credit (HCTC) programs. EITC performs expanded customer service, public outreach, enforcement, and research efforts to reduce claims and erroneous filings associated with the program. EITC comprises the full spectrum of taxpayer services and compliance activities. However, EITC payments actually refunded to individuals or credited against other tax liabilities are not included in program costs.

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

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2008 and 2007

K. Custodial Activity

Non-exchange Revenues

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 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

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. 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 IRS, but rather a cost to the Federal government as a whole.

L. Earmarked Funds

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

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

The Private Collection Agent Program (20X5510) was established under the *American Jobs Creation Act of 2004*. IRS has been authorized to enter into contracts with private collection agencies (PCAs) to assist in the collection of delinquent Federal tax liabilities. A portion of the collections are retained by IRS to pay the PCAs and fund enforcement activities.

M. Allocation Transfers

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

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2008 and 2007

N. 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 IRS. Actuarial FECA liability represents the liability for future workers' compensation benefits, which includes the expected liability for death, disability, medical, and miscellaneous costs for approved cases. DOL estimates the liability for future payments as a result of past events.

Employee Pension Benefits

IRS employees participated in the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS). For employees covered by CSRS, the IRS contributes 7% of the employees' gross pay for regular and 7.5% for law enforcement officers' retirement. For employees covered by FERS, the IRS contributes 11.2% of employees' gross pay for regular and 24.9% for law enforcement officers' retirement.

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

Employee Health and Life Insurance Benefits

Employees are eligible to participate in the Federal Employees Health Benefit Program (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. IRS recognizes the full cost of providing these benefits.

O. 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

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INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2008 and 2007

reporting of assets, liabilities, revenues, and expenses and the disclosure of contingent liabilities. Actual results could differ from those estimates.

P. Reclassifications

Certain prior year amounts have been reclassified to conform to current year presentation in the disclosures.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2008 and 2007

Note 2. Fund Balance with Treasury

(In Millions)	2008	2007
General Funds	$ 1,986	$ 1,937
Special Funds	82	136
Revolving Funds	5	6
Other Funds	(1)	(5)
Fund Balance with Treasury	**$ 2,072**	**$ 2,074**

(In Millions)	2008	2007
Unobligated balances:		
Available	$ 224	$ 171
Unavailable	466	493
Obligated Balance not yet disbursed	1,394	1,427
Non-Budgetary FBWT	(12)	(17)
Status of Fund Balance with Treasury	**$ 2,072**	**$ 2,074**

Note 3. Other Assets

(In Millions)	2008		2007	
	Intra-governmental	With the Public	Intra-governmental	With the Public
Advances	$ 137	$ 9	$ 162	$ 8
Accounts receivable, net	45	5	17	7
Forfeited property held for sale	-	3	-	2
Clearing accounts	4	-	8	(3)
Other Assets	**$ 186**	**$ 17**	**$ 187**	**$ 14**

Note 4. Cash and Other Monetary Assets

(In Millions)	2008	2007
Imprest Fund	$ 4	$ 4
Other monetary assets	129	161
Cash and Other Monetary Assets	**$ 133**	**$ 165**

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INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2008 and 2007

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

(In Billions)	2008	2007
Federal taxes receivable	$ 112	$ 98
Allowance for uncollectible taxes receivable	(83)	(72)
Federal taxes receivable, net and Due to Treasury	**$ 29**	**$ 26**

Federal taxes receivable consists of tax assessments, penalties and interest not paid or abated which were agreed to by the taxpayer and 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)	2008		2007	
	Intra-governmental	With the Public	Intra-governmental	With the Public
Due from Treasury	$ 3,064	$ -	$ 1,675	$ -
Federal taxes receivable, net	-	29,000	-	26,000
Other monetary assets	-	129	-	161
Non-entity Assets	**$ 3,064**	**$ 29,129**	**$ 1,675**	**$ 26,161**

Non-entity assets are not available for IRS's use. The IRS collects Federal taxes receivable for the U.S. Government but does not have the authority to spend them.

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INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2008 and 2007

Note 7. Property and Equipment

(In Millions)	Useful Life (Years)	Cost	Accumulated Depreciation	2008 Net Book Value	2007 Net Book Value
ADP assets	3 to 7	$ 1,842	$ (1,422)	$ 420	$ 441
Internal use software	7 to 17	795	(432)	363	438
Leasehold improvements	10	509	(356)	153	165
Major systems	7	422	(422)	-	2
Internal use software – work in process		172	-	172	99
Vehicles	5	85	(55)	30	27
Furniture and non-ADP equipment	8 to 10	67	(54)	13	12
Assets under capital lease	4 to 10	24	(17)	7	9
Investigative equipment	10	8	(7)	1	1
Property and Equipment		**$ 3,924**	**$ (2,765)**	**$ 1,159**	**$ 1,194**

The Cost column represents the historical cost of property and equipment, net of disposals. The cost basis for FY 2008 and FY 2007 is $3,924 million and $3,721 million, respectively. Accumulated depreciation for FY 2008 and FY 2007 is $2,765 million and $2,527 million, respectively.

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

- Modernized E-File is an electronic filing system for tax returns.
- Customer Account Data Engine (CADE) is a project to replace IRS's master files for taxpayer accounts.
- Account Management Services (AMS) will support users with CADE access and query capabilities.
- Integrated Financial System (IFS) is an 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.
- Filing & Payment Compliance provides functionality to enable private debt collection and manage delinquent tax cases.
- 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) provides the functionality needed for custodial financial management reporting.

In fiscal year 2008 due to funding issues, Correspondence Examination Automation Support (CEAS) and Examination Desktop Support System (EDSS) were terminated. In fiscal year 2007, these projects were in work in process. The accumulated costs have been recognized as a loss on disposal in fiscal year 2008.

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INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2008 and 2007

Deployed Internal Use Software

(In Millions)	Cost	Accumulated Depreciation	2008 Net Book Value	2007 Net Book Value
Modernized E-File	$ 183	$ (87)	$ 96	$ 103
CADE	148	(53)	95	101
Integrated Financial System	147	(74)	73	95
E-Services	141	(90)	51	70
STIR	76	(60)	16	27
Filing & Payment Compliance	28	(7)	21	25
Customer Communications	25	(25)	-	3
Enterprise Systems Management	16	(13)	3	6
Internet Refund Fact of Filing	15	(12)	3	6
Other	16	(11)	5	2
Deployed Internal Use Software	**$ 795**	**$ (432)**	**$ 363**	**$ 438**

Work in Process Internal Use Software

(In Millions)	2008	2007
CADE	$ 108	$ 57
AMS	48	23
Modernized E File	14	7
CDDB	2	2
EDSS	-	6
CEAS	-	4
Work in Process Internal Use Software	**$ 172**	**$ 99**

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INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2008 and 2007

Note 8. Liabilities

Other Liabilities

(In Millions)	2008 Current	2008 Non-Current	2008 Total
Intragovernmental:			
Accrued payroll and benefits	$ 67	$ -	$ 67
Accrued FECA liability	42	55	97
Accrued expense	33	-	33
Other Liabilities	**$ 142**	**$ 55**	**$ 197**
With the Public:			
Accrued annual leave	$ 506	$ -	$ 506
Actuarial FECA liability	-	481	481
Accrued payroll and benefits	290	-	290
Accrued expenses	221	-	221
Liability for Deposit Funds and Clearing Accounts	132	-	132
Accounts payables	52	-	52
Net capital lease liability (Note 9)	3	-	3
Other Liabilities	**$ 1,204**	**$ 481**	**$ 1,685**

(In Millions)	2007 Current	2007 Non-Current	2007 Total
Intragovernmental:			
Accrued payroll and benefits	$ 55	$ -	$ 55
Accrued FECA liability	43	55	98
Accrued expenses	23	-	23
Other Liabilities	**$ 121**	**$ 55**	**$ 176**
With the Public:			
Accrued annual leave	$ 480	$ -	$ 480
Actuarial FECA liability	-	465	465
Accrued payroll and benefits	281	-	281
Accrued expenses	208	-	208
Liability for Deposit Funds and Clearing Accounts	161	-	161
Accounts payable	86	-	86
Installment agreement liability	8	-	8
Net capital lease liability (Note 9)	-	3	3
Other Liabilities	**$ 1,224**	**$ 468**	**$ 1,692**

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2008 and 2007

Liabilities Not Covered by Budgetary Resources

(In Millions)	2008		2007	
	Intra-governmental	With the Public	Intra-governmental	With the Public
Actuarial FECA liability	$ -	$ 481	$ -	$ 465
Accrued annual leave	-	506	-	480
Accrued FECA liability	97	-	98	-
Installment agreement liability	-	-	-	8
Liabilities Not Covered by Budgetary Resources	**$ 97**	**$ 987**	**$ 98**	**$ 953**

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

Note 9. Leases

Capital Leases

The net capital lease liability was $3 million as of September 30, 2008 and 2007. The lease for the ADP equipment is covered by budgetary resources. The future lease payment due in fiscal year 2009 is the final payment.

Operating Leases

(In Millions) Fiscal Year	Lease Payment
2009	$ 9
2010	9
2011	10
2012	8
2013	4
After 2013	-
Total Future Lease Payments	**$ 40**

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, 2008 and 2007

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 unfavorable outcome is remote. As of September 30, 2008 and 2007, there were no estimated contingent liabilities arising from these actions.

For some of the legal actions to which 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, 2008 and 2007, 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.

As of September 30, 2008 and 2007, the IRS does not have contractual commitments for payments on obligations related to canceled appropriations.

Note 11. Cost and Earned Revenue by Programs

	2008				
(In Millions)	Taxpayer Assistance and Education	Filing and Account Services	Compliance	Administration of Tax Credit Programs	Total
Intragovernmental Gross Cost	$ 119	$ 1,494	$ 2,456	$ 41	$ 4,110
Gross Costs with the Public	504	2,108	5,680	143	8,435
Program Costs	623	3,602	8,136	184	12,545
Intragovernmental Earned Revenue	(3)	(15)	(53)	-	(71)
Earned Revenue from the Public	(3)	(46)	(232)	-	(281)
Program Revenues	(6)	(61)	(285)	-	(352)
Net Cost of Operations	**$ 617**	**$ 3,541**	**$ 7,851**	**$ 184**	**$ 12,193**

	2007				
(In Millions)	Taxpayer Assistance and Education	Filing and Account Services	Compliance	Administration of Tax Credit Programs	Total
Intragovernmental Gross Cost	$ 75	$ 1,497	$ 2,353	$ 41	$ 3,966
Gross Costs with the Public	404	2,143	5,349	150	8,046
Program Costs	479	3,640	7,702	191	12,012
Intragovernmental Earned Revenue	(1)	(8)	(41)	-	(50)
Earned Revenue from the Public	(2)	(35)	(190)	-	(227)
Program Revenues	(3)	(43)	(231)	-	(277)
Net Cost of Operations	**$ 476**	**$ 3,597**	**$ 7,471**	**$ 191**	**$ 11,735**

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INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2008 and 2007

Note 12. Statement of Budgetary Resources

Obligations Incurred

(In Millions)	2008	2007
Direct - Category B	$ 11,342	$ 10,808
Reimbursable - Category B	142	89
Obligations Incurred	**$ 11,484**	**$ 10,897**

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 of 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)	$ 11,561	$ 10,897	$ 164	$ 10,526
Included on SBR, not in President's Budget				
Expired Funds	(383)	(26)	-	-
IRS Miscellaneous Retained Fees	(129)	-	-	-
Distributed Offsetting Receipts	-	-	(164)	164
Other	2	1	-	5
Included in President's Budget, not on SBR				
Tax credits and interest refunds to taxpayers	57,817	57,817	-	57,817
Payments to informants	13	13	-	13
Budget of the United States Government	**$ 68,881**	**$ 68,702**	**$ -**	**$ 68,525**

The *FY 2010 Budget of the United States Government* (President's Budget) presenting the actual amounts for the year ended September 30, 2008 has not been published as of the issue date of these financial statements. The FY 2010 President's Budget is scheduled for publication in February 2009. A reconciliation of the FY 2007 column on the Statement of Budgetary Resources (SBR) to the actual amounts for FY 2007 in the FY 2009 President's Budget for budgetary resources, obligations incurred, distributed offsetting receipts, and net outlays is presented above.

The President's Budget includes appropriations for EITC, Child Tax Credit, HCTC, interest relating to taxpayer refunds and informant payments totaling $58 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, 2008 and 2007

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 $917 million and $960 million for the periods ended September 30, 2008 and 2007, respectively.

Note 13. Collections of Federal Tax Revenue

(In Billions)	Tax Year 2008	Tax Year 2007	Tax Year 2006	Prior Years	Collections Received FY 2008	Collections Received FY 2007
Individual income, FICA/SECA, and other	$ 1,455 *	$ 799	$ 24	$ 17	$ 2,295	$ 2,202
Corporate income	222 **	114	2	16	354	395
Excise	38	14	-	-	52	53
Estate and gift	-	19	1	10	30	27
Railroad retirement	4	1	-	-	5	5
Federal unemployment	5	2	-	-	7	7
Collections of Federal Tax Revenue	**$ 1,724**	**$ 949**	**$ 27**	**$ 43**	**$ 2,743**	**$ 2,689**

* Includes other collections of $329 million

** Includes tax year 2009 corporate income tax receipts of $10 billion.

In FY 2008, individual income, FICA/SECA, and other taxes include $79 billion in payroll taxes collected from other Federal agencies.

Note 14. Federal Tax Refund Activity

(In Billions)	Tax Year 2008	Tax Year 2007	Tax Year 2006	Prior Years	Refunds Disbursed FY 2008	Refunds Disbursed FY 2007
Individual income, FICA/SECA, and other	$ 1	$ 342	$ 19	$ 7	$ 369	$ 261
Corporate income	2	20	10	23	55	28
Excise	-	1	-	-	1	2
Estate and gift	-	-	1	-	1	1
Federal Tax Refund Activity	**$ 3**	**$ 363**	**$ 30**	**$ 30**	**$ 426**	**$ 292**

Individual income, FICA/SECA, and other refund amounts include EITC, child tax credit and stimulus rebate payments. The *Economic Stimulus Act of 2008*, (P.L. 110-185), included provisions to help stimulate the economy through recovery rebates. In fiscal year 2008, the IRS disbursed $94.3 billion of tax refunds to eligible taxpayers of up to $600 for individuals and $1,200 for couples, with an additional $300 for each child.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2008 and 2007

Note 15. Reconciliation of Net Cost of Operations to Budget

(In Millions)	2008	2007
Resources used to finance activities:		
Obligations incurred	$ 11,484	$ 10,897
Spending authority from offsetting collections and recoveries	(264)	(302)
Distributed offsetting receipts	(201)	(164)
Other exchange revenues not in budget	(40)	(40)
Imputed financing	1,067	1,094
Transfers in/out without reimbursement	30	13
	12,076	**11,498**
Resources that do not fund net cost of operations:		
Changes in goods, services and benefits ordered but not yet received or provided	40	167
Costs capitalized on the balance sheet	(321)	(292)
	(281)	**(125)**
Costs that do not require resources in current period:		
Depreciation and amortization	333	370
Decrease in unfunded liabilities	41	(21)
Revaluation of assets and liabilities	22	9
Other	2	4
	398	**362**
Net Cost of Operations	**$ 12,193**	**$ 11,735**

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 IRS's programs and operations 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.

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INTERNAL REVENUE SERVICE

Required Supplementary Information - Unaudited

For the Years Ended September 30, 2008 and 2007

Schedule of Budgetary Resources by Major Budget Accounts

	2008				
(In Millions)	Taxpayer Service	Enforcement	Operations Support	Other Appropriations	Total
Budgetary Resources					
Unobligated Balance, Brought Forward, October 1	$ 183	$ 101	$ 134	$ 246	$ 664
Recoveries of Prior Year Unpaid Obligations	22	21	51	12	106
Budget Authority					
Appropriations	2,201	4,780	3,832	483	11,296
Spending Authority from Offsetting Collections	42	61	47	8	158
Nonexpenditure Transfers, Net	163	6	96	(247)	18
Permanently Not Available	(34)	(17)	(16)	(1)	(68)
Total Budgetary Resources	**$ 2,577**	**$ 4,952**	**$ 4,144**	**$ 501**	**$ 12,174**
Status of Budgetary Resources					
Obligations Incurred	$ 2,396	$ 4,852	$ 3,960	$ 276	$ 11,484
Unobligated Balance – Available	23	13	74	114	224
Unobligated Balance – Not Available	158	87	110	111	466
Total Status of Budgetary Resources	**$ 2,577**	**$ 4,952**	**$ 4,144**	**$ 501**	**$ 12,174**
Change in Obligated Balance:					
Obligated Balance, Net, Brought Forward, October 1	$ 235	$ 296	$ 753	$ 143	$ 1,427
Obligations Incurred	2,396	4,852	3,960	276	11,484
Gross Outlays	(2,385)	(4,814)	(3,894)	(295)	(11,388)
Recoveries of Prior Year Unpaid Obligations, Actual	(22)	(21)	(51)	(12)	(106)
Change in Uncollected Customer Payments from Federal Sources	-	(12)	(11)	-	(23)
Obligated Balances, Net, End of Period	**$ 224**	**$ 301**	**$ 757**	**$ 112**	**$ 1,394**
Net Outlays					
Gross Outlays	$ 2,385	$ 4,814	$ 3,894	$ 295	$ 11,388
Offsetting Collections	(42)	(49)	(36)	(9)	(136)
Distributed Offsetting Receipts	-	-	-	(201)	(201)
Net Outlays	**$ 2,343**	**$ 4,765**	**$ 3,858**	**$ 85**	**$ 11,051**

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INTERNAL REVENUE SERVICE

Required Supplementary Information - Unaudited

For the Years Ended September 30, 2008 and 2007

Schedule of Budgetary Resources by Major Budget Accounts

	2007				
(In Millions)	Taxpayer Service	Enforcement	Operations Support	Other Appropriations	Total
Budgetary Resources					
Unobligated Balance, Brought Forward, October 1	$ 154	$ 85	$ 91	$ 222	$ 552
Recoveries of Prior Year Unpaid Obligations	89	36	44	14	183
Budget Authority					
Appropriations	2,157	4,742	3,471	406	10,776
Spending Authority from Offsetting Collections	30	48	31	10	119
Nonexpenditure Transfers, Net	53	(82)	170	(137)	4
Permanently Not Available	(33)	(13)	(23)	(4)	(73)
Total Budgetary Resources	**$ 2,450**	**$ 4,816**	**$ 3,784**	**$ 511**	**$ 11,561**
Status of Budgetary Resources					
Obligations Incurred	$ 2,267	$ 4,715	$ 3,650	$ 265	$ 10,897
Unobligated Balance – Available	11	16	54	90	171
Unobligated Balance – Not Available	172	85	80	156	493
Total Status of Budgetary Resources	**$ 2,450**	**$ 4,816**	**$ 3,784**	**$ 511**	**$ 11,561**
Change in Obligated Balance:					
Obligated Balance, Net, Brought Forward, October 1	$ 448	$ 324	$ 572	$ 178	$ 1,522
Obligations Incurred	2,267	4,715	3,650	265	10,897
Gross Outlays	(2,391)	(4,706)	(3,416)	(287)	(10,800)
Recoveries of Prior Year Unpaid Obligations, Actual	(89)	(36)	(44)	(14)	(183)
Change in Uncollected Customer Payments from Federal Sources	-	(1)	(8)	-	(9)
Obligated Balances, Net, End of Period	**$ 235**	**$ 296**	**$ 754**	**$ 142**	**$ 1,427**
Net Outlays					
Gross Outlays	$ 2,391	$ 4,706	$ 3,416	$ 287	$ 10,800
Offsetting Collections	(30)	(46)	(23)	(11)	(110)
Distributed Offsetting Receipts	-	-	-	(164)	(164)
Net Outlays	**$ 2,361**	**$ 4,660**	**$ 3,393**	**$ 112**	**$ 10,526**

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INTERNAL REVENUE SERVICE

Required Supplementary Information - Unaudited

For the Years Ended September 30, 2008 and 2007

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 2008, the total estimated payout (including principal and interest) for claims pending judicial review by the Federal courts is $5.0 billion and by Appeals is $17.0 billion. In FY 2007, the total estimated payout (including principal and interest) for claims pending judicial review by the Federal courts was $8.8 billion and by Appeals was $5.9 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 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)	2008	2007
Total unpaid assessments	$ 278	$ 263
Compliance assessments	(67)	(65)
Write-offs	(99)	(100)
Gross Federal taxes receivables	112	98
Allowance for uncollectible taxes receivable	(83)	(72)
Federal taxes receivable, net	**$ 29**	**$ 26**

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

To eliminate double-counting, the compliance assessments reported above exclude trust fund recovery penalties, totaling $4 billion as of September 30, 2008 and $6 billion as of September 30, 2007, 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 IRS may also recover portions of those businesses' unpaid assessments from any and all individual officers and directors against whom a trust fund recovery penalty is assessed.

INTERNAL REVENUE SERVICE

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2008 and 2007

Statement of Net Cost by Responsibility Segment:

(In Millions)	2008	2007
Operating divisions:		
WAGE	$ 3,266	$ 3,048
SBSE	2,585	2,548
LMSB	842	821
TEGE	272	267
Total	6,965	6,684
Functional divisions:		
Appeals	218	211
Chief Counsel	326	319
Criminal Investigations	632	604
Taxpayer Advocate	207	192
Communications	28	26
Total	1,411	1,352
Operating Net Cost	**8,376**	**8,036**
General and Administration	1,598	1,555
Information Technology	1,864	1,766
Depreciation/Loss on Disposal	355	378
Net Cost of Operations	**$ 12,193**	**$ 11,735**

Child Tax Credit

The child tax credit provided under Internal Revenue Code (26 USC) Section 24 was originally authorized by the Taxpayer Relief Act of 1997 (Public Law 105-34). The child tax credit is a special credit for taxpayers who work, whose earnings fall below the established allowance ceiling, and who have a qualifying child. In FY 2008, IRS issued $34 billion in child tax credit refunds. An additional $31 billion of child tax credits were applied to reduce taxpayer liability. In FY 2007, IRS issued $16 billion in child tax credit refunds. An additional $31 billion of child tax credits were applied to reduce taxpayer liability.

Earned Income Tax Credit

The EITC is a special credit for employed taxpayers whose earnings fall below the established allowance ceiling. In FY 2008, IRS issued $41 billion in EITC refunds. In FY 2007, IRS issued $38 billion in EITC refunds. An additional $6.2 billion and $5.1 billion of the EITC was applied to reduce taxpayer liability for FY 2008 and FY 2007, respectively.

INTERNAL REVENUE SERVICE

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2008 and 2007

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% of wages and tips up to $102,000 and an employer matching amount of 6.2% bringing the total rate to 12.4%. These benefits are also funded by a self-employment tax of 12.4% on self employment income up to $102,000 for calendar year 2008. The income ceiling for both wages and tips and self-employment income was $97,500 for calendar year 2007. Remaining benefits under FICA pertain to hospital benefits (referred to as "Medicare") and are funded by a separate 1.45% tax on all wages and tips (there is no wage limit) and the employer matching contribution of 1.45% bringing the total rate to 2.9%. Self-employed individuals pay a Medicare tax of 2.9% on all self employment income. Social Security taxes collected by IRS were estimated to be approximately $665 billion and $664 billion in FY 2008 and FY 2007, respectively. Medicare taxes collected by IRS were estimated to be approximately $195 billion and $193 billion in FY 2008 and FY 2007, 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, represents the 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 IRS's balance sheet. The tax gap and the collection gap are related and overlapping concepts, but they have significant differences. The collection gap is a cumulative balance sheet concept for a particular point in time, while the tax gap is like an income statement item for a single year. Moreover, the tax gap estimates include all noncompliance, while the collection gap includes only amounts that have been assessed (a small portion of all noncompliance). Also, the tax gap includes only tax, while the collection gap includes tax, penalties, and interest.

INTERNAL REVENUE SERVICE

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2008 and 2007

Tax Burden and Tax Expenditures

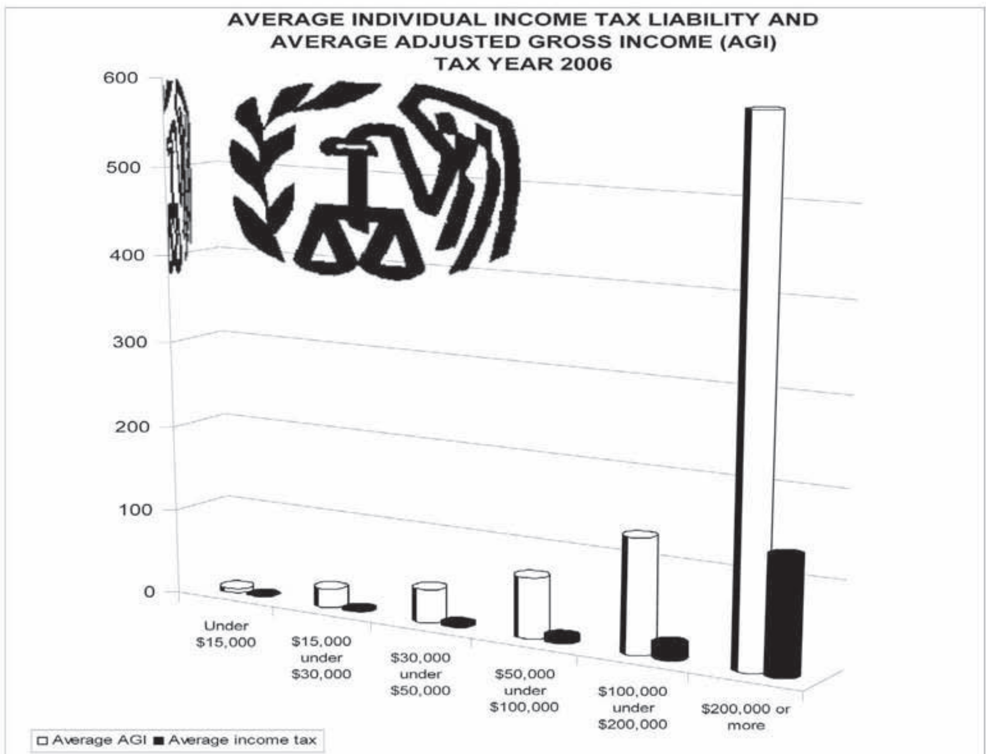
The Internal Revenue Code provides for progressive rates of tax, whereby higher incomes are generally subject to higher rates of tax. The following graphs and charts present the latest available information on income tax and adjusted gross income (AGI) for individuals by AGI level and for corporations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

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

INTERNAL REVENUE SERVICE

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2008 and 2007



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........................	37,614	188,624	3,141	5,015	84	1.7%
$15,000 under $30,000...........	29,649	655,386	22,562	22,105	761	3.4%
$30,000 under $50,000...........	24,907	973,569	59,846	39,088	2,403	6.1%
$50,000 under $100,000.........	30,053	2,123,894	185,019	70,672	6,156	8.7%
$100,000 under $200,000......	12,110	1,610,028	210,538	132,956	17,386	13.1%
$200,000 or more..................	4,088	2,431,160	545,226	594,740	133,380	22.4%
Total.....................................	**138,421**	**7,982,661**	**1,026,332**	-	-	-

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

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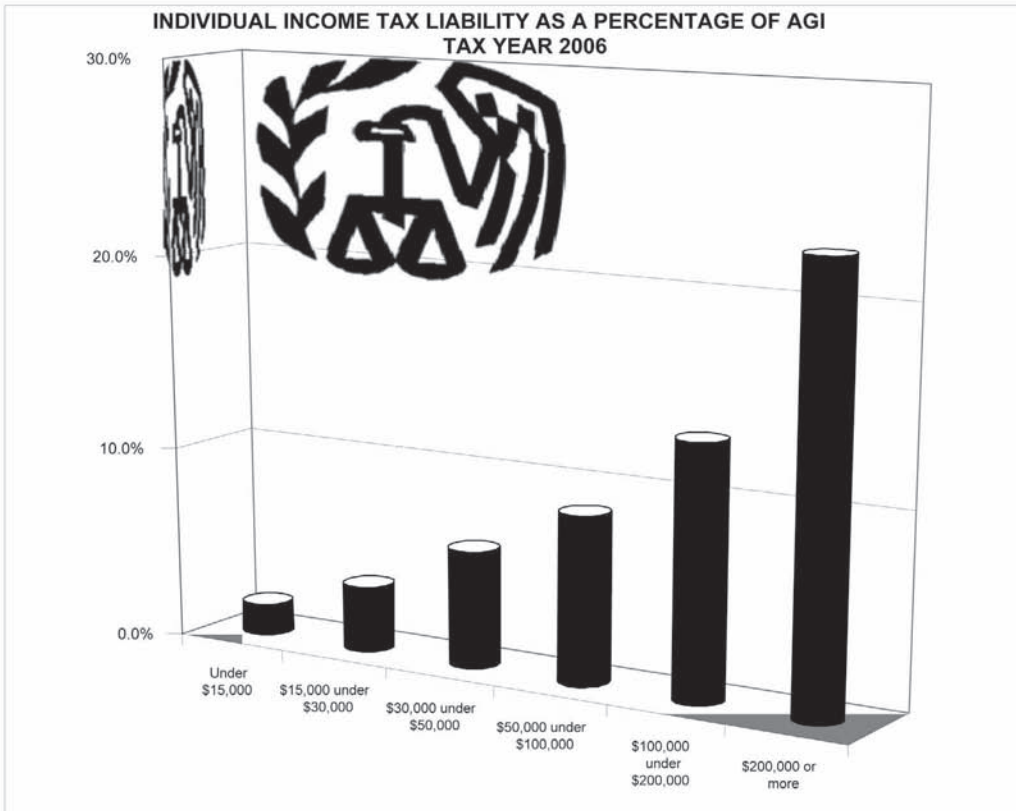
INTERNAL REVENUE SERVICE

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2008 and 2007



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

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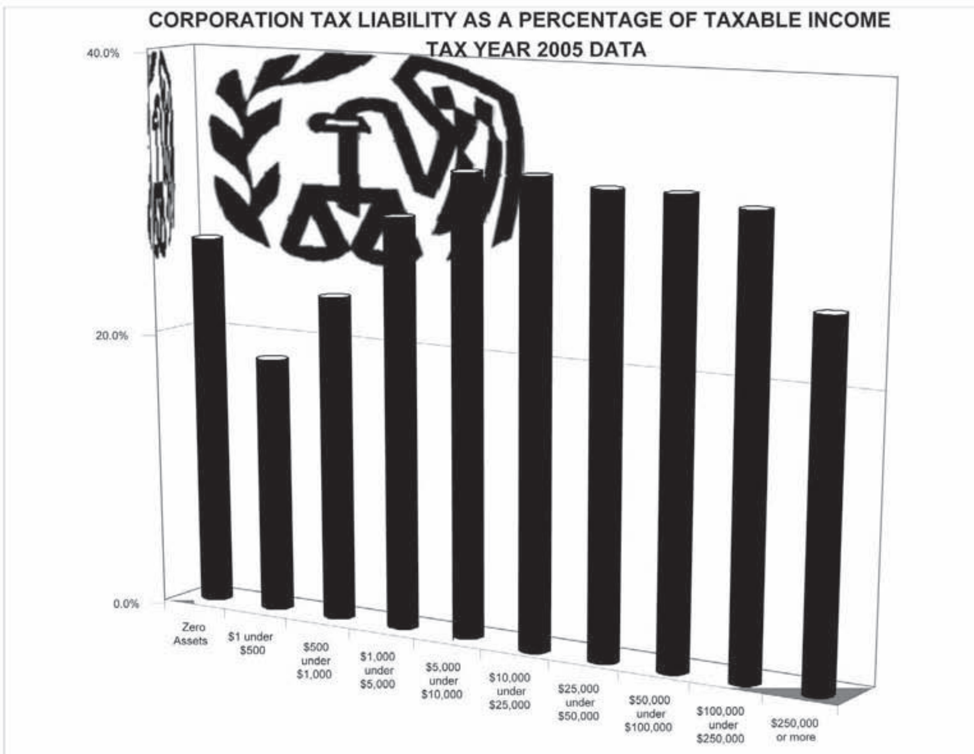
INTERNAL REVENUE SERVICE

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2008 and 2007



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............................	19,086	5,094	26.7%
$1 under $500..........................	9,223	1,698	18.4%
$500 under $1,000.................	4,473	1,043	23.3%
$1,000 under $5,000..............	14,935	4,372	29.3%
$5,000 under $10,000............	9,367	3,060	32.7%
$10,000 under $25,000...........	13,506	4,456	33.0%
$25,000 under $50,000...........	13,459	4,366	32.4%
$50,000 under $100,000.........	14,239	4,624	32.5%
$100,000 under $250,000.......	31,250	9,935	31.8%
$250,000 or more...................	1,071,781	273,431	25.5%
Total.......................................	**1,201,319**	312,079	**26.0%**

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

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Appendix I: Material Weaknesses, Significant Deficiency, and Compliance Issues

Material Weaknesses

During our audits of the Internal Revenue Service's (IRS) fiscal years 2008 and 2007 financial statements, we identified three material weaknesses in internal control. These material weaknesses have given rise to significant management challenges that have (1) impaired management's ability to prepare its balance sheet without extensive compensating procedures, (2) limited the availability of reliable information to assist management in effectively managing operations on an ongoing basis, (3) resulted in errors in taxpayer accounts, (4) increased taxpayer burden, and (5) reduced assurance that data processed by IRS's information systems are reliable and appropriately protected. The issues that we have identified and discuss in this report relate to IRS's controls over (1) financial reporting, (2) unpaid tax assessments, and (3) information security. We reported on each of these issues last year[1] and in prior audits. We highlight these issues in the following sections.

In previous years, we reported a material weakness in IRS's internal control over tax revenue and refunds because IRS's controls were not fully effective in providing management the essential information it needs to make informed decisions on how best to maximize the federal government's ability to collect tax revenues owed and minimize the risk of paying improper tax refunds. Specifically, in our fiscal year 2007 audit, we reported that IRS did not have agencywide cost-benefit information; related cost-based performance measures; or an agency-wide, systematic approach to maximizing its enforcement efforts. We also reported that IRS had made significant progress in addressing these issues, such as developing a cost accounting policy that provides guidance in managerial cost concepts for the agency and initiating several cost pilot projects to develop a methodology for determining the full cost of IRS's various enforcement programs.

During fiscal year 2008, IRS made further significant progress. IRS (1) improved its cost accounting by establishing an Office of Cost Accounting within the Chief Financial Officer's organization to implement its cost accounting policy and by completing three cost pilot projects to demonstrate the viability of IRS's methodology for determining the full cost of its enforcement programs, (2) further enhanced its performance measures and completed development of return on investment information for the Earned Income Tax Credit program that includes full

[1]GAO, *Financial Audit: IRS's Fiscal Years 2007 and 2006 Financial Statements*, GAO-08-166 (Washington, D.C.: Nov. 9, 2007).

costs, (3) established corporate governance bodies that collectively represent significant progress in establishing an agencywide approach to governance of IRS's enforcement activities, and (4) improved its management of tax collection efforts by continuing to implement sophisticated computer analysis and modeling to prioritize and focus its collection activities. IRS has also developed plans to perform ongoing analyses of the tax gap, which will include information on the extent of overclaims, of which disbursements of improper refunds are a component. IRS's actions have sufficiently mitigated the affects of these weaknesses in control over tax revenue and refunds such that we no longer consider them to constitute a material weakness. However, the remaining control deficiencies, we believe, constitute a significant deficiency in internal control. This is discussed in a later section of this report.

Financial Reporting

In fiscal year 2008, as in prior years, IRS did not have financial management systems adequate to enable it to timely and accurately generate and report the information needed to both prepare financial statements and manage operations on an ongoing basis. To overcome these systemic deficiencies with respect to preparation of its annual financial statements, IRS was compelled to employ extensive compensating procedures. During fiscal year 2008, IRS (1) did not have an adequate general ledger system for tax-related transactions, and (2) was unable to readily determine the costs of its discrete activities and programs and did not have cost-based performance information. Although IRS's financial statements were fairly stated as of September 30, 2008 and September 30, 2007, the underlying records do not provide the real-time data needed to assist in managing operations on a daily basis and to provide an informed basis for making or justifying resource allocation decisions.

In fiscal year 2007,[2] we reported that IRS's core general ledger system for tax-administration-related transactions, the Interim Revenue Accounting Control System (IRACS), was not supported by adequate audit trails for any of the most material tax related balances, including tax revenue, tax refunds, or taxes receivable. Such traceability is necessary to enable IRS to ensure that recorded transactions are complete, accurate, and supported by underlying records. During fiscal year 2008, IRS devoted significant resources to addressing this condition and made substantial

[2] GAO-08-166.

progress. For example, IRS instituted the use of trace identification numbers (trace ID) for revenue and refund transactions in order to provide this traceability from IRACS back to source documentation and throughout IRS's financial management system. For tax refunds, as well as for tax revenue transactions processed through the Electronic Federal Tax Payment System (EFTPS),[3] we were able to verify that these trace IDs were effective in providing this transaction traceability. However, we also found that for tax revenue transactions processed outside of EFTPS (which accounted for about 22 percent of total tax revenue collected in fiscal year 2008), providing this traceability to IRACS necessitated IRS employees transcribing the trace IDs manually for input. Since trace IDs for revenue transactions are numerous digits in length, there is a significant risk of human error inherent in this process. As of September 30, 2008, IRS had not instituted controls to minimize the risk of transcription and input errors occurring and not being detected and corrected. In addition, and as we reported in prior years, IRS's reported balance for federal taxes receivable, which comprised over 81 percent of IRS's total assets as reported on its fiscal year 2008 balance sheet, was not posted to IRACS.[4] This was because it was the product of a complex statistical estimation process rather than the summation of the traditional posting of individual transactions.[5] Consequently, IRACS does not substantially comply with the U.S. Government Standard General Ledger (SGL) at the transaction level, and Federal Financial Management Systems Requirements (FFMSR) embodied in OMB Circular No. A-127, Financial Management Systems.[6]

[3]EFTPS is an automated tax payment system that allows taxpayers to make federal tax payments electronically, and processes deposit data related to payroll and other taxes paid by federal agencies through the Federal Agency Tax Payments and Returns II System. By law, businesses with employment or other depository taxes that exceed $200,000 annually are required to use EFTPS. 26 U.S.C. § 6302(h), 26 C.F.R. § 1-6302(h).

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

[5]This issue is discussed in more detail in the material weakness in controls over unpaid tax assessments section of this report.

[6]OMB, Circular No. A-127, *Financial Management Systems* (Washington, D.C.: Dec. 1, 2004). FFMSR require application of the SGL at the transaction level and states that conformance requires, among other items, that transaction detail for SGL accounts be readily available in the financial management system and be traceable to specific SGL account codes.

During fiscal year 2007, we reported that IRS continued to make progress in improving its cost accounting capabilities. Specifically, IRS issued its first cost accounting policy in August 2007, which provided guidance on the concepts and requirements for managerial cost accounting within IRS. The purpose of this policy is to outline a clear set of guidelines for IRS to use to accumulate and report on the full costs of its programs, activities, and associated outputs to allow for better decision making. In addition, we reported that IRS was conducting a series of cost pilot projects in an effort to establish the relationship between its costs and its products and services.

During fiscal year 2008, IRS completed the cost pilot projects and concluded that it has the capability to use the cost data within its Integrated Financial System (IFS) and the associated workload and production data from its business unit systems to calculate the full costs of its products, services, and programs. IRS produced cost information for three of its programs (i.e., Automated Underreporter, Field Assistance, and Submission Processing) [7] and plans to periodically produce this information and expand the availability of cost accounting information to other programs in future years. In fiscal year 2009, IRS plans to prioritize its products and services for which cost information is needed and develop the necessary processes to systematically produce full cost accounting information for them to support management decision making.

We commend IRS for the positive steps it has taken in developing a practical approach to use the cost information within IFS to systematically produce managerial cost data that are defensible, reliable, and consistent. Moving expeditiously to determine its cost accounting priorities and develop the processes to routinely produce the associated cost accounting data will allow IRS to realize the full potential of its cost accounting capabilities.

[7] Automated Underreporter is an IRS program that compares information on tax returns to related information submitted electronically by third parties to identify potential unreported taxable income. Field Assistance is the IRS office that manages Taxpayer Assistance Centers located throughout the country. These centers are designed to provide comprehensive face-to-face assistance to taxpayers as well as assistance through telephone and written correspondence. Submission processing is the data processing arm of IRS. These units process paper and electronic submissions at IRS service center campuses. This includes depositing tax payments, correcting errors, and forwarding data to IRS's computing centers for analysis and posting to taxpayer accounts.

Despite significant progress made during fiscal year 2008, the continued existence of these financial reporting weaknesses once again compelled IRS to expend more time and effort to maintain its accounting records and generate financial management information than would otherwise have been necessary. Further, despite these efforts, IRS continued to lack reliable and timely financial information to assist in managing operations throughout fiscal year 2008. Addressing the financial management deficiencies discussed above would enhance this process by providing management the reliable and timely information that it needs to support informed decision making without having to resort to costly and time-consuming procedures to compensate for information system deficiencies.

Unpaid Tax Assessments

During fiscal year 2008, we continued to find serious internal control issues that affected IRS's management of unpaid tax assessments. Specifically, we continued to find (1) that 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 (2) errors and delays in recording taxpayer information, payments, and other activities. While IRS made progress in addressing the lack of a subsidiary ledger for unpaid assessments, certain system limitations and errors in taxpayer accounts nevertheless continued to hinder IRS's ability to effectively manage its unpaid tax assessments.

Unpaid assessments are legally enforceable claims against taxpayers and consist of taxes, penalties, and interest that have not been collected or abated.[8] Based on federal accounting standards, unpaid assessments are required to be classified into one of the following three categories for reporting purposes: federal taxes receivables, compliance assessments,

[8]Abatements are reductions in tax assessments and are a normal part of IRS's tax administration process. Abatements may occur for a number of reasons. For example, a taxpayer may file an amended return claiming a lower tax liability than previously reported or a qualifying corporation may claim a net operating loss which created a credit that can be carried back to reduce a prior year's tax liability.

and write-offs.[9] However, IRS's master files[10] and general ledger were not designed to classify and report out each of these three categories of unpaid assessments in accordance with federal accounting standards. To compensate for this, IRS must apply statistical sampling and estimation techniques to data from its master files to estimate the year-end balances of (1) taxes receivable in its financial statements and required supplementary information, and (2) compliance assessments and write-offs in its required supplementary information. This manual compensating process is complex, labor-intensive, and requires several months to complete.

While IRS has made significant progress over the last several years, it continues to lack a subsidiary ledger that tracks and accumulates unpaid assessments and their status on an ongoing basis for business purposes, including external reporting. Recognizing the seriousness of this deficiency, IRS began a phased-in implementation of the Custodial Detail Data Base (CDDB) in 2006. As discussed earlier, one of the key objectives of CDDB is to ultimately serve as a subsidiary ledger for IRS's tax administration activities, including tax revenue receipts, tax refund disbursements, and unpaid tax debt. CDDB would function as a subsidiary ledger for unpaid tax assessments by linking and classifying taxpayer account information from IRS's master files to its general ledger for tax administration activities, IRACS. IRS enhanced CDDB in fiscal year 2008 to weekly analyze and record unpaid assessment balances from its master file, including related interest and penalty accruals, to its general ledger by the various financial reporting categories (taxes receivable, compliance assessments, and write-offs). These enhancements established CDDB's capability to function as a subsidiary ledger for unpaid tax debt.

[9]Federal taxes receivable are taxes due from taxpayers for which IRS can support the existence of a receivable through taxpayer agreement or a favorable court ruling. Compliance assessments are assessments where neither the taxpayer nor the court has affirmed that the amounts are owed. Write-offs represent unpaid tax assessments for which IRS does not expect further collections because of factors such as the taxpayer's death, bankruptcy, or insolvency. Of these three classifications of unpaid tax assessments, only net federal taxes receivable are reported on the financial statements. IRS also categorizes certain unpaid assessments into a fourth category referred to as memo. IRS places accounts into this category when they do not meet any of the other three unpaid assessment categories.

[10]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.

However, IRS is presently unable to use CDDB as its subsidiary ledger for posting tax debt information to its general ledger in a manner that ensures reliable external reporting. Even though CDDB is capable of analyzing master file data weekly to produce tax debt information classified into the various financial reporting categories, this information still contains material inaccuracies. For example, through its use of its statistical sampling and estimation techniques, IRS identified errors necessitating over $14 billion in adjustments to the year-end gross taxes receivable balance produced by CDDB. Thus, while the use of CDDB has refined this process, it continued to take IRS several months to complete, required multibillion-dollar adjustments, and produced amounts that after adjustments were still only reliable as of the last day of the fiscal year. Furthermore, IRS does not record in IRACS the amounts derived from the statistical estimation process, including taxes receivable. Hence, the taxes receivable balance and related amounts due to Treasury reported on the balance sheet are not traceable to IRACS. Since they are products of a statistical estimation process rather than summations of individual transactions, there is also currently no transaction traceability from the taxes receivable - related amounts on IRS financial statements back to underlying source documentation. Consequently, the lack of a fully functioning subsidiary ledger continues to inhibit IRS's ability to develop reliable and timely financial management reports useful for external reporting. Full operational capability of CDDB depends on the successful implementation of future system releases planned through 2009 and the ability of these releases to address current limitations in accurately classifying all of IRS's unpaid assessments.

IRS's management and reporting of unpaid tax assessments also continued to be hindered by inaccurate tax records. We continued to find errors in taxpayer records resulting from IRS's not recording information accurately and timely. Such errors directly affect the accuracy of the tax debt information classified by category as produced by CDDB. Additionally, such errors can cause frustration to taxpayers who either have already paid taxes owed or who owe significantly lower amounts.

For example, during our audit, we found that IRS erroneously assessed a gift tax against a taxpayer for over $14 billion. The taxpayer had filed a tax return reporting a gift valued at approximately $260,000 made with no taxes due.[11] However, IRS entered amounts from two separate lines of the tax return as a single amount into its system, causing it to record the value of the gift as almost $26 billion. This, in turn, caused IRS's systems to calculate a tax deficiency of almost $12 billion. Along with associated penalties and interest, IRS sent the taxpayer an erroneous notice of taxes due for over $14 billion. In another example, IRS assessed a business over $9 million in penalties for failing to provide a required supporting schedule along with its quarterly payroll tax return and sent the business a notice for the amount due. When IRS subsequently examined the business tax return, it determined that the required schedule was in fact attached to the return. Although IRS identified and subsequently corrected these errors, it did so only after inconveniencing the taxpayers. In addition, because the $14 billion erroneous gift tax assessment posted to its master files just prior to IRS's fiscal year-end cut-off, the balance was included in the year-end taxes receivable balance produced by CDDB. Consequently, IRS had to make an additional adjustment to deduct the $14 billion when deriving its year-end taxes receivable balance for external financial reporting. This $14 billion adjustment was in addition to the $14 billion adjustment recorded to the CDDB-produced balance based on IRS's statistical estimation of the balance for taxes receivable.

We also continued to find errors involving IRS's failure to properly record payments to all related taxpayer accounts associated with unpaid payroll taxes.[12] As in prior years,[13] IRS's systems are still unable to automatically reflect a reduction in the amounts owed on the related accounts when the business or any officer of that business pays some or all of the outstanding taxes. However, IRS has made significant progress in this area over the

[11]For tax year 2007, the lifetime unified tax credit reduced or eliminated tax liability for taxable gifts below the $1 million exclusion amount. This means taxpayers can make up to $1 million in taxable gifts over their lifetime without having to pay the gift tax. See 26 U.S.C. § 2505; see also IRS Publication 950, *Introduction to Estate and Gift Taxes* (rev. Sept. 2008).

[12]When a company does not pay the taxes it withholds from employees' wages, such as Social Security or individual income tax withholdings, IRS has the authority to assess all responsible officers individually for the taxes withheld from employees. Although assessed to multiple parties, the liability 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 business. The tax assessments made against business officers are known as trust fund recovery penalties. See 26 U.S.C. § 6672 and implementing IRS guidance in the *Internal Revenue Manual* at § 4.23.9.13, Trust Fund Recovery Penalty (May 14, 2008).

[13]GAO-08-166.

past several years. For example, IRS established procedures to more clearly link each penalty assessment against an officer to a specific tax period of the business account and began phasing in the use of an Automated Trust Fund Recovery (ATFR) system intended to properly cross-reference payments received. As a result of IRS's actions, the number of errors we identified this year was significantly less than in prior years. IRS also enhanced ATFR in fiscal year 2008 to begin automatically reducing the amounts owed on all related accounts when a payment is received from one related party. However, the system is currently unable to process all payments related to such cases. Consequently, IRS must continue to manually reduce the account balance on related accounts for some payments. Thus, the opportunity for errors and omissions continues to exist.

Additionally, we again found errors in IRS's master file programs for calculating and assessing penalties associated with outstanding tax debt.[14] For example, we identified two separate situations where IRS's computer programs used an earlier date than prescribed in its policies to begin the calculation of the penalty amount. In another instance, IRS's computer programs failed to reduce the penalty rate used to accrue additional penalties on the outstanding balance of taxes owed once the taxpayer entered into an installment agreement with IRS to pay off the tax liability over time. In these cases, the penalties assessed against the taxpayers were higher than they should have been. While these errors did not affect a significant number of taxpayers nor have a material affect on IRS's unpaid assessment balance, they nevertheless represent yet another type of error contained in IRS's records of unpaid assessments that affect the accuracy of reporting and could adversely affect taxpayers.

IRS processing delays also contributed to inaccurate tax records. During our audit, we identified three cases where documentation showed that a business had been defunct[15] for some time but IRS had not recorded the defunct status of the business in its master files. One of these businesses had been defunct since May 2005. As a result, CDDB misclassified these accounts as taxes receivable rather than as write-offs. IRS had to reclassify

[14]GAO, *Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements*, GAO-07-136 (Washington, D.C.: Nov. 9, 2006); *Management Report: Improvements Needed in IRS's Internal Controls*, GAO-07-689R (Washington, D.C.: May 11, 2007).

[15]IRS defines a defunct business as 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.

a substantial portion of the balance of these accounts as part of its estimation process.

These processing errors and delays contribute to inaccurate tax records and result in IRS having to make numerous adjustments as part of its process for estimating the balance of net taxes receivable and other unpaid tax assessments. When IRS identified errors and delays similar to those described above when reviewing its sample of unpaid assessment cases, it recorded adjustments to the affected account to reflect the correct value of that account at the point in time that IRS extracted the account information. On the basis of a statistical projection of these individual adjustments, IRS had to make multibillion dollar adjustments to the year-end balances of all three categories of unpaid assessments produced by CDDB in order to produce reliable amounts for external reporting on its balance sheet and required supplementary information.

Furthermore, such processing errors and delays contribute to IRS's inability to timely release federal tax liens against taxpayers who have fully satisfied or are otherwise relieved of their tax liability. As with the delays previously described, delays by IRS in recording bankruptcy discharges and processing offers-in-compromise[16] result not only in inaccurate tax records but also delays in IRS's release of federal tax liens. This, in turn, causes undue burden to taxpayers who are attempting to sell property or apply for commercial credit.[17]

The progress IRS has made to date with CDDB is an important step in moving toward a subsidiary ledger that links account information in IRS's master files with its general ledger for tax administration activities. However, IRS must still address the issues that prevent it from using unadjusted CDDB information to support the general ledger for external reporting. This will require further enhancements to CDDB to enable it to more accurately distinguish between the three categories of unpaid tax assessments, so that balances are ultimately recorded in the proper general ledger accounts. Also, in order to ensure accurate financial reporting and to minimize undue burden on taxpayers, IRS faces a continuing challenge to address the factors that cause inaccuracies in

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

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

taxpayer account records and to maintain the integrity of the account information going forward.

Information Security

To effectively fulfill its tax processing responsibility, IRS relies extensively on computerized systems to support its financial and mission-related operations. Effective information system controls are essential to ensuring that taxpayer and financial information is adequately protected from inadvertent or deliberate misuse; fraudulent use; and improper disclosure, modification, or destruction. Ineffective system controls can impair the accuracy, completeness, and timeliness of information used by management and, in the absence of effective compensating procedures, increase the potential for undetected material misstatements in the agency's financial statements.

Significant information security weaknesses identified during our previous audits remained uncorrected and continued to jeopardize the confidentiality, availability, and integrity of information processed by IRS's key systems, increasing the risk of material misstatement for financial reporting. IRS has made progress in resolving these weaknesses, taking actions such as implementing controls for unauthenticated network access and user IDs on the mainframe, encrypting sensitive data going across the IRS network, improving the patching of critical vulnerabilities, improving the disposal of removable media, and updating contingency plans to document critical business processes.

Despite these actions, weaknesses remain. For example, sensitive information, including user IDs and passwords for mission-critical applications, continued to be readily available to any user on IRS's internal network. These IDs and passwords could be used by a malicious user to compromise data flowing to and from IFS. Other continuing weaknesses included the existence of passwords that were not complex enough to avoid being guessed or cracked. In addition, although IRS had improved its application of vendor-supplied system patches that protect against known vulnerabilities, it still had not consistently patched systems in a timely manner. The agency's procurement system, which processed approximately $1.8 billion of obligations in fiscal year 2008, also remained at risk because previously reported weaknesses had not been corrected. These weaknesses included (1) not restricting users' ability to bypass application controls, (2) continuing to use unencrypted protocols, and (3) not removing separated employees' access in a timely manner. These outstanding weaknesses increase the risk that data processed by the agency's financial management systems are not reliable.

In fiscal year 2008, we and the Treasury Inspector General for Tax Administration (TIGTA) continued to identify new weaknesses in controls for protecting access to systems and information, as well as other information security controls that affect key financial systems, such as IRACS. For example, the processing environment that supports IRACS lacks a configuration baseline, which prevents IRS from adequately tracking and monitoring changes to the system, thereby increasing the risk that unauthorized program changes may not be detected. In addition, weaknesses in access controls to network devices could allow users unneeded authorization to IRS's network infrastructure and allow unauthorized access to applications and data supported by the network, including IFS. Similarly, TIGTA has also reported[18] that access controls over the administration of network devices were not effective to control unauthorized use. TIGTA found that system administrators had set up accounts that could allow them to bypass authentication controls and make undetected changes to network devices, noting that this condition could allow a disgruntled employee or contractor to make changes to those devices to steal taxpayer information or disrupt IRS computer operations. TIGTA also recently reported[19] that two of IRS's most important modernized systems—CADE and the Account Management Services (AMS)[20]—were deployed with known security vulnerabilities relating to the protection of sensitive data, system access, monitoring of system access, and disaster recovery. As a result, TIGTA concluded that these vulnerabilities increase the risks that (1) an unscrupulous person, with little chance of detection, could gain unauthorized access to the vast amount of taxpayer information the IRS processes, and (2) the systems could not be recovered effectively and efficiently during an emergency.

[18] Treasury Inspector General for Tax Administration, *Inadequate Security Controls Over Routers and Switches Jeopardize Sensitive Taxpayer Information*, 2008-20-071 (Washington, D.C.: Mar. 26, 2008).

[19] Treasury Inspector General for Tax Administration, *The Internal Revenue Service Deployed Two of Its Most Important Modernized Systems With Known Security Vulnerabilities*, 2008-20-163 (Washington, D.C.: Sept. 24, 2008).

[20] According to the TIGTA report, AMS will provide IRS employees faster and improved access to taxpayer account data, which will minimize taxpayer interaction and provide more timely responses to and resolution of taxpayer inquiries. Initiated in August 2006, the AMS project is scheduled to cost more than $700 million to develop, operate, and maintain through calendar year 2024. The first release of AMS, deployed in October 2007, was limited to achieving address changes in the CADE environment.

The weaknesses in IRS's financial systems are due in part to IRS's not fully implementing its information security program[21] to ensure that controls are effectively established and maintained. IRS has developed and documented its program, but it has not fully or consistently implemented program requirements for key information systems. For example, although IRS has developed and implemented a process to address deficiencies in its information security policies, procedures, and practices, it did not sufficiently verify whether remedial actions were implemented or effective in mitigating the vulnerability. To illustrate, IRS informed us that they had corrected 65 of the 115 previously reported weaknesses. However, we found that remedial actions for 16 of the 65 weaknesses that IRS informed us had been corrected had not been fully implemented.

Until IRS takes additional steps to fully implement key elements of its information security program, 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.

The unresolved deficiencies from prior audits and the newly identified deficiencies in fiscal year 2008 represent a material weakness in IRS's internal control over its financial systems. Collectively, these deficiencies reduce IRS's ability to ensure that its financial and taxpayer information is secure and, in the absence of effective compensating procedures, increase the potential for undetected material misstatements in the agency's financial statements. We plan to issue a separate report on the newly identified deficiencies and the status of previously identified deficiencies.

To address these deficiencies, IRS has various initiatives under way. IRS has developed and documented a detailed road map to guide its efforts in targeting critical weaknesses. Additionally, the agency is in the process of implementing a comprehensive plan to address numerous information security weaknesses, such as those associated with network and system access, audit trails, system software configuration, security roles and responsibilities, and contingency planning. According to the plan, some of these weaknesses are not scheduled to be resolved for 4 or more years,

[21] In December 2002, Congress enacted the Federal Information Security Management Act of 2002 (FISMA), which requires agencies to develop, document, and implement an information security program. FISMA was enacted as title III of the E-Government Act of 2002, Pub. L. No. 107-347, 116 Stat. 2946 (Dec. 17, 2002). The agency information security program requirement is codified at 44 U.S.C. § 3544(b).

including one not scheduled for completion until the start of fiscal year 2014. These efforts are a positive step towards improving the agency's overall information security posture.

Significant Deficiency

In addition to the material weaknesses previously discussed, we identified a significant deficiency concerning weaknesses in IRS's internal control over tax revenue and refunds.

In our previous report on the results of our audit of IRS's fiscal year 2007 financial statements,[22] we also discussed weaknesses in IRS's internal control designed to safeguard hard-copy taxpayer receipts and data, which we considered to constitute a significant deficiency. For example, we identified weaknesses in (1) physical security controls designed to prevent unauthorized access to IRS's receipt processing facilities, (2) procedural safeguards and controls designed to account for, control, and protect taxpayer receipts and related taxpayer information, and (3) controls designed to safeguard hard-copy taxpayer receipts and related taxpayer data during transport between IRS business units and to or from third parties, such as depository institutions. We had been reporting on this significant deficiency each year since our fiscal year 1997 financial audit, and IRS has devoted substantial efforts over the years to address the issues comprising this significant deficiency. In fiscal year 2008, we found that IRS significantly improved the controls that safeguard hard-copy taxpayer receipts and data processed at its primary submission processing facilities-service center campuses and lockbox banks.[23] Most notably, controls were significantly improved at IRS's lockbox banks, which processed approximately $411 billion in hard-copy taxpayer receipts in fiscal year 2008, or nearly 78 percent of all hard-copy tax payments received. For example, the number of internal control issues in this area we identified in fiscal year 2008 decreased by 80 percent from fiscal year 2007, and for the first time, we did not identify any issues at one of the three lockbox banks we visited. These improvements, combined with the progress we reported in previous audits, have enabled us to conclude that remaining issues identified during fiscal year 2008 related to hard-copy

[22]GAO-08-166.

[23]Lockbox banks are commercial banks that operate under contract with the Financial Management Service to provide tax receipt processing and deposit services on behalf of IRS.

taxpayer receipts and data no longer constitute a significant deficiency in internal control.

Tax Revenues and Refunds

Weaknesses in control over tax revenue and refunds continue to hamper IRS's ability to optimize the use of its limited resources to collect unpaid taxes and minimize payment of improper refunds. Specifically, IRS has not (1) developed performance metrics and goals on the cost of, and the revenue collected from, IRS's various enforcement programs and activities,[24] and (2) fully established and implemented the financial management structure and processes to provide IRS key financial management data on costs and enforcement tax revenue. These deficiencies inhibit IRS's ability to appropriately assess and routinely monitor the relative merits of its various enforcement initiatives and adjust its strategies as needed. This, in turn, can significantly affect the level of enforcement tax revenue collected and improper refunds disbursed.[25] Addressing these issues successfully is fundamental to IRS's ability to effectively apply cost and enforcement revenue information to managing its enforcement activities, especially the collection of unpaid taxes.

IRS's existing agencywide enforcement performance measures and related performance goals do not include measures of the full cost of, or the revenue collected from, enforcement activities. Rather, IRS's current performance measures focus on monitoring the internal enforcement-related processes used by IRS, such as the number of cases examined.[26] We have previously reported on and made recommendations regarding IRS's lack of performance measures based on reliable full cost and benefit data. For example, based on the findings from our audit of IRS's fiscal year

[24]One exception is the Earned Income Tax Credit program for which IRS has developed such metrics.

[25]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.

[26]Process-oriented measures used by IRS include elements such as taxes assessed, the number of each type of case that is worked on and the number of cases closed. For example, IRS uses process measures related to the Automated Underreporter Program (AUR), which is designed to identify under-reported income by matching taxpayer-reported information against information submitted to IRS by third parties, such as interest or dividend information submitted by financial institutions. IRS's current AUR performance measures focus on the number of additional tax assessments made, number of taxpayer returns examined and number of cases closed, rather than measuring the extent of collections received.

1999 financial statements, we recommended that IRS develop the data to support meaningful cost information categories and cost-based performance measures.[27] These recommendations remained open in our July 2008 update on the status of recommendations we have made to IRS.[28] In addition, in our June 2008 report on IRS's tax collection process,[29] we reported that IRS has not set its performance measures and related goals to measure dollars collected. Additionally, in our July 2008 report on IRS's collection of unpaid payroll taxes,[30] we reported that, although IRS has made the collection of unpaid payroll taxes one of its top priorities, it has not established goals or measures to assess its progress in collecting or preventing the accumulation of payroll tax debt. We further reported that IRS officials stated that they do not have specific lower-level performance measures that target collection actions or collection results for unpaid payroll taxes. We noted that such performance measures could be useful to IRS in measuring the success of its efforts to collect or prevent the further accumulation of unpaid payroll taxes and to formulate more effective approaches to dealing with this compliance issue.

IRS management must consider many factors beyond cost and collections, such as coverage, compliance, and budgetary issues, when making resource allocation decisions. These factors, and the decisions IRS makes about how to respond to them, have a significant impact on collections. However, using full cost and collection information is also important. Performance metrics and related goals for IRS's enforcement programs and activities, including measures of dollars collected compared to related costs incurred, are essential tools to assist management in assessing the relative merits of its options and optimizing the allocation of its resources. Consequently, measures that focus management's attention on the effectiveness of its programs in achieving its primary mission of collecting taxes are fundamentally important.

[27]GAO, *Internal Revenue Service: Serious Weaknesses Impact Ability to Report on and Manage Operations*, GAO/AIMD-99-196 (Washington, D.C.: Aug. 9, 1999).

[28]GAO, *Internal Revenue Service: Status of GAO Financial Audit and Related Financial Management Report Recommendations*, GAO-08-693 (July 2, 2008).

[29]GAO, *Tax Debt Collection: IRS Has a Complex Process to Attempt to Collect Billions of Dollars in Unpaid Tax Debts*, GAO-08-728 (Washington, D.C.: June 13, 2008).

[30]GAO, *Tax Compliance: Businesses Owe Billions in Federal Payroll Taxes*, GAO-08-617 (Washington, D.C.: July 25, 2008). Payroll taxes are amounts employers withhold from employees' wages for federal income taxes, Social Security, and Medicare, as well as the employers' mandatory matching contributions for Social Security and Medicare taxes.

As we discussed, IRS has not completed the process of developing and institutionalizing the use of full cost data to measure the costs of its various enforcement programs. IRS's recent completion of three cost pilot projects to demonstrate its ability to determine the full cost of selected activities is a notable achievement. However, IRS has not yet applied a comparable methodology to determine the full cost of its full range of programs, though it plans to do so.

Additionally, IRS has not designed performance metrics that use enforcement revenue data. Although IRS has detailed enforcement revenue data, as we have previously reported, [31] it has not developed performance metrics or goals for dollars collected to measure the effectiveness of IRS's various enforcement programs. IRS officials have said that they do not make such enforcement revenue evaluations because of the potential for violating section 1204 (Basis for evaluation of Internal Revenue Service employees) of the Internal Revenue Service Restructuring and Reform Act of 1998, which prohibits the use of "records of tax enforcement results" to evaluate employees or impose or suggest production quotas or goals for employees and requires their performance be evaluated on the "fair and equitable treatment of taxpayers."[32] The statute does not establish a blanket prohibition on using quantity measures to evaluate organization performance, and implementing IRS regulations and guidance provide instructions on the proper uses of these statistical data.[33] The guidance, issued in April 2007, specifically allows the use of "records of tax enforcement results" for forecasting, financial planning, resource management and the formulation of case selection criteria. Therefore, IRS may use enforcement results, such as revenue collected, to evaluate enforcement programs and activities to make well-informed resource allocation decisions, but it must do so consistent with the prohibitions in section 1204 and implementing IRS regulations and guidance.

[31] GAO-08-728.

[32] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 1204, 112 Stat. 681, 722 (July 22, 1998)(*reprinted in* 26 U.S.C. § 7804 note).

[33] See Regulation 801 (26 C.F.R. pt. 801), *Balanced System for Measuring Organizational and Employee Performance Within the Internal Revenue Service* (Oct. 17, 2005); *Internal Revenue Manual*, § 1.5.2, *Managing Statistics in a Balanced Measurement System: Uses of Statistics* (Apr. 1, 2007). For example, Regulation 801 states "Modern management practice and various statutory and regulatory provisions require the IRS to set performance goals for organizational units and to measure the results achieved by those units with respect to those goals." 26 C.F.R. § 801.1T(a)(2).

Until such time as IRS has both full cost and enforcement revenue data available to measure return on investment and related organizational performance measures and goals, IRS's evaluation of its programs and related decisions will continue to be based on the results of internal compliance processes rather than on the degree to which these programs are effective in collecting unpaid taxes. Without accurate data on program effectiveness, IRS cannot assess the extent to which its allocation of limited resources among competing priorities is maximizing the agency's ability to collect unpaid taxes.

The ability to provide IRS with full cost and revenue data on enforcement programs requires an organization structure and processes that can produce managerial cost and enforcement revenue accounting data and then implement their use. As discussed earlier, IRS has taken significant actions to implement managerial cost accounting. However, IRS has not completed the task of institutionalizing the use of managerial full cost data to support cost based performance measures or informed resource allocation decisions. IRS has yet to (1) develop a formalized plan to implement the cost policy and institutionalize the use of full cost information agencywide in making resource allocation decisions, (2) develop a monitoring plan through which IRS can ensure that the cost policy is being systematically and appropriately used, (3) extend its development of systemically produced managerial full cost information to the full range of IRS enforcement programs and activities, and (4) develop plans to institutionalize the use of full cost information in both strategic planning and ongoing operational resource allocation decisions agencywide. As mentioned previously, IRS has also not institutionalized the use of enforcement revenue accounting data.

Given the environment in which it operates, IRS cannot be expected to collect all taxes owed through enhancements to internal control alone. The level of uncollected taxes is affected by many factors beyond IRS's control. Also, in deploying its resources to its various programs and activities, IRS must consider other factors besides maximizing revenue collection, minimizing improper refund payments, and minimizing costs incurred, such as ensuring it is applying the tax code fairly and improving overall compliance. Nevertheless, it is incumbent upon IRS to make optimum use of its available resources and to be able to credibly demonstrate it is doing so to Congress and the public. Successfully addressing its remaining control deficiencies will help position IRS to do so.

Compliance Issues

Our work on compliance with selected provisions of laws and regulations disclosed one instance of noncompliance that is reportable under U.S. generally accepted government auditing standards and OMB guidance. 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 FFMIA.

Release of Federal Tax Liens

The Internal Revenue Code grants IRS the power to file a lien against the property of any taxpayer who neglects or refuses to pay all assessed federal taxes. The lien becomes effective when it is filed with a designated office, such as a courthouse in the county where the taxpayer's property is located.[34] The lien serves to protect the interest of the federal government and as a public notice to current and potential creditors of the government's interest in the taxpayer's property. For example, federal tax liens are disclosed in credit reports of individuals. Under section 6325 of the Internal Revenue Code, IRS is required to release federal tax liens within 30 days after the date the tax liability is satisfied or has become legally unenforceable or the Secretary of the Treasury has accepted a bond for the assessed tax.

In our prior audits, we found that IRS did not always release the applicable federal tax lien within 30 days of the tax liability being either paid off or abated, as required by the Internal Revenue Code.[35] In response, IRS has taken a number of actions over the past several years to improve its lien processing. For example, IRS centralized all lien processing at its Cincinnati Service Center Campus in 2005. In addition, in July 2006, IRS enhanced various lien processing-related exception reports to include a cumulative list of unresolved lien releases, allowing it to more readily track the release status and take corrective action.

Despite the actions IRS has taken to date to improve its lien release process, our work in fiscal year 2008 continued to find that IRS did not always timely release all tax liens where the taxpayer had paid in full or was otherwise relieved of a tax liability. In prior audits, we tested a statistical sample of tax cases with liens in which the taxpayers' total outstanding tax liabilities were either paid off or abated during the fiscal year under audit. Beginning in fiscal year 2006, IRS began performing its

[34] 26 U.S.C. §§ 6321, 6323.

[35] GAO-08-166.

own test of the effectiveness of its lien release process as part of implementing the requirements of the revised OMB Circular No. A-123[36] and we reviewed its test results. For fiscal year 2008, we once again reviewed and validated IRS's test results.

In its 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 2008, IRS found 7 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 more than 494 days. On the basis of its sample, IRS estimated that for about 12 percent of unpaid tax assessment cases resolved in fiscal year 2008 for which it had filed a tax lien, it did not release the lien within 30 days.[37]

Various processing delays resulted in IRS not releasing these liens timely. In one case, IRS had not entered data on the existence of a lien onto the taxpayer's master file account until after the taxpayer had fully paid the tax liability. Since the taxpayer's account balance had already been updated to reflect payment, there was no payment activity after the lien had been posted to trigger the lien release. In another case, a taxpayer had two separate accounts in IRS's master file for the same tax liability. When IRS filed a lien against the taxpayer, it posted the lien to both accounts. After the taxpayer paid the balance of taxes owed in full, IRS initiated the lien release on only one of the accounts. In the two cases above, IRS only discovered its error and initiated the lien releases as a result of its A-123 review. In two other cases, IRS entered into an offer-in-compromise (OIC) with taxpayers but did not promptly take the necessary steps to release its liens after receiving the agreed upon payments. In another case, IRS did not timely update the taxpayer's master file account to reflect that the tax debt had been discharged in bankruptcy court. In still another case, IRS

[36]OMB's revised Circular No. A-123, *Management's Responsibility for Internal Control*, became effective on October 1, 2005. Circular No. A-123 provides updated internal control guidance and new 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 Treasury, of which IRS is a significant component.

[37]IRS reports it is 95 percent confident that the percentage of cases in which the lien was not released within 30 days does not exceed 21 percent.

made a data entry error when entering the taxpayer's satisfying payment information into the taxpayer's account. Due to the error, the master file rejected the data and IRS had to subsequently re-enter the information. This delayed the posting of the satisfying payment to the taxpayer's account, which in turn delayed the initiation of the lien release. In a final example, IRS received the taxpayer's satisfying payment just prior to the annual 3-week period during which IRS was scheduled to perform maintenance on its master files. During this period, IRS could not record the payment in the taxpayer's master file account, which delayed the initiation of the lien release process. This delay, in turn, resulted in IRS releasing the lien more than 30 days after receipt of the satisfying payment. However, the delay in this case exceeded the 30 day limit by only 3 days.

These issues are similar to those we reported in prior audits.[38] We issued a report in May 2007 that discussed factors contributing to IRS's failure to timely release federal tax liens and made recommendations to address those issues.[39] IRS has not yet completed actions to fully address all of these recommendations. 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 2008, we continued to find 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), federal accounting standards (U.S. generally accepted accounting principles), and the SGL at the transaction level. In its Federal Managers' Financial Integrity Act of 1982 assurance statement to Treasury, IRS also reported that its financial management systems did not substantially comply with the requirements of FFMIA in fiscal year 2008.

IRS's core general ledger system for tax-related activities, IRACS, does not conform to the requirements of FFMSR, which are embodied in OMB Circular No. A-127, and also does not comply with the SGL at the transaction level. Specifically, as we noted earlier in this report, IRS

[38]GAO-08-166.

[39]GAO, *Management Report: Improvements Needed in IRS's Internal Controls*, GAO-07-689R (Washington, D.C.: May 11, 2007).

continues to lack transaction traceability for taxes receivable, which in fiscal year 2008 was again the product of a complex statistical estimation process and was not recorded in IRACS, although it accounted for over 81 percent of the assets reported by IRS on its balance sheet as of September 30, 2008. IRACS also does not post transactions in conformance with SGL posting models. In addition, material weaknesses in information security controls continue to threaten the confidentiality, integrity, and availability of IRS's financial processing systems and information. In fiscal year 2008, we continued to identify weaknesses in controls for protecting access to systems and information, as well as other information security controls that affect IRS's key financial systems, specifically IFS and IRACS. A key reason for the presence of these information security weaknesses in IRS's financial systems is that IRS has not yet fully implemented a security program to ensure that controls are effectively established and maintained.

IRS's financial management systems do not comply with federal accounting standards because IRS did not have reliable, current information on the costs of its activities available to support decision making on a routine basis, consistent with Statement of Federal Financial Accounting Standards No 4, *Managerial Cost Accounting*. Although IRS believes its recently completed cost pilots have demonstrated its ability to do so, IRS has not applied the cost information maintained in the cost module of IFS to the tax related activities processed by separate legacy information systems. IRS's financial management systems also do not comply with federal accounting standards because, as discussed previously, IRS has three material weaknesses in its internal control.

IRS's implementation of the first release of IFS represented a major step forward and has provided significant benefits, such as enhanced audit trails for non-tax amounts and a cost module. However, IRS continues to rely on obsolete systems to process tax revenues, tax refunds, and unpaid tax assessments, including taxes receivable. IRS will need to address the limitations of these tax administration systems if it is to fully resolve many of its long-standing financial management challenges. In addition, since these systems do not interface with IFS—which accounts for and reports only IRS's non-tax administrative activities—IRS will also need to determine how to overcome this separation to successfully apply the cost information in IFS to its tax-related transactions. As discussed, IRS has completed several pilot projects intended to explore ways of addressing this issue, but has not yet applied what has been learned to determining the full cost of its program activities.

IRS has established a remediation plan to address the conditions affecting its systems' inability to substantially comply with the requirements of FFMIA. This plan outlines the actions to be taken to resolve these issues, but these actions are long-term in nature and are tied to IRS's systems modernization efforts. OMB continuously monitors IRS's progress in remediating its systems deficiencies.[40]

[40]When the planned resolution period exceeds FFMIA's standard 3-year period, section 803(c)(4) of FFMIA requires that Treasury, with the concurrence of the Director of OMB, specify the most feasible date for bringing its systems into substantial compliance with the three FFMIA systems requirements and designate a Treasury official who shall be responsible for bringing its systems into substantial compliance by that date.

Appendix II: Details on Audit Methodology

To fulfill our responsibilities as the auditor of IRS's financial statements, we did the following:

- We examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements. This included selecting statistical samples of unpaid assessments, revenue, refunds, accrued expenses, payroll, nonpayroll, property and equipment, accounts payable, and undelivered order transactions. These statistical samples were selected primarily to substantiate balances and activities reported in IRS's financial statements. Consequently, dollar errors or amounts can and have been statistically projected 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, can be and have been statistically projected to the appropriate populations.

- We assessed the accounting principles used and significant estimates made by management.

- We evaluated the overall presentation of the financial statements.

- We obtained an understanding of IRS and its operations, including its internal control related to financial reporting (including safeguarding assets) and compliance with laws and regulations (including the execution of transactions in accordance with budget authority).

- We tested relevant internal control over financial reporting (including safeguarding assets) and compliance, and evaluated the design and operating effectiveness of internal control.

- We considered IRS's process for evaluating and reporting on internal control and financial management systems under 31 U.S.C. § 3512 (c), (d), commonly referred to as the Federal Managers' Financial Integrity Act of 1982, and OMB Circular No. A-123, *Management's Responsibility for Internal Control.*

- We tested compliance with selected provisions of the following laws and regulations: Anti-Deficiency Act, as amended (31 U.S.C. § 1341(a)(1) and 31 U.S.C. § 1517(a)); Purpose Statute (31 U.S.C. § 1301(a)); Release of lien (26 U.S.C. § 6325 (a)); Interest on underpayment, nonpayment, or extension of time for payment of tax (26 U.S.C. § 6601); Interest on overpayments (26 U.S.C. § 6611); Determination of rate of interest (26 U.S.C. § 6621); Failure to file tax return or to pay tax (26 U.S.C. § 6651); Failure by individual to pay estimated income tax (26 U.S.C. § 6654); Failure by corporation to pay estimated income tax (26 U.S.C. § 6655); General rule on deposit of internal revenue collections (26 U.S.C. § 7809(a); Interest penalties under the Prompt Payment Act (31 U.S.C. § 3902(a), (b), and (f); Limitations on discount payments under the Prompt Payment Act (31 U.S.C. § 3904); Pay and Allowance System for Civilian Employees (5 U.S.C. §§ 5332 and 5343, and 29 U.S.C. § 206); Federal Employees' Retirement System Act of 1986, as amended (5 U.S.C. §§ 8422, 8423, and 8432(c)(1)(A)); Social Security Act of 1935, as amended (26 U.S.C. §§ 3101 and 3121 and 42 U.S.C. § 430); Federal Employees Health Benefits Act of 1959, as amended (5 U.S.C. §§ 8905, 8906, and 8909); Financial Services and General Government Appropriations Act, 2008, Pub. L. No. 110-161, div. D, tit. I, 121 Stat. 1844 (Dec. 26, 2007); Revised Continuing Appropriations Resolution, 2007, Pub. L. No. 110-5, §§ 101, 103, 104, 21050, 21053, 121 Stat. 8, 9, 54 (Feb. 15, 2007), which incorporates by reference certain provisions in the Department of the Treasury Appropriations Act, 2006, Pub. L. No. 109-115, div. A, tit. II, 119 Stat. 2432, 2436-7 (Nov. 30, 2005); and Revised Continuing Appropriations Resolution, 2007, Pub. L. No. 110-5, §§ 21051, 21052, 121 Stat. 8, 54 (Feb. 15, 2007), which incorporates by reference certain provisions in Title II of H.R. 5576 (109th Congress, June 14, 2006); Economic Stimulus Act of 2008, Pub. L. No. 110-185, 122 Stat. 613 (Feb. 13, 2008).

- We tested whether IRS's financial management systems substantially comply with the three requirements of the Federal Financial Management Improvement Act of 1996 (Pub. L. No. 104-208, div. A, § 101(f), tit. VIII, 110 Stat. 3009, 3009-389 (Sept. 30, 1996); (*reprinted in* 31. U.S.C. § 3512 note).

Appendix III: Comments from the Internal Revenue Service

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

COMMISSIONER

November 5, 2008

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 2008 and 2007 Financial Statements.* We are pleased that the Internal Revenue Service (IRS) received an unqualified opinion on the combined financial statements for the ninth consecutive year. The unqualified opinion demonstrates that the IRS accurately accounts for approximately $2.7 trillion in tax revenue receipts, $426 billion in tax refunds, and $11 billion in IRS appropriated funds.

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

We are dedicated to continuing to improve financial management at the IRS, as evidenced by the following additional FY 2008 achievements:

- Conducted A-123 activities by testing transaction processes material to Treasury's Consolidated Financial Statements, including 12 administrative processes related to $10 billion in administrative transactions and five custodial tax processes related to $2.7 trillion in tax revenues
- Completed required Federal Information Security Management Act activities, including contingency plan testing on 247 applications and systems and live disaster recovery tests for all major applications
- Achieved a 35% reduction in Trust Fund Recovery Penalty (TFRP) cross reference errors using Custodial Detail Data Base (CDDB) reports and classified $27 billion (77%) of the $35 billion TFRP inventory

- Implemented a 20 digit trace-ID in all payment systems which enables CDDB to identify each individual tax revenue payment to support traceability to the Interim Revenue Accounting Control System
- Completed the necessary actions to support a downgrade of the Federal Managers' Financial Integrity Act Material Weakness for Earned Income Tax Credit

Improving information security continues to be a priority for the IRS. The IRS established the Office of Online Fraud Detection and Prevention to address increasing and evolving threats online affecting both the IRS and taxpayers. We also completed a corrective action plan to address information technology security training, systems auditing, access controls, system security configuration control, and systems disaster recovery. We continue risk assessments of business processes to address identity protection and analyzed the use of social security numbers for reduction and elimination where possible.

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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