PART 3:

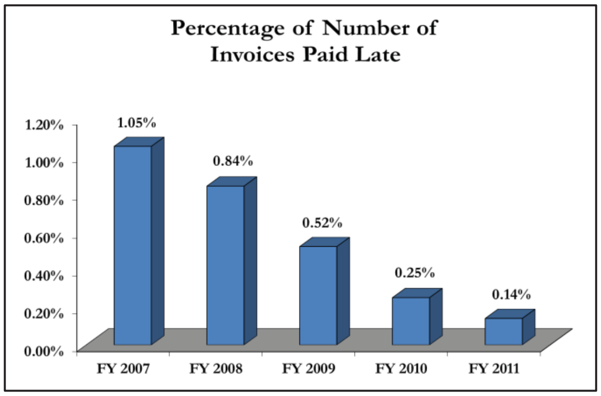
Other Accompanying Information

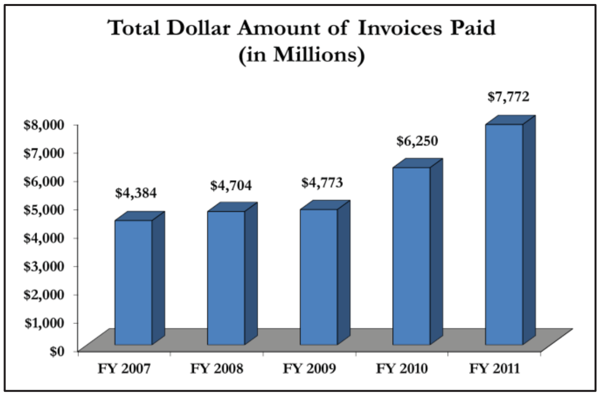
APPENDIX A: OTHER ACCOMPANYING INFORMATION (UNAUDITED)

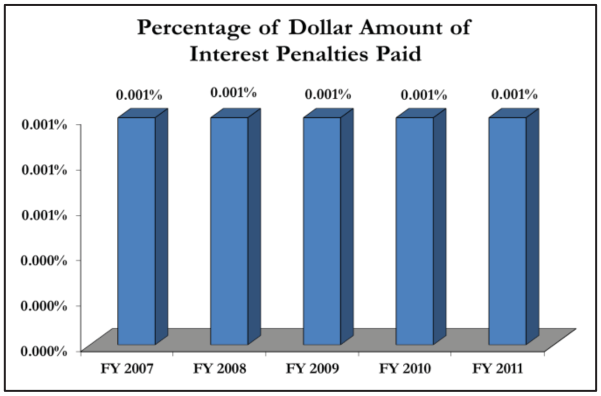
This section provides Other Accompanying Information as prescribed by Office of Management and Budget (OMB) Circular No. A-136, *Financial Reporting Requirements*.

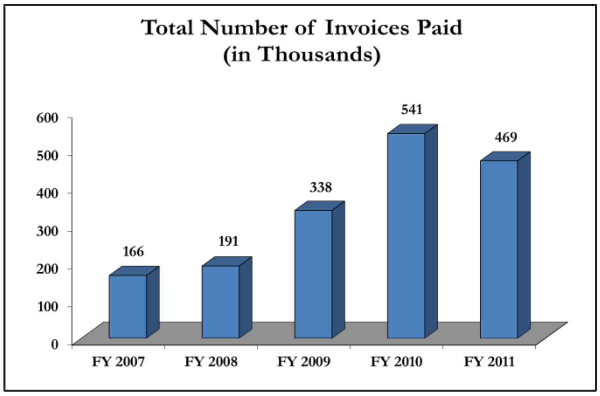
PROMPT PAYMENT

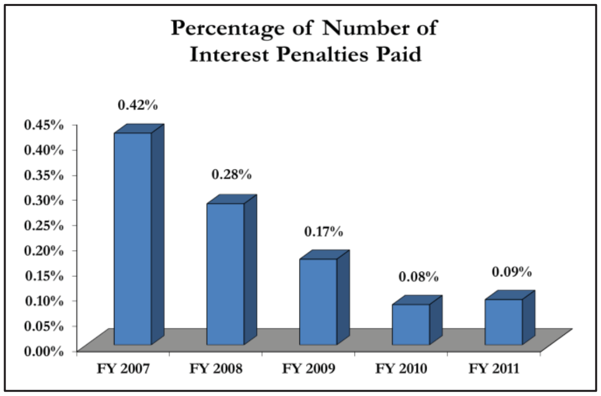
The *Prompt Payment Act* requires federal agencies to make timely payments to vendors for supplies and services, to pay interest penalties when payments are made after the due date, and to take cash discounts only when they are economically justified. Treasury bureaus report Prompt Payment data monthly to the Department, and the bureaus conduct periodic quality control reviews to identify potential problems.











Tax Gap

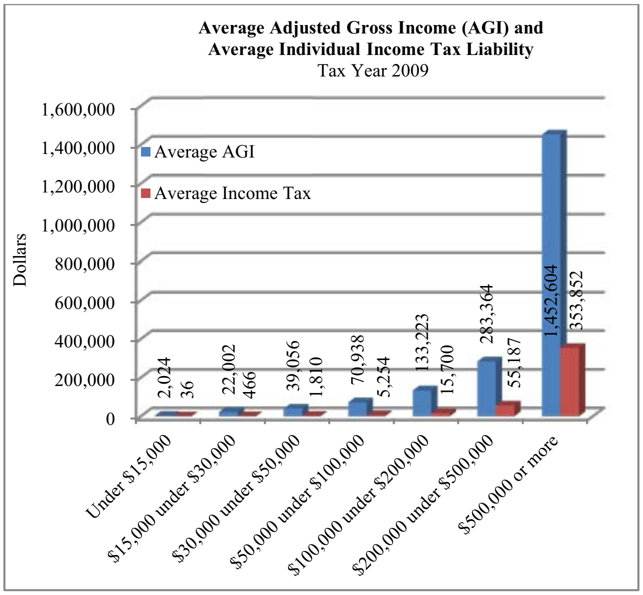
Reducing the tax gap is at the heart of IRS' enforcement programs. The tax gap is the difference between what taxpayers should pay and what they actually pay due to not filing tax returns, not paying their reported tax liability on time, or failing to report their correct tax liability. The tax gap, about $345 billion based on updated tax year 2001 estimates, represents the amount of noncompliance with the tax laws. Underreporting tax liability accounts for 82 percent of the gap, with the remainder almost evenly divided between non-filing (8 percent) and underpaying (10 percent). 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.

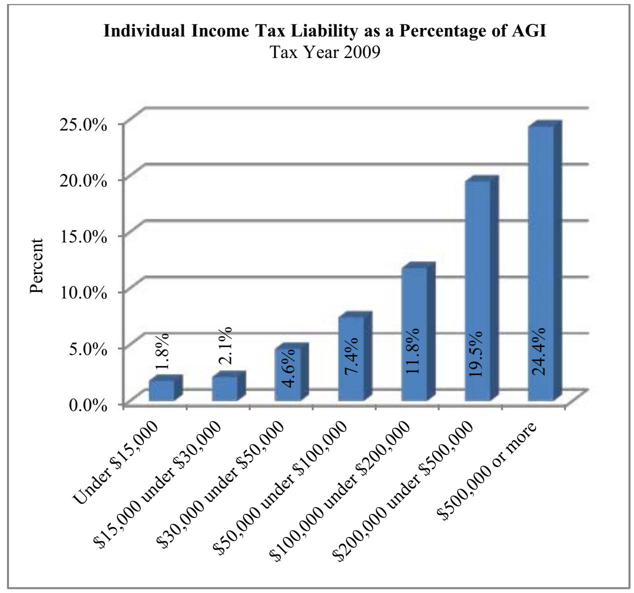
The IRS will update the tax gap estimate in December 2011. The tax gap is the aggregate amount of tax (i.e., excluding interest and penalties) that is imposed by the tax laws for any given tax year but is not paid voluntarily and timely. The tax gap arises from the three types of noncompliance: not filing required tax returns on time or at all (the non-filing 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 non-filing gap and the underreporting gap must be estimated. 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. Obviously, some of the tax gap arises from intentional (willful) noncompliance, and some of it arises from unintentional mistakes.

The collection gap is the cumulative amount of tax, penalties, and interest that has been assessed over many years, but has not been paid by a certain point in time, and which the IRS expects to remain uncollectible. In essence, it represents the difference between the total balance of unpaid assessments and the net taxes receivable reported on the IRS' 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).

Tax Burden

The Internal Revenue Code (IRC) 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) Division.

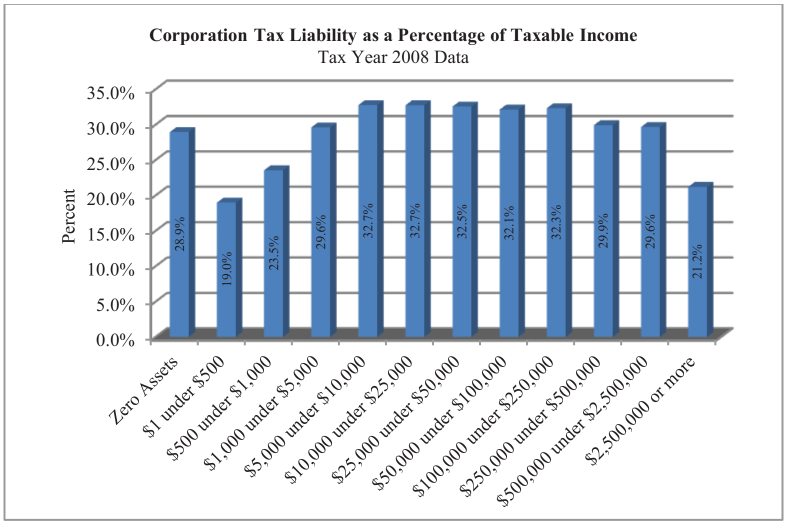




INDIVIDUAL INCOME TAX LIABILITY

Tax Year 2009

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



CORPORATION TAX LIABILIT Y

Tax Year 2008

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

APPENDIX B: IMPROPER PAYMENTS

On July 22, 2010, President Obama signed into law the *Improper Payments Elimination and Recovery Act* (IPERA, Pub. L. 111-204). IPERA amends the *Improper Payments Information Act* (IPIA), generally repeals the *Recovery Auditing Act*, and significantly increases agency payment recapture efforts by expanding the types of payments to be reviewed and lowering the dollar threshold of annual payments that requires agencies to conduct payment recapture audit programs. Agencies continue to be required to review their programs and activities annually to identify those susceptible to significant improper payments. OMB Circular No. A-123, *Management's Responsibility for Internal Control,* Appendix C, *Requirements for Effective Measurement and Remediation of Improper Payments* (A-123, Appendix C), amended April 14, 2011, defines "significant improper payments" as gross annual improper payments in a program exceeding both the threshold of 2.5 percent and $10 million of total program funding or $100 million regardless of the improper payment percentage. A-123, Appendix C also requires the agency to implement a corrective action plan that includes improper payment root cause identification, reduction targets, and accountability.

Section 2(B) of IPERA allows the development of an alternative for meeting the requirements for obtaining a statistically valid estimate of the annual amount of improper payments for federal programs that are so complex that developing an annual error rate is not feasible. Agencies may establish an annual estimate for a high-risk component of a complex program (e.g., a specific program population) with OMB approval. Agencies must also perform trend analyses to update the program's baseline error rate in the interim years between detailed program studies. When development of a statistically valid error rate is possible, the reduction targets are revised and become the basis for future trend analyses.

I. RISK ASSESSMENTS

Each year, the Department develops a comprehensive inventory of the funding sources for all programs and activities and distributes it to the Treasury bureaus and offices. The bureaus and offices must perform risk assessments at the payment type level (e.g., payroll, contracts, vendors, travel, etc.). During fiscal year 2011, Treasury lowered the assessment threshold for program or activity funding from $10 million to $1 million. The Department's risk assessment follows the Committee of Sponsoring Organizations of the Treadway Commission (COSO) Internal Control Integrated Framework. The framework includes:

1. Internal Control Environment
2. Risk Assessment
3. Internal Control Activities
4. Information and Communications
5. Monitoring

Within the COSO Integrated Framework the factors addressed to determine risk levels include:

Operating Environment – Existence of factors which necessitate or allow for loosening of financial controls; any known instances of fraud

Payment Processing Controls – Management's implementation of internal controls over payment processes including existence of current documentation, the assessment of design and operating effectiveness of internal controls over payments, the identification of deficiencies related to payment processes, and whether or not effective compensating controls are present

Quality of Internal Monitoring Controls – Periodic internal program reviews to determine if payments are made properly; strength of documentation requirements and standards to support testing of design and operating effectiveness for key payment controls

Human Capital – Experience, training, and size of payment staff; ability of staff to handle peak payment requirements; level of management oversight, and monitoring against fraudulent activity

Prior to the enactment of the IPERA changes to IPIA, Treasury maintained and performed a robust improper payment risk assessment process in which the new IPERA payment types were included. During fiscal year 2011, Treasury enhanced its risk assessment tool by expanding the scope of risk assessment factors which were included in the revised A-123, Appendix C.

For those payment types resulting in high-risk assessments that comprise at least 2.5 percent and $10 million or $100 million of a total funding source, (1) statistical sampling must be performed to determine the actual improper payment rate, and (2) a corrective action plan must be developed and submitted to the Department and OMB for approval. Responses to the risk assessments produce a score that falls into pre-determined categories of risk. The following table describes the actions required at each risk level:

Risk Level	Required Action(s)
High Risk ≥ 2.5% Error Rate & > $10 Million or $100,000,000	Corrective Action Plan
Medium Risk	Review Payment Controls for Improvement
Low Risk	No Further Action Required

The results of the risk assessments performed across the Department in fiscal year 2011 resulted in all programs and activities being of low and medium risk susceptibility for improper payments, except for the IRS's Earned Income Tax Credit (EITC) program. The EITC's high-risk status is well-documented, having been identified previously in the former Section 57 of OMB Circular No. A-11, *Preparation, Submission, and Execution of the Budget*, and has been deemed a complex program for the purposes of the IPIA. OMB's guidance requires additional reporting on programs deemed high-risk; that information, for the EITC program only, follows.

II. STATISTICAL SAMPLING

EITC Program

The EITC is a refundable federal tax credit that offsets income taxes owed by low-income workers and, if the credit exceeds the amount of taxes owed, provides a lump-sum refund to those who qualify.

This section describes how the IRS currently develops its erroneous payment projections for the EITC. The most recent projection is based on a tax year 2007 reporting compliance study that estimated the level of improper overclaims for fiscal year 2011 to range between $13.7 to $16.7 billion and 21.2 percent (lower bound) to 25.8 percent (upper bound) of approximately $64.7 billion in total program payments.

The complexity of the EITC program, the nature of tax processing, and the expense of compliance studies preclude statistical sampling on an annual basis to develop error rates for comparison to reduction targets. The estimates are based primarily on information from the IRS's National Research Program (NRP) reporting compliance study of individual income tax returns for tax year 2007—the most recent year for which compliance information from a statistically valid, random sample of individual tax returns is available.

Under the tax year 2007 NRP reporting compliance study, which reviewed individual income tax returns filed during calendar year 2008 for tax year 2007, 2,200 of the returns in the regular NRP sample were EITC claimants randomly selected for examination.

This selection method allows the measures for the individual income tax return filing population to be estimated from the results of the NRP sample returns. Because one of the objectives of the NRP is to provide data for compliance measurement, NRP procedures and data collection differ from those followed in standard examination programs. NRP classification and examination procedures are more comprehensive in scope and depth than those for standard examination programs. These expanded procedures were designed to provide a more thorough determination of what taxpayers should have reported on their returns. The tax year 2007 NRP individual income tax return study covered filers of all types of individual income tax returns. The NRP study results for this EITC claimant subset of NRP returns were the primary source of data for the improper payments estimates. Other data and information sources used for the estimates included the IRS Enforcement Revenue Information System, which tracks assessments and collections from IRS enforcement-related activities, and Treasury Department fiscal year 2011 EITC budget estimates.

III. Corrective Actions

This section describes the ongoing and planned corrective actions to reduce the improper payment rate for Treasury's only high-risk susceptible program, the EITC.

Root Causes

The root causes of EITC improper payments are from the following sources:

Authentication – An estimated 75 percent or $11.4 billion in improper payments result from authentication errors. These errors include errors associated with the inability to authenticate qualifying child eligibility requirements, mainly relationship and residency requirements, filing status, when married couples file as single or head of household, and eligibility in nontraditional and complex living situations. Authentication is completed on a portion of this error category during pre-refund examinations.

Verification – An estimated 25 percent or $3.8 billion in improper payments result from verification errors. These errors relate to improper income reporting which allows claimants to fall within the EITC income limitations and qualify for the EITC. The errors include both underreporting and overreporting of income by both wage earners and taxpayers who report being self-employed. Income reported through information returns such as Forms W-2, Forms 1099, etc., which can be used for verification of some income, becomes available only after tax returns are processed. Under law IRS must process income tax returns within 45 days of receipt or pay interest to taxpayers.

Base Program

In 2011, the IRS prevented more than $3.7 billion from being paid in error. The prevention activity primarily focused on three areas:

- **Examinations** – IRS identifies tax returns for examination and holds the EITC portion of the refund until an audit can be conducted. This is the only ongoing IRS audit program where exams are conducted before a refund is released. The examination closures and enforcement revenue protected in the charts below do not include test initiatives
- **Math Error** – Refers to an automated process in which the IRS identifies math or other statistical irregularities and automatically prepares an adjusted return for a taxpayer. Legislation is required for math error use
- **Document Matching** – Involves comparing income information provided by the taxpayer with matching information (e.g., W-2s, 1099s) from employers to identify discrepancies

The chart below shows significant results from fiscal year 2006 through an estimate of fiscal year 2012. In fiscal year 2011 alone, the IRS conducted an estimated 484,000 examinations, issued approximately 300,000 math error notices, and closed nearly 1.2 million document matching reviews.

Compliance Activities								
	FY06	FY07	FY08	FY09	FY10*	FY11**	FY12***	FY06-FY12 Total
Examination Closures	517,617	503,267	503,755	508,180	473,999	483,785	484,000	3,474,603
Math Error Notices	460,316	393,263	432,797	355,416	341,824	300,000	250,000	2,533,616
Document Matching ****	364,020	734,603	727,916	688,087	904,920	1,178,129	1,178,000	5,775,675
Amended Returns[1]			32,473	25,395	19,347	14,319	14,000	105,534

* Restated actual.
** Preliminary estimates.
*** Estimate based on fiscal year 2011 preliminary data.
**** Document Matching includes enterprise data. Enterprise data not available for fiscal year 2006.
[1] Amended returns are a subset of Examination Closures.

These activities had a significant effect. Treasury projects that continued enforcement efforts will protect a total of nearly $25 billion in revenue through fiscal year 2012.

Enforcement Revenue Protected (Dollars in Billions)								
	FY06	FY07	FY08	FY09	FY10*	FY11**	FY12***	FY06-FY12 Total
Examination Closures	$ 1.50	$ 1.49	$ 2.00	$ 2.15	$ 1.97	$ 2.04	$ 2.04	$ 13.19
Math Error Notices	$ 0.46	$ 0.41	$ 0.44	$ 0.40	$ 0.41	$ 0.36	$ 0.31	$ 2.79
Document Matching ****	$ 0.60	$ 1.29	$ 1.23	$ 1.17	$ 1.43	$ 1.32	$ 1.32	$ 8.36
Amended Returns			$ 0.07	$ 0.07	$ 0.06	$ .04	$ .04	$ 0.28
TOTAL	$ 2.56	$ 3.19	$ 3.74	$ 3.79	$ 3.87	$ 3.76	$ 3.71	$ 24.62

* Restated actual.
** Preliminary estimates.
*** Estimate based on fiscal year 2011 preliminary data.
**** Document Matching includes enterprise data. Enterprise data not available for fiscal year 2006.

Maximizing Current Business Processes

- In fiscal year 2011, IRS completed activities associated with a suite of EITC paid preparer treatments, based on risk-based selections, to influence the accuracy of EITC returns filed. IRS increased the number of due diligence audits by over 100 percent, visits by revenue and criminal investigation agents by 50 percent, and educational and compliance notices to first-time and experienced preparers by 25 percent over the prior year. The percentage of paid preparers penalized as a result of due diligence audits remained high at 90 percent. Proposed due diligence penalties increased by almost 250 percent to over $10.4 million. IRS also proposed other penalties of over $250,000. Additionally, IRS obtained four injunctions against EITC preparers with a revenue impact of over $60 million.

- IRS completed strategic studies to update the estimates of the two key EITC performance measures, participation rate and error rate, which comply with the *Government Performance and Results Act of 1993*. IRS also delivered estimates of EITC participation for tax year 2008, using a Census-IRS match. In addition, IRS used research data from the fiscal year 2011 enterprise research strategy to develop a fiscal year 2012 strategy in partnership with internal organizations to better focus EITC compliance and outreach activities.

- IRS continued its partnership with members from two key tax software associations to collaborate on efforts to help reduce EITC errors and assist preparers in meeting their EITC due diligence requirements. In fiscal year 2011, the partnership delivered an EITC Schedule C and Records Reconstruction Training to help preparers meet their due diligence requirements with self-employed clients.

IV. Improper Payment Reporting

The following table provides the improper payment reduction outlook for Treasury's only high-risk susceptible program, the EITC:

Improper Payment (IP) Reduction Outlook (Dollars in Billions)

Program	2010 Outlays	2010 %	2010 $	2011 Outlays	2011 IP%	2011 IP$	2012 Est. Outlays	2012 IP%	2012 IP$	2013 Est. Outlays	2013 IP%	2013 IP$	2014 Est. Outlays	2014 IP%	2014 IP$
EITC Upper Bound Estimate	$64.2	28.7%	$18.4	$64.7	25.8%	$16.7	$57.0	25.8%	$14.7	$57.0	25.8%	$14.7	$51.2	25.8%	$13.2
EITC Lower Bound Estimate	$64.2	23.9%	$15.3	$64.7	21.2%	$13.7	$57.0	21.2%	$12.1	$57.0	21.2%	$12.1	$51.2	21.2%	$10.9

The term "Outlays" equals "Estimated Claims".
Estimated Claims: Estimated total claims for the EITC are based on projections of EITC tax expenditures plus outlays as estimated by the Office of Tax Analysis within the Department of the Treasury, adjusted to account for the difference between taxpayer claims and accounts received by taxpayers due to return processing and enforcement.
IP % and IP $: These estimates follow the prior approach which provided a range for the error rate (%) and improper payments amounts ($).
2010 and 2011 estimates include Recovery Act EITC provisions which expanded the EITC for families with three children and increased the beginning of the phase-out range for couples filing a joint return.

Underpayments are not included in the estimate of improper payments. Underpayments do not appear with sufficient frequency in the statistically valid test data to have a measurable effect on the estimate.

V. Recapture of Improper Payments Reporting

In accordance with IPERA and OMB Circular No. A-123, Appendix C, Treasury performs and reports annually on its payment recapture program. In fiscal year 2011, Treasury incorporated the IPERA amendments into the existing Treasury payment recapture (recovery audit) program. Prior to the enactment of the IPERA changes to IPIA, Treasury maintained and performed a robust improper payment risk assessment process which already included the new IPERA payment types.

During fiscal year 2011, Treasury issued contracts and other reviewed payments totaling approximately $37 billion. The dollar amount of reviewed payments increased during fiscal year 2011 due to the amended *A-123, Appendix C* for payment recapture audits. The amended act expanded the payment types reviewed from contracts to include grants, benefits, loans, and miscellaneous payments.

Treasury's annual risk assessment process includes a review of pre-payment controls that minimize the likelihood and occurrence of improper payments. Treasury requires each bureau and office to conduct post-award audits and report on payment recapture activities, contracts issued, improper payments made, and recoveries achieved. Bureaus and offices may use payment recapture audit contingency firms to perform many of the steps in their payment recapture auditing program and identify candidates for payment recapture action. However, no Treasury bureaus used contractors to perform recapture activities. Treasury employees performed this work.

Treasury considers both pre- and post-reviews to identify payment errors a sound management practice that should be included among basic payment controls. All of Treasury's bureaus have a process to identify improper payments during post-reviews. At times, bureaus may use the results of IG and GAO reviews to help them identify payment anomalies and target areas for improvement. However, Treasury applies extensive payment controls at the time each payment is processed, making recapture activity minimal.

Payment Recapture Audit Reporting

Type of Payment	Amount Subject to Review for 2011 Reporting	Actual Amount Reviewed and Reported (2011)	Amount Identified for Recovery (2011)	Amount Recovered (2011)	% of Amount Recovered out of Amount Identified (2011)	Amount Outstanding (2011)	% of Amount Outstanding out of Amount Identified (2011)
Contracts	$ 7,739,282,783	$ 7,255,403,811	$ 302,429	$ 276,813	92.0%	$ 26,936	8.0%
Grants	$ 4,290,756,639	$ 4,290,756,639	$ 428,274	$ 428,274	100.0%	-	0.0%
Benefits	$ 610,224,028	$ 1,566,192	$ 1,438	$ 1,438	100.0%	-	0.0%
Loans	$ 2,494,584,214	$ 2,494,584,214	-	-	-	-	-
Other	$ 23,295,631,387	$ 23,295,631,387	$ 46,380	$ 46,256	100.0%	$ 124	0.0%

Type of Payment	Amount Determined Not to be Collectable (2011)	% of Amount Determined Not to be Collectable out of Amount Identified (2011)	Amounts Identified for Recovery (2004-2010)	Amounts Recovered (2004-2010)	Cumulative Amounts Identified for Recovery (2004-2011)	Cumulative Amounts Recovered (2004-2011)	Cumulative Amounts Outstanding (2004-2011)	Cumulative Amounts Determined Not to be Collectable (2004-2011)
Contracts	$ 11,709	4.0%	$ 7,200,597	$6,018,579*	$ 7,503,026	$6,295,392*	$ 26,936	$ 75,130
Grants	-	-	-	-	-	-	-	-
Benefits	-	-	-	-	-	-	-	-
Loans	-	-	-	-	-	-	-	-
Other	-	-	-	-	-	-	-	-

* *Does not include an amount of approximately $750,000 reported for fiscal year 2005, which was subsequently recovered after the reporting period.*

The payment recapture audit targets listed below are preliminary estimates developed by Treasury bureaus and offices based on historical performance and current payment recapture audit programs.

Type ofPayment	2011 Amount Identified	2011 Amount Recovered	2011 Recovery Rate (Amount Recovered / Amount Identified)	2012 Recovery Rate Target	2013 Recovery Rate Target	2014 Recovery Rate Target
Contracts	$ 302,429	$ 276,813	92.0%	95.0%	95.0%	95.0%
Grants	$ 428,274	$ 428,274	100.0%	100.0%	100.0%	100.0%
Benefits	$ 1,438	$ 1,438	100.0%	100.0%	100.0%	100.0%
Loans	$ -	$ -	100.0%	100.0%	100.0%	100.0%
Other	$ 46,380	$ 46,256	100.0%	100.0%	100.0%	100.0%

Due to the delayed release of IPERA implementation guidance, Treasury's bureaus were not able to fully implement or develop the mechanisms to acquire the additional information specified in the amended Payment Recapture Audit guidance to complete the following tables: (1) Aging of Outstanding Overpayments, (2) Disposition of Recaptured Funds, and (3) Overpayments Recaptured Outside of Payment Recapture Audits (refer to additional comments under section IX below).

VI. Accountability

The Secretary of the Treasury has delegated responsibility for addressing improper payments to the Assistant Secretary for Management and Chief Financial Officer (ASM/CFO). Improper payments fall under the Department's management and internal control program. A major component of the internal control program is risk assessments, which are an extension of each bureau's annual improper payment elimination and recovery review process, as required under A-123, Appendix C. Under Treasury Directive 40-04, *Treasury Internal (Management) Control Program*, executives and other managers are required to have management control responsibilities as part of their annual performance plans. With oversight mechanisms such as the Treasury CFO Council and the IRS's Financial and Management Controls Executive Steering Committee (FMC ESC), managerial responsibility and accountability in all management and internal control areas are visible and well-documented. Improper payments also have been monitored for improvement as a significant deficiency under the *Federal Managers' Financial Integrity Act*. Treasury has identified executives who are responsible and accountable for reducing the level of EITC overclaims, while other senior and mid-level officials have responsibility for monitoring progress in this area as bureau and program internal control officers.

VII. Information Systems and other Infrastructure

Overall, Treasury has the internal controls, human capital, and information systems and other infrastructure it needs to reduce improper payments to the targeted levels.

VIII. Limiting Statutory and Regulatory Barriers

Treasury's overall management assessment of IPERA did not uncover any limiting statutory or regulatory barriers with the exception of the high-risk EITC program.

A number of factors continue to serve as barriers to reducing overclaims in the EITC program. These include:

- Complexity of the tax law
- Structure of the EITC
- Confusion among eligible claimants
- High turnover of eligible claimants
- Unscrupulous return preparers
- Fraud

No one of these factors can be considered the primary driver of program error. Furthermore, the interaction among the factors makes addressing the credit's erroneous claims rate, while balancing the need to ensure the credit makes its way to taxpayers who are eligible, extremely difficult.

IX. Additional Comments

Treasury made a concerted effort to fully implement the Payment Recapture Audit portion of IPERA during fiscal year 2011. Due to the timing of the OMB guidance, critical competing priorities, and resource constraints, the program was not fully implemented. However, the Department is in the process of developing an updated plan to ensure implementation no later than the end of fiscal year 2013, which is the year that the improper payment rate criterion for identifying a significant improper payment is lowered from 2.5 percent to 1.5 percent and the targeted payment recapture recovery rate should reach 85 percent overall.

Appendix C: MANAGEMENT AND PERFORMANCE CHALLENGES AND RESPONSES

In accordance with the *Reports Consolidation Act of 2000*, the Inspectors General issue Semiannual Reports to Congress that identify specific management and performance challenges facing the Department. At the end of each fiscal year, the Treasury OIG and TIGTA send an update of these management challenges to the Secretary and cite any new challenges for the upcoming fiscal year. SIGTARP does not provide the Secretary with a semiannual report or annual update on management and performance challenges. This Appendix contains the incoming management and performance challenges letters from OIG and TIGTA and the Secretary's responses describing actions taken and planned to address the challenges.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

OFFICE OF
INSPECTOR GENERAL

October 24, 2011

INFORMATION MEMORANDUM FOR SECRETARY GEITHNER

FROM: Eric M. Thorson
Inspector General

SUBJECT: Management and Performance Challenges Facing the Department of the Treasury (OIG-CA-12-001)

In accordance with the Reports Consolidation Act of 2000, we are providing you with our perspective on the most serious management and performance challenges facing the Department of the Treasury.

In assessing the Department's most serious challenges, we are mindful of the budget environment being faced by Treasury and the entire federal government as the Administration and the Congress looks for ways to address the country's budget deficit. Cuts to programs and operations are likely although the extent of any cuts and the specific nature of the cuts are unknown as of this writing. With that as a backdrop, the Treasury Department has in recent years been given a number of new responsibilities that are critical to this country's sustained economic strength. More often than not, the Department has been faced with needing to start up and administer these new responsibilities with very thin staffing and resources. I know that the Department's senior leadership is fully cognizant of these pressures and the need for strong management. That said, if the Department is faced with reduced funding, my office will monitor and examine how Treasury's programs and operations are impacted and we look forward to working with the Department leadership in this regard. We also cannot emphasize enough to the Department's stakeholders the critical importance that Treasury is resourced sufficiently to maintain an appropriate control infrastructure.

We continue to report the four challenges from last year.

- Transformation of Financial Regulation
- Management of Treasury's Authorities Intended to Support and Improve the Economy
- Anti-Money Laundering and Terrorist Financing/Bank Secrecy Act Enforcement
- Management of Capital Investments

We are not reporting any new challenges this year. However, in addition to the above challenges, we are reporting an elevated concern about one matter, information security, and the need for constant and effective surveillance over Treasury's security posture.

Challenge 1: Transformation of Financial Regulation

In response to the need for financial reform, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) in July 2010. Dodd-Frank established new responsibilities for Treasury and created new offices tasked to fulfill those responsibilities.

Dodd-Frank established the Financial Stability Oversight Council (FSOC), which you chair as the Treasury Secretary. FSOC's mission is to identify risks to financial stability that could arise from the activities of large, interconnected financial companies; respond to any emerging threats to the financial system; and promote market discipline. As required, FSOC issued its first annual report in July 2011. The report contained recommendations to (1) heighten risk management and supervisory attention in specific areas, (2) further reforms to address structural vulnerabilities in key markets, (3) take steps to address reform of the housing finance market, and (4) ensure interagency coordination on financial regulatory reform. This is an important early step, but FSOC still has work ahead to meet all of its responsibilities. For example, Dodd-Frank calls for the consolidated supervision and heightened prudential standards for large, interconnected nonbank financial companies. FSOC also has the authority to designate nonbank financial companies for consolidated supervision and to recommend heightened standards for these firms and large bank holding companies. In this regard, the Board of Governors of the Federal Reserve System would be responsible for supervising these firms and adopting specific prudential rules. As of this writing, FSOC is still in the process of establishing the framework for identifying systemically significant nonbank financial institutions. To that end, on October 11, 2011, FSOC issued a notice of proposed rulemaking that among other things, set forth a three-stage process in non-emergency situations to determine whether to subject a nonbank financial company to Board of Governors supervision and prudential standards. Each stage of the process would involve an analysis based on an increasing amount of information. FSOC did finalize the rules for implementing its authority under Dodd-Frank for designating financial market utilities[1] as systemically important in July of this year. Financial market utilities so designated are subject to (1) risk management standards governing the operations related to the payment, clearing, and settlement activities, and (2) additional examinations and reporting requirements, as well as potential enforcement actions.

The Council of Inspectors General on Financial Oversight (CIGFO), which I chair, was also established by Dodd-Frank. It facilitates the sharing of information among member inspectors general with a focus on reporting our concerns that may apply to the broader financial sector and ways to improve financial oversight. Accordingly, CIGFO will be an important source of independent, unbiased analysis to FSOC. As required, CIGFO met on a quarterly basis and issued its first annual report in July 2011. That report discussed current and pending joint projects of CIGFO members and CIGFO's conclusion that FSOC had either met or is on target to

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[1] The term "financial market utility" means any person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and the person. However, the term does not include entities such as national securities exchanges, national securities associations, and many others.

meet all requirements to date. CIGFO has approved guidelines for the establishment and procedures of working groups. In the future, CIGFO anticipates establishing a working group to oversee the process of designating systemically important nonbank financial institutions for heightened prudential supervision by the Board of Governors.

Additionally, Dodd-Frank established two new offices within Treasury: the Office of Financial Research (OFR) and the Federal Insurance Office (FIO). The OFR is to be a data collection, research and analysis arm of FSOC. The OFR will operate under a Presidentially-appointed, Senate-confirmed Director. As of this writing, a nominee to serve as the OFR Director has not been announced. Among other things, the OFR Director is to report to Congress annually on the office's activities and its assessments of systemic risk, with the first report due July 21, 2012. The FIO is charged with monitoring the insurance industry, including identifying gaps or issues in the regulation of insurance that could contribute to a systemic crisis in the insurance industry or financial system. The FIO Director, whom you appointed in March of this year, is to advise FSOC on insurance matters. We are currently reviewing the Department's progress in standing up OFR and our future work plans include a review of FIO.

Intended to streamline the supervision of depository institutions and holding companies, Dodd-Frank transferred the powers and duties of the Office of Thrift Supervision (OTS) to the Office of the Comptroller of the Currency (OCC), the Board of Governors, and the Federal Deposit Insurance Corporation (FDIC) effective July 21, 2011. As required by Dodd-Frank, we and the Offices of Inspector General of FDIC and the Board of Governors completed two reviews on the transfer during 2011. The first review reported on the planning for the transfer and the second review reported on the status of the transfer 6 months later. The reviews found that the planning was generally adequate and that transfer activities occurred as planned. However, we also reported on items that were still "works-in-progress." We will continue to monitor those items as part of our future reviews.

The other regulatory challenges that we discussed last year still remain. Specifically, since September 2007, 113 Treasury-regulated financial institutions have failed, with estimated losses to the Deposit Insurance Fund of approximately $36.3 billion. This is an increase of 23 financial institutions and $1.8 billion in losses since my last challenges letter. With more than 800 banks on FDIC's troubled bank list, we anticipate bank failures to continue into the foreseeable future.

Although many factors contributed to the turmoil in the financial markets, our work found that OCC and OTS did not identify early or force timely correction of unsafe and unsound practices by numerous failed institutions under their respective supervision. The irresponsible lending practices of many institutions are now well-recognized. At the same time, they also engaged in other high-risk activities, including high asset concentrations in commercial real estate and overreliance on unpredictable wholesale funding to fund growth. Last year, the unprecedented speed at which servicers were foreclosing on defaulted mortgages revealed flaws in the processing of those foreclosures. In response, the federal banking regulators completed a horizontal review of foreclosure practices at major mortgage servicers. The review found deficiencies in the servicers' foreclosure processes including weak management oversight, foreclosure document deficiencies, poor oversight of third parties involved in the foreclosure process, and inadequate risk control systems. As a result, the federal banking regulators issued formal enforcement actions against 14 mortgage servicers and 2 third party providers subject to the review. While it is too soon to tell whether these servicing deficiencies have been addressed, the foreclosure crisis has certainly impacted an already stressed housing market, with no significant turnaround yet in sight.

Our office is mandated to review the failures of Treasury-regulated financial institutions that result in material losses to the Deposit Insurance Fund. Since 2007, we have completed 42 such reviews and are engaged in 13 others. These reviews identify the causes of the failures and assess the supervision exercised. OCC has been responsive to our recommendations for improving supervision. Dodd-Frank now mandates that our office also review failures that result in non-material losses to the Deposit Insurance Fund. To that end, we have completed 44 such reviews. However, neither the material nor non-material reviews address the broader supervisory effectiveness of the federal banking regulators as a whole or the effectiveness of the supervisory structure. It is therefore essential that OCC continue to take a critical look at its supervisory processes to identify areas for improvement in those processes to better protect the financial health of the banking industry and consumers going forward.

In my last memorandum, I discussed the challenges Treasury faced in standing up the Bureau of Consumer Financial Protection (CFPB). I am pleased to note that since then, Treasury was successful in this effort. CFPB opened for business on July 21, 2011, as planned. Established by Dodd-Frank, the purpose of CFPB is to implement and, where applicable, enforce federal consumer financial law consistently to ensure that all consumers have access to markets for consumer financial products and services and that those markets are fair, transparent, and competitive. CFPB is an independent bureau of the Board of Governors but Treasury has a unique role in its operations. Specifically, until a Director is appointed, you are charged with exercising some, but not all, of the Director's authorities. On July 18, 2011, the President nominated Richard Cordray to be the first Director of CFPB. That nomination is currently pending before the Senate. It should be noted that, while no specific legislation has been proposed, there is much discussion in the Congress on whether the form of governance over CFPB should be changed. The Board of Governors Inspector General is designated by Dodd-Frank to provide oversight of CFPB. However, with Treasury's current statutory role under Dodd-Frank, our office will continue to coordinate with the Board of Governors OIG on CFPB oversight matters.

Clearly, as we have said in the past, the intention of Dodd-Frank is most notably to prevent, or at least minimize, the impact of a future financial sector crisis on our economy. In order to accomplish this, Dodd-Frank has placed a great deal of responsibility within Treasury and you, as the Treasury Secretary. The management challenge from our perspective is to maintain an effective FSOC process supported by the newly created offices within Treasury and the streamlined banking regulatory structure that timely identifies and strongly responds to emerging risks. This is especially important in times of economic growth and financial institution profitability when such government action is generally unpopular.

Challenge 2: Management of Treasury's Authorities Intended to Support and Improve the Economy

Congress provided Treasury with broad authorities to address the financial crisis under the Housing and Economic Recovery Act (HERA) and the Emergency Economic Stabilization Act (EESA) enacted in 2008, the American Recovery and Reinvestment Act of 2009 (Recovery Act), and the Small Business Jobs Act of 2010. Certain authorities in HERA and EESA have now expired but challenges remain in managing Treasury's outstanding investments. To a large extent, Treasury's program administration under these Acts has matured. However, investment decisions involving the Small Business Jobs Act programs have only recently been completed. Our discussion of this challenge will begin with the most recent act to improve and support the economy and then discuss the others for which Treasury is responsible.

<u>Management of the Small Business Lending Fund and State Small Business Credit Initiative</u>

Enacted in September 2010, the Small Business Jobs Act of 2010 created a $30 billion Small Business Lending Fund (SBLF) within Treasury and provided $1.5 billion to be allocated by Treasury to eligible state programs through the State Small Business Credit Initiative (SSBCI). The Act represents a key initiative of the Administration to increase lending to small businesses, and thereby, support job creation. Both programs were slow to disburse funds to intended recipients, with Treasury approving the majority of SBLF and SSBCI applications during the last quarter of fiscal year 2011. This occurred because the majority of applicants waited to apply within weeks of the application deadlines and significant delays were encountered in implementing the SBLF program. As a result, Treasury was rushed in making a significant number of SBLF investment decisions to meet funding deadlines, and disbursed the initial installment of SSBCI funds without establishing clear oversight obligations of participating states. Now that Treasury has completed the approval process for these two programs, the challenge for Treasury will be to exercise sufficient oversight to ensure that funds are used appropriately by participants, SBLF dividends owed Treasury are paid, and that the programs achieve intended results.

<u>SBLF</u> As of September 27, 2011, Treasury had disbursed more than $4 billion to 332 financial institutions across the country. Of the institutions funded, 42 percent were institutions that used their SBLF investment to refinance securities issued under the Troubled Asset Relief Program (TARP) Capital Purchase Program. Institutions receiving investments under the SBLF program are expected to pay dividends to Treasury at rates that will decrease as the amount of qualified small business lending the institution does increases. During the first 4½ years of Treasury's investment, participating institutions initially pay dividends to Treasury of up to 5 percent but that rate may be reduced to as low as 1 percent based on their demonstrated increase in small business lending, which is self-reported by the participating institutions. The dividends are non-cumulative, meaning that institutions are under no obligation to make dividend payments as scheduled or to pay off previously missed payments before exiting the program. That said, there are provisions for increased restrictions as dividends are missed, including a prohibition against paying dividends on common stock and a provision for Treasury to appoint up to two members to the bank's board of directors. The

effectiveness of these measures, however, may be impacted if the institution's regulator has restricted it from making dividend payments.

Treasury will face many challenges in ensuring that the SBLF program meets its intended objective of increasing lending to small businesses and in measuring program performance. Under the terms of the authorizing legislation, SBLF funds are intended to stimulate lending to small businesses, but participating institutions are under no obligation to increase their small business lending activity. Once SBLF funds are disbursed and become commingled with other funds of the participating institutions, it will be difficult to track how the funds are spent. Participants are also not required to report how they use Treasury's investments. Additionally, Treasury is reliant on unverified information reported by participating institutions on their small business lending activity to measure performance and to make dividend rate adjustments.

SSBCI As of September 27, 2011, 53 states, territories, and eligible municipalities (participating states) had applied for $1.5 billion in SSBCI funding. Of the 53 participating states, 31 had received their first funding allocations of approximately $0.3 billion. Under SSBCI, participating states may obtain funding for programs that partner with private lenders to extend credit to small businesses. Such programs may include those that finance loan loss reserves; and provide loan insurance, loan guaranties, venture capital funds, and collateral support. If a state does not have an existing small business lending program, it can establish one in order to access SSBCI funding. States must provide Treasury with plans for using their funding allocations for review and approval, and report quarterly and annually on results. Another key feature is that participating states receive their allocations in one-third increments. Treasury may withhold a successive increment to a state pending the results of an audit by our office.

Primary oversight of the use of SSBCI funds is the responsibility of each participating state. The states are required to provide Treasury with quarterly assurances that their programs approved for SSBCI funding are in compliance with program requirements. However, Treasury will face challenges in holding states accountable for the proper use of funds as it has not clearly defined the oversight obligations of states or specified minimum standards for determining whether participating states have fulfilled their oversight responsibilities. Treasury has also not required participating states to collect and review compliance assurances made by lenders and borrowers or defined what constitutes a material adverse change in a state's financial or operational condition that must be reported to Treasury. As a result, Treasury will have difficulty finding states to be in default of program requirements and holding states accountable should our office find that a state has intentionally or recklessly misused funds.

Management of Recovery Act Programs

Treasury is responsible for overseeing an estimated $150 billion of Recovery Act funding and tax relief. Treasury's oversight responsibilities include programs that provide payments for specified energy property in lieu of tax credits, payments to states for low-income housing projects in lieu of tax credits, grants and tax credits through the Community Development Financial Institutions Fund, economic recovery payments to social security beneficiaries and others, and payments to U.S. territories for distribution to their citizens.

Several of these programs involve very large dollar amounts. It is estimated that Treasury's Recovery Act payments in lieu of tax credit programs, for specified energy property and **to** states for low-income housing projects, will cost more than $20 billion over their lives. To date, Treasury has already awarded approximately $13 billion under these programs. Payments made to recipients under the specified energy property program alone comprise more than $9 billion of the funds awarded to date and the number of applicants is expected to grow with the program's application deadline now extended through fiscal year 2012. We previously reported that Treasury dedicated only a small number of staff to award and monitor these funds. It did, however, implement a process for the specified energy property program whereby the Department of Energy's National Renewable Energy Laboratory performs a technical review of payment applications and advises Treasury on award decisions. For larger dollar payments, Treasury also requires the applicant to obtain a review of project costs by an independent public accounting firm. We conducted a number of audits of recipients of payments under the specified energy property program to ensure funds were properly awarded to eligible applicants for eligible properties and have found some questionable claims involving several million dollars in total. We plan to continue our audits of recipients in fiscal year 2012 and will report any major instances of program abuse as necessary.

Management of the Housing and Economic Recovery Act and the Emergency Economic Stabilization Act

Through several HERA and EESA programs, Treasury injected much needed capital into financial institutions and businesses.

Under HERA, Treasury continues to address the distressed financial condition of Fannie Mae and Freddie Mac which are under the conservatorship of the Federal Housing Finance Agency. In order to cover the continuing losses of the two entities and their ability to maintain a positive net worth, Treasury agreed to purchase senior preferred stock as necessary, and as of June 30, 2011, invested $164 billion in the two entities. Treasury also purchased $225 billion of mortgage-backed securities (MBS) issued by the two entities under a temporary purchase program that expired in December 2009. In March 2011, Treasury began to wind down its MBS portfolio and has steadily reduced the portfolio by about $10 billion a month. As of September 2011, Treasury received proceeds of $64 billion through sales of its MBS and $118 billion in principal repayments. So far, over the life of its investment, Treasury has earned $20 billion in interest. The remaining principal outstanding is approximately $60 billion. Through the Housing Finance Agency Initiative supporting state and local finance agencies, Treasury purchased securities in Fannie Mae and Freddie Mac backed by state and local Housing Finance Agency bonds (New Issue Bond Program) and a participation interest in the obligations of Fannie Mae and Freddie Mac (Temporary Credit and Liquidity Program). Prior to expiring in December 2009, Treasury purchased $15.3 billion of securities under the New Issue Bond Program and provided $8.3 billion under the Temporary Credit and Liquidity Program. Even with this assistance, the future of both entities is still in question and prolonged assistance may be required. On a positive note, Freddie Mac did report positive net worth in the second quarter of 2011, the first positive quarter since 2009. Accordingly, there was no increase to Treasury's senior preferred stock investment in Freddie Mac.

As required by Dodd-Frank, Treasury and the Department of Housing and Urban Development conducted a study on ending the conservatorship of Fannie Mae and Freddie Mac and minimizing the cost to taxpayers. The report on this study was presented to Congress in February 2011. Regarding the long-term structure of housing finance, the report provided three options for consideration without recommending a specific option. The three options are (1) a privatized system of housing finance with the government insurance role limited to the Federal Housing Administration (FHA), the U.S. Department of Agriculture (USDA), and the Department of Veterans Affairs (VA) with assistance for narrowly targeted groups of borrowers; (2) a privatized system of housing finance with assistance from FHA, USDA, and VA for narrowly targeted groups of borrowers and a guarantee mechanism to scale up during times of crisis; and (3) a privatized system of housing finance with FHA, USDA, and VA assistance for low- and moderate-income borrowers and catastrophic reinsurance behind significant private capital. The legislative process for housing finance reform is in an early stage and it is difficult to predict what lies ahead for winding down the Fannie Mae and Freddie Mac conservatorships and reforming housing finance in the long run.

TARP, established under EESA, gave Treasury the authorities necessary to bolster credit availability and address other serious problems in the domestic and world financial markets. Treasury's Office of Financial Stability administers TARP, and through several of its programs, made purchases of direct loans and equity investments in many financial institutions and other businesses, as well as guaranteed other troubled mortgage-related and financial assets. Authority to make new investments under the TARP program expired on October 3, 2010. Treasury, however, is continuing to make payments for programs which have existing contracts and commitments. Treasury's challenge in this area has changed from standing-up and running TARP programs to winding them down and recovering its investment. That means Treasury's focus is on managing and exiting from its current TARP investments. To date, Treasury has reported positive returns from the sale of its investments in the banking industry and has begun reducing its investment in American International Group (AIG). EESA also established a special inspector general for TARP and imposed oversight and periodic reporting requirements on both the special inspector general and Government Accountability Office.

As conditions improve, Treasury will need to continue to work with its partners to disassemble the structure established to support recovery efforts and ensure that federal funds no longer needed for those efforts are returned in an orderly manner to the Treasury general fund.

<u>2012 Pending Initiatives</u>

In addition to SBLF and SSBCI, the Small Business Jobs Act of 2010 provided Treasury with authority to guarantee the full amounts of bonds and notes issued for community and economic development activities not to exceed 30 years. Under this authority, Treasury may issue up to

10 guarantees of no less than $100 million each, but may not exceed $1 billion in total aggregate guarantees in any fiscal year. As the program administrator, the Community Development Financial Institutions Fund is tasked with setting regulations and implementing the program by September 27, 2012. Our office plans to assess the progress of the program's implementation in 2012.

Included in the President's legislative proposal, "The American Jobs Act of 2011," is a provision establishing the American Infrastructure Financing Authority (AIFA), as a wholly owned Government Corporation, that would provide direct loans and loan guarantees to facilitate infrastructure projects that are both economically viable and of regional or national significance. The proposed aggregate amount of direct loans and loan guarantees made by AIFA in any single fiscal year may not exceed (1) $10 billion during the first 2 years of operations; (2) $20 billion during years 3 through 9 of operations; or (3) $50 billion during any year thereafter. Although not a Treasury program, the legislation calls for Treasury to assist in implementing AIFA and in carrying out its purpose. Under the proposal, our office would provide oversight of AIFA for the first 5 years and thereafter the oversight would be provided by a Presidentially-appointed, Senate-confirmed special inspector general. Given the potential implications to our office, we will monitor the Congress's consideration of the proposal and respond appropriately.

Challenge 3: Anti-Money Laundering and Terrorist Financing/Bank Secrecy Act Enforcement

As we have reported in the past, ensuring criminals and terrorists do not use our financial networks to sustain their operations and/or launch attacks against the U.S. continues to be a challenge. Following the terrorist attacks of 2001, Treasury established the Office of Terrorism and Financial Intelligence (TFI). TFI is dedicated to disrupting the ability of terrorist organizations to fund their operations. TFI brings together intelligence gathering and analysis, economic sanctions, international cooperation, and private-sector cooperation to identify donors, financiers, and facilitators supporting terrorist organizations, and disrupt their ability to fund them. Enhancing the transparency of the financial system is one of the cornerstones of this effort. Treasury carries out its responsibilities to enhance financial transparency through the Bank Secrecy Act (BSA) and USA Patriot Act. The Financial Crimes Enforcement Network (FinCEN) is the Treasury bureau responsible for administering BSA.

Over the past decade, TFI has made good progress in closing the vulnerabilities that allowed money launderers and terrorists to use the financial system to support their activities. Nonetheless, significant challenges remain. One challenge is ensuring the continued cooperation and coordination of all the organizations involved in its anti-money laundering and combating terrorist financing efforts. A large number of federal and state entities participate with FinCEN to ensure compliance with BSA, including the four federal banking agencies, the Internal Revenue Service (IRS), the Securities and Exchange Commission, the Department of Justice, and all the state regulators. Many of these entities also participate in efforts to ensure compliance with U.S. foreign sanction programs administered by Treasury's Office of Foreign Assets Control (OFAC).

To be effective, Treasury must establish and maintain working relationships with these numerous entities. Neither FinCEN nor OFAC have the resources or capability to maintain compliance with their programs without significant help from these other organizations. To this end, Treasury has entered into memoranda of understanding with many federal and state regulators in an attempt to build a consistent and effective process. As of last year, FinCEN had signed memoranda of understanding with 7 federal and 51 state regulators to ensure that information is exchanged between FinCEN and the entities charged with examining for BSA compliance. While important to promote the cooperation and coordination needed, it should be noted that these instruments are nonbinding and carry no penalties for violations, and their overall effectiveness has not been independently assessed.

Last year, financial institutions filed approximately 15 million BSA reports, including over 1.3 million suspicious activity reports. While the number of suspicious activity reports has been increasing since 2001, the numbers alone do not necessarily indicate everything is going well. Audits we have done have found problems with the quality of the data reported. Other audits have also identified gaps in the regulatory examination programs of the bank regulators and examining agencies. FinCEN needs to continue its efforts to work with regulators and examining agencies to ensure that financial institutions establish effective BSA compliance programs and file accurate and complete BSA reports, as required. Furthermore, FinCEN still needs to complete work to issue anti-money laundering regulations as it determines appropriate for some non-bank financial institutions, such as vehicle dealers; pawnbrokers; travel agents; finance companies; real estate closing and settlement services; and financial services intermediaries, such as investment advisors.

BSA data is currently maintained by IRS and access to the database is generally handled through an IRS system known as WebCBRS. FinCEN's BSA Information Technology (IT) Modernization program, begun in 2008, is being built to ensure efficient management, safeguarding, and use of BSA information. BSA IT Modernization will reengineer BSA data architecture, update the infrastructure, implement more innovative web services and enhanced electronic filing, and provide increased analytical tools. FinCEN believes modernization will provide increased data integrity, and maximize value for its state and federal partners. This program, which we believe is needed, has yet to reach a point of broad-based integration testing and is highly dependent on continued funding, a challenge for many programs today. The BSA IT Modernization project is also discussed in challenge 4.

FinCEN is mandating the use of its BSA E-Filing network starting in June 2012. BSA E-Filing allows financial institutions to file reports with FinCEN electronically. We anticipate that this will improve data quality in that data will be more quickly entered into the database and that some of the errors or omissions that previously occurred through paper filings should be reduced if not eliminated. However, until this can be verified, FinCEN and IRS will need to continue to monitor data quality. Last year we noted that FinCEN has a particularly difficult challenge in dealing with MSBs. FinCEN has taken steps to improve MSB examination coverage and compliance. In the past year, FinCEN has finalized new rules and increased enforcement designed to ensure MSBs comply with BSA requirements, including registration and report filing requirements. However, ensuring MSBs register with FinCEN has been a continuing challenge.

Furthermore, IRS serves as the examining agency for MSBs but has limited resources to inspect MSBs or even identify unregistered MSBs. FinCEN and IRS need to work together to ensure that MSBs operating in this country are identified, properly registered, and in compliance with all applicable laws and regulations.

FinCEN has also been concerned with MSBs that use informal value transfer systems and with MSBs that issue, redeem, or sell prepaid access, through physical (cards or other devices) or non-physical (e.g., code, electronic serial number, mobile identification number, and/or personal identification number) means. MSBs using informal value transfers have been identified in a number of attempts to launder proceeds of criminal activity or finance terrorism. Similarly, prepaid access can make it easier for some to engage in money laundering or terrorist financing. In September 2010, FinCEN notified financial institutions to be vigilant and file suspicious activity reports on MSBs that may be inappropriately using informal value transfers when they use financial institutions to store currency, clear checks, remit and receive funds, and obtain other financial services. This past summer, FinCEN issued a final rule applying customer identification, recordkeeping, and reporting obligations to providers and sellers of prepaid access. Ensuring compliance with these rules will be a major challenge.

To detect possible illicit wire transfer use of the financial system, FinCEN also proposed a regulatory requirement for certain depository institutions and MSBs to report cross-border electronic transmittals of funds. FinCEN determined that establishing a centralized database will greatly assist law enforcement in detecting and ferreting out transnational organized crime, multinational drug cartels, terrorist financing, and international tax evasion. Ensuring financial institutions, particularly MSBs, comply with the cross-border electronic transaction reporting requirements, as well as managing this new database, will be another significant challenge for FinCEN. It should be noted that this system cannot be fully implemented until FinCEN completes its work on its BSA IT Modernization project, scheduled for 2014.

Other matters of concern are beginning to appear or are on the horizon. One concern we reported before is that the focus on safety and soundness resulting from the recent financial crisis may have reduced the attention financial institutions have given to BSA and OFAC compliance. Another concern is the increasing use of mobile devices for banking, internet banking, internet gaming, and peer-to-peer transactions. FinCEN, OFAC, and other regulatory agencies will need to ensure that providers of these services ensure transactions are transparent and conform to BSA requirements. Monitoring the transactions of tomorrow may prove to be increasingly difficult for Treasury.

Given the criticality of this management challenge to the Department's mission, we continue to consider anti-money laundering and combating terrorist financing as inherently high-risk. Mandatory work, particularly material loss reviews of failed banks, prevented us from starting any new audits in this area in fiscal years 2009 and 2010. In fiscal year 2011, we initiated audits of the MSB compliance program, the BSA IT Modernization project, and OFAC licensing (a program that allows exceptions to sanction programs upon OFAC's legal review and approval), which we plan to complete in fiscal year 2012.

Challenge 4: Management of Capital Investments

Managing large capital investments, particularly information technology investments, is a difficult challenge for any organization, whether public or private. As a new development, after several years of attempting to centrally manage large infrastructure investments at the Department level, Treasury has announced that it will de-consolidate all infrastructure investments to the bureaus. This move is intended to improve efficiency and transparency, cost savings and avoidance, and overall governance.

In prior years, we reported on a number of capital investment projects that either failed or had serious problems. This year, we continue to identify challenges with ongoing IT investments.

> Replacement telecommunications platform Treasury plans to spend $3.7 billion on its Information Technology Infrastructure Telecommunications Systems and Services investment. Treasury was originally to have begun implementation of TNet, a major component, in November 2007 but the project was delayed until August 2009. In September 2011, we reported serious problems with the initial contracting and project management of TNet that contributed to the delay and the unnecessary expenditure of $33 million to maintain the prior telecommunications system in the interim. While TNet has become operational across Treasury, it is not yet fully compliant with Federal security requirements, and issues with change requests, incident response, and contractor billings need to be addressed.
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> Common identity management system The Treasury Enterprise Identity, Credential and Access Management (TEICAM) is a $147 million effort to implement Homeland Security Presidential Directive 12 requirements for a common identity standard. As of August 2011, Treasury reported that the system was $40 million over planned costs.
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> Data center consolidation OMB initiated the Federal Data Center Consolidation Initiative to reduce the number of federal data centers. In this regard, Treasury had over 60 data centers around the country. During fiscal year 2011, Treasury closed 3 data centers. This was accomplished in part by the Financial Management Service and the Bureau of the Public Debt consolidating their infrastructure and data center operations. Treasury plans to close another 12 data centers by 2015. Its ability to successfully consolidate data centers and achieve budget savings is contingent on adapting shared infrastructure services.
>
> FinCEN BSA IT Modernization As discussed in Challenge 3, Treasury, through FinCEN, is undertaking a major project known as BSA IT Modernization. Already underway, the project is expected to cost about $120 million and is expected to be completed in 2014. The project has yet to undergo broad-based integration testing, is complicated, and will require continued coordination between FinCEN and IRS. A prior attempt, from 2004 to 2006, to develop a new BSA system ended in failure with over $17 million wasted because of shortcomings in project planning, management, and oversight. However, early indications from our audit work are that project management is much improved for this project.

Treasury should exercise continuous vigilance in managing the investments described above and others due to previously reported problems with large capital investments, and billions of procurement dollars at risk. Moreover, it remains to be seen whether Treasury's decision to de-consolidate all infrastructure investments will improve efficiency and transparency, cost savings and avoidance, and overall governance as intended. We plan to assess the results of this change in managing Treasury's infrastructure investments going forward.

Matter of Concern

Although we are not reporting this as a management and performance challenge, we want to highlight an area of increasing concern -- information security.

We reported information security as a serious management and performance challenge at Treasury for a number of years but removed the challenge in 2009. We did so because Treasury had made significant strides in improving and institutionalizing its information security controls, as was evident from our annual Federal Information Security Management audits and evaluations. We believe that remains the case today. However, notwithstanding Treasury's strong security stance, cyber attacks against federal government systems by foreign governments and the hacker community are unrelenting and increasing. Treasury's information systems are critical to the Nation, and thus potential targets of those wishing to do grave harm. Accordingly, this is a very troubling situation that requires the highest level of continual attention to ensure, as we said when we removed the challenge, that information security policies remain current and practices do not deteriorate.

We would be pleased to discuss our views on these management and performance challenges in more detail.

cc: Daniel Tangherlini
Assistant Secretary for Management, Chief Financial Officer, and
Chief Performance Officer

INSPECTOR GENERAL
FOR TAX
ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20005

October 14, 2011

MEMORANDUM FOR SECRETARY GEITHNER

FROM: J. Russell George J. Russell George
Inspector General

SUBJECT: Management and Performance Challenges Facing the Internal Revenue Service for Fiscal Year 2012

The *Reports Consolidation Act of 2000*[2] requires that the Treasury Inspector General for Tax Administration (TIGTA) summarize, for inclusion in the *Department of the Treasury Accountability Report for Fiscal Year 2011*, its perspective on the most serious management and performance challenges confronting the Internal Revenue Service (IRS). The issues described in this document are derived from a variety of activities conducted and reviewed by TIGTA.

Each year, TIGTA evaluates IRS programs, operations, and management functions to identify the areas of highest vulnerability to the Nation's tax system. For Fiscal Year 2012, the top 10 management and performance challenges in order of priority are:

1. Security for Taxpayer Data and Employees;
2. Tax Compliance Initiatives;
2. Modernization;
4. Implementing Major Tax Law Changes;
5. Fraudulent Claims and Improper Payments;
6. Providing Quality Taxpayer Service Operations;
7. Human Capital;
8. Globalization;
9. Taxpayer Protection and Rights; and
10. Achieving Program Efficiencies and Cost Savings.

TIGTA's assessment of the major IRS management challenges for Fiscal Year 2012 has changed from the prior fiscal year. Due to the mission-critical nature of both modernization and tax compliance initiatives, TIGTA considers tax compliance and modernization as serious enough management challenges to jointly rank at number two, following security. However, the current status of the United States economy and the watchful eye of the American public on the management of our Nation's Government are driving the need more than ever for the IRS to efficiently and effectively collect taxes

[2] 31 U.S.C. § 3516(d) (2006).

owed to the Federal Government. In addition, the IRS recently downgraded its longstanding material weakness[3] status of the Modernization Program. As such, tax compliance is listed before the ongoing major challenge of modernization. Also note that the prior Erroneous and Improper Payments and Credits challenge has expanded to become Fraudulent Claims and Improper Payments and has moved from the seventh to the fifth most significant challenge facing the IRS.

Although not listed, complexity of the tax law remains a serious underlying issue that has wide-ranging implications for both the IRS and taxpayers. This complexity, including frequent revisions to the Internal Revenue Code, makes it increasingly difficult for the IRS to explain and enforce the tax laws and more costly and time-consuming for taxpayers who want to comply. When the Internal Revenue Code is used as a vehicle for implementation of policy changes, the IRS will continue to face the challenge of responding quickly by shifting resources and altering established plans.

The following information for each of these management and performance challenges is being provided to promote economy, efficiency, and effectiveness in the IRS's administration of the Nation's tax laws.

SECURITY FOR TAXPAYER DATA AND EMPLOYEES

As our Nation's tax collector and administrator of the Internal Revenue Code, the IRS received more than 230 million tax returns, of which 141 million were from individual taxpayers, and collected more than $2.3 trillion in revenue in 2010. Information from these tax returns is converted into electronic format, processed, and maintained in over 190 computer system applications for use by IRS employees. As computer use continues to be inextricably integrated into the IRS's core business processes, effective information systems security becomes essential to ensure that data are protected against inadvertent or deliberate misuse, improper disclosure, or destruction, and that computer operations supporting tax administration are secured against disruption or compromise.

The IRS faces the daunting task of securing its computer systems against the growing threat of cyberattack. According to the Department of Homeland Security's U.S. Computer Emergency Readiness Team, cyberattacks against Federal websites and networks increased almost 40 percent in 2010. More recently, in July 2011, the Pentagon acknowledged a serious data breach when a Department of Defense contractor suffered one of its largest cyberattacks ever and more than 24,000 files containing sensitive data were stolen by a foreign government. Computer security has been problematical for the IRS since 1997, when the IRS initially reported computer security as a material weakness during its annual evaluation of internal accounting and administrative controls under the *Federal Managers Financial*

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[3] In the event that an agency determines the existence of shortcomings in operations or systems which severely impair or threaten its ability to accomplish its mission or to prepare timely and accurate financial statements, the Department of the Treasury directs its bureaus to declare a material weakness on that particular area.

Integrity Act of 1982.[4] The IRS further divided this material weakness into nine areas: (1) network access controls; (2) key computer applications and system access controls; (3) software configuration; (4) functional business, operating, and program unit security roles and responsibilities; (5) segregation of duties between system and security administrators; (6) contingency planning and disaster recovery; (7) monitoring of key networks and systems; (8) security training; and (9) certification and accreditation.

As of April 2011, the IRS had officially closed three of the nine areas: segregation of duties between system and security administrators (closed in September 2005), security training (June 2008), and certification and accreditation (December 2008). In addition, the IRS completed all corrective actions on two other areas: network access controls (completed in July 2010) and functional business, operating, and program unit security roles and responsibilities (March 2009). The other four material weakness areas remain open and are actively being resolved. While the IRS has made progress in the area of computer security, it needs to continue to place a high priority on its improvement.

In addition, identity theft continues to be a significant problem for taxpayers and the IRS. Identity thieves are filing fraudulent tax returns and obtaining refunds. The IRS usually does not become aware of a problem until after the legitimate taxpayer files a tax return. At that time, the IRS often determines that two tax returns have been filed using the same name and Social Security Number. The legitimate taxpayer's refund is then delayed while the IRS attempts to determine who the legitimate taxpayer is. Meanwhile, the identity thief has obtained a fraudulent tax refund, which the IRS is unlikely to recover. As such, effectively authenticating legitimate taxpayers is a pressing challenge for the IRS as it develops and implements updates to its mission-critical systems and processes.

Beyond safeguarding a vast amount of sensitive financial and personal data, the IRS must also protect approximately 100,000 employees and contractors working in over 700 facilities throughout the country. The February 2010 attack on an IRS facility in Austin, Texas, was a stark reminder of the dangers that IRS employees face each day in trying to perform their jobs. Animosity towards the tax collection process is nothing new, but the Austin incident highlights a surge in hostility towards the Federal Government. Also, the ongoing public debate regarding the new health care law and continued concerns over the country's economy could fuel threats against the Federal Government, including IRS employees and facilities. These are challenging operating conditions for the IRS that underscore the need for continued vigilance in the area of physical and personnel security.

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[4] 31 U.S.C. §§ 1105, 1106, 1108, 1113, 3512 (2006). The *Federal Managers' Financial Integrity Act* (FMFIA) requires that agency management establish and maintain effective internal controls to achieve the objectives of: 1) effective and efficient operations, 2) reliable financial reporting, and 3) compliance with applicable laws and regulations. The FMFIA also requires the head of each Executive agency to report annually to the President and Congress on the effectiveness of the internal controls and any identified material weaknesses in those controls. Reporting material weaknesses under the FMFIA is not limited to weaknesses over financial reporting.

TAX COMPLIANCE INITIATIVES

Another serious challenge confronting the IRS is tax compliance. Despite an estimated voluntary compliance rate of 84 percent and IRS enforcement efforts, a significant amount of income remains unreported and unpaid. Tax compliance initiatives include the administration of tax regulations, collection of the correct amount of tax from businesses and individuals, and the oversight of tax-exempt and government entities.

The IRS's challenge related to tax-exempt and government entities is providing assistance to those entities that provide a valued societal benefit while ensuring that these entities remain in compliance with the tax laws associated with their tax-exempt status. The various types of tax-exempt entities include exempt organizations, sponsors of retirement plans, Indian tribal governments, issuers of tax-exempt and other tax-advantaged bonds, and Federal, State, and local governments.

Increasing voluntary taxpayer compliance and reducing the Tax Gap[5] are the focus of many IRS initiatives. The IRS continues to face significant challenges in obtaining complete and timely compliance data and in developing methods necessary to interpret the data. Even with improved data collection, however, the IRS needs broader strategies and more research to determine what actions are most effective in addressing taxpayer noncompliance. The IRS's strategy for reducing the Tax Gap is largely dependent on funding for additional compliance resources and legislative changes. In its Fiscal Year 2012 budget submission, the IRS requested a 2.9 percent increase in enforcement funds over its Fiscal Year 2011 request.

Businesses and Individuals

The IRS estimated the gross Tax Gap for Tax Year 2001 (the most current figures available) to be approximately $345 billion. Underreporting of taxes, which comprises four major components (individual income tax, employment tax, corporate income tax, and estate and excise taxes), is estimated at $285 billion and accounts for the largest portion (over 80 percent) of the Tax Gap. In fact, the underreporting of individual income tax and employment tax combined constitutes over 70 percent of the gross Tax Gap.

The absence of laws to prevent Federal agencies, including the IRS, from awarding contracts to businesses that have delinquent tax liabilities is contributing to the Tax Gap. During Fiscal Year 2010, President Obama directed the Department of the Treasury and the Office of Management and Budget to evaluate agencies' contract award processes and make recommendations to ensure that Federal contractors with serious tax delinquencies do not receive new work from Federal agencies. In a Fiscal Year 2011 report,[6] we determined that the IRS has opportunities to improve the use of the Federal Payment Levy Program[7] to collect delinquent tax liabilities

[5] The IRS defines the Tax Gap as the difference between the estimated amount taxpayers owe and the amount they voluntarily and timely paid for a tax year.

[6] TIGTA, Ref. No. 2011-30-013, *Existing Practices Allowed IRS Contractors to Receive Payments While Owing Delinquent Taxes* (2011).

[7] The Federal Payment Levy Program is an automated process that issues tax levies to collect delinquent Federal taxes through the Financial Management Service from Social Security payments, Federal agency salaries, retirement, and contract awards.

from IRS contractors. Our audit identified that the IRS blocked 11 contractors with delinquent liabilities totaling approximately $4.3 million from inclusion in the Program. These contractors received more than $356 million in payments from the IRS and approximately $3.7 billion in payments from other Federal agencies. For eight of these contractors, the amount of delinquent taxes that could have been collected if the tax accounts had not been blocked from inclusion totaled $3.8 million.

Tax-Exempt Entities

The IRS continues to face challenges in administering programs focused on ensuring that tax-exempt organizations comply with applicable laws and regulations to qualify for their exempt status. Legislative changes and judicial decisions contribute to a constantly changing environment affecting today's nonprofit and tax-exempt organizations. For example, the *Patient Protection and Affordable Care Act* (Affordable Care Act)[8] added several new requirements for tax-exempt hospitals to maintain their exempt status.

Since more than $15 trillion in U.S. assets are currently controlled by tax-exempt organizations or held in exempt retirement programs and financial instruments, the IRS recognized in its most recent strategic plan that careful oversight of the nonprofit and exempt sector is more important than ever before. In its Fiscal Year 2012 budget submission, the IRS stated that it must continue focused oversight of the tax-exempt sector.

In a report issued in Fiscal Year 2011,[9] we reviewed the IRS process that allows public employers who determine they are not in compliance with various employment and income tax laws to step forward and be accountable by entering into an agreement with the IRS to become compliant. While this assists the IRS in improving compliance in the government sector without using scarce resources to uncover noncompliance, the IRS did not always properly control, process, and monitor all requests for agreements received from its customers. As a result, TIGTA found inconsistencies, inaccuracies, potential taxpayer rights violations, and weak internal controls that increased the risk of error, fraud, or abuse. In addition, TIGTA identified changes that could lead to an increase in the number of agreements being requested, heightening the need to begin building a more defined agreement program.

Tax Return Preparers

Greater numbers of taxpayers are turning to tax return preparers for assistance. In Calendar Year 2010, the IRS processed approximately 81.5 million individual Federal income tax returns prepared by paid preparers. However, these preparers were not required to meet or comply with any national standards before selling tax preparation services to the public.

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[8] Pub. L. No. 111-148, 124 Stat. 119 (2010) (codified as amended in scattered sections of 18 U.S.C., 20 U.S.C., 21 U.S.C., 25 U.S.C., 26 U.S.C., 28 U.S.C., 29 U.S.C., 30 U.S.C., 31 U.S.C., 35 U.S.C., and 42 U.S.C.).
[9] TIGTA, Ref. No. 2011-10-042, *Improvements Are Needed in the Voluntary Closing Agreement Process for Public Employers* (2011).

A series of reports (including reviews conducted by TIGTA, the U.S. Government Accountability Office, and other agencies) strongly suggested a need to regulate those who prepare Federal tax returns and led the IRS to launch its Return Preparer Review in June 2009. The following December, after its own six-month study of the problem, the IRS announced a suite of proposed reforms to improve oversight of the return preparer community.

The IRS began implementing the new preparer requirements in Fiscal Year 2011, but we reported in September 2010 that it will take years for the IRS to implement the Return Preparer Program and to realize its impact.[10] When the decision was made to register preparers in September 2010, the IRS had only begun to implement the Return Preparer Program and had not established all of its requirements. The IRS also had not established the organizational structure of the Program, determined how it will test to ensure all preparers met the requirements, determined how it will enforce Program requirements, or developed the system(s) and processes necessary to administer and oversee the Program. It will not be until Calendar Year 2014 that all preparers will be subjected to all suitability and competency tests. In the meantime, the IRS will develop and implement an enforcement strategy. Currently, the IRS does not have a sufficient management information system to gather data on preparers. Further, the IRS will need to ensure that taxpayers understand the new requirements and the importance of using only registered preparers to prepare their tax returns.

MODERNIZATION

The Business Systems Modernization Program (Modernization Program) is a complex effort to modernize IRS technology and related business processes. It involves integrating thousands of hardware and software components while replacing outdated technology and maintaining the current tax system. The IRS originally estimated that the Modernization Program would last up to 15 years and incur contractor costs of approximately $8 billion. The Program is going on its 14th year and has received approximately $3.46 billion for contractor services, plus an additional $554 million for internal IRS costs.

Factors that characterize the IRS's complex information technology environment include widely varying inputs from taxpayers (from simple concise records to complex voluminous documents), seasonal processing with extreme variations in processing loads, transaction rates on the order of billions per year, and data storage measured in trillions of bytes. The Modernization Program is working toward providing improved benefits to taxpayers that include:

- Issuing refunds, on average, five days faster than existing legacy systems;
- Offering electronic filing capability for individuals, large corporations, small businesses, tax-exempt organizations, and partnerships, with dramatically reduced processing error rates;

[10] TIGTA, Ref. No. 2010-40-127, *It Will Take Years to Implement the Return Preparer Program and to Realize Its Impact* (2010).

- Delivering web-based services for tax practitioners, taxpayers, and IRS employees; and
- Providing IRS customer service representatives with faster and improved access to taxpayer account data with real-time data entry, validation, and updates of taxpayer addresses.

The IRS's modernization efforts continue to focus on core tax administration systems designed to provide more sophisticated tools to taxpayers and to IRS employees. The Modernization Program provides new information technology capabilities and the related benefits. Since January 2011, the IRS has implemented new versions of the current Customer Account Data Engine,[11] the Modernized e-File system,[12] and the Account Management Services system.[13] Additionally, the IRS has continued making progress in preparing for the deployment of the Customer Account Data Engine 2 system.[14]

The Modernization Program has continued to help improve IRS operations and has demonstrated successes in improving business practices by implementing new information technology solutions. Management of project costs and schedules has shown dramatic improvement since the previous year, but some systems development disciplines continue to need attention.

Since 1995, the IRS had identified and reported the Modernization Program as a material weakness. In June 2011, the IRS Commissioner certified, in a memorandum to the Department of the Treasury's Assistant Secretary for Management and Chief Financial Officer, that the previously identified internal and management control issues had been fully addressed and the Modernization Program no longer warranted being identified as a material weakness. While we support the IRS's decision, we believe the Program remains a risk for the IRS, and we suggest that it continue to stress improvements in its overall processes and performance.

IMPLEMENTING MAJOR TAX LAW CHANGES

Each filing season tests the IRS's ability to implement tax law changes made by the Congress. Most individual taxpayers file their income tax returns during the annual January through April period and, if needed, it is usually during this same time period that they contact the IRS with questions about specific tax laws or filing procedures. Correctly implementing late tax law changes remains a significant challenge because

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[11] The Customer Account Data Engine is the foundation for managing taxpayer accounts in the IRS Modernization plan. When completed, its databases and related applications will replace existing IRS Master File processing systems and will include applications for daily posting, settlement, maintenance, refund processing, and issue detection for taxpayer tax account and return data.
[12] The Modernized e-File system is a replacement of the current IRS tax return filing technology with a modernized, Internet-based electronic filing platform.
[13] The Account Management Services system provides IRS employees with the ability to view, access, update, and manage taxpayer data.
[14] The Customer Account Data Engine 2 system creates a modernized processing and data-centric infrastructure that will enable the IRS to improve the accuracy and speed of individual taxpayer account processing, enhance the customer experience through improved access to account information, and increase the effectiveness and efficiency of agency operations.

the IRS must often act quickly to assess the changes and determine the necessary actions to ensure all legislated requirements are satisfied. In addition, the IRS must often create new or revise existing tax forms, instructions, and publications; revise internal operating procedures; and reprogram major computer systems used for processing tax returns. Pertinent examples of major tax law changes that contribute to this management and performance challenge are provided below.

Health Care

The recently enacted health care reform statute known as the Affordable Care Act contains an extensive array of tax law changes that will present a continuing source of challenges for the IRS in the coming years. While the Department of Health and Human Services will have the lead role in the policy provisions of the Affordable Care Act, the IRS will administer the law's numerous tax provisions. The IRS estimates that at least 42 provisions will either add to or amend the tax code and at least eight will require the IRS to build new processes that do not exist within the current tax administration system. Examples of new IRS responsibilities resulting from this law include:

- Providing tax credits to businesses and individuals to assist in covering the cost of health coverage;
- Administering the mandate for individuals to purchase health coverage or be subject to a penalty on their individual Federal tax returns; and
- Administering multiple tax provisions designed to raise revenues to offset the cost of health care reform.

For Fiscal Years 2011 and 2012, TIGTA identified a critical need to initiate 16 audits related to the Affordable Care Act to oversee the implementation of such significant provisions as:

- Small Business Health Care Tax Credit;
- Qualified Therapeutic Discovery Project Credit;
- Annual Fees Assessed on Branded Prescription Pharmaceutical Manufacturers and Importers;
- Expansion of the Adoption Credit;
- Indoor Tanning Excise Tax;
- Tax-Exempt Hospital Provisions; and
- Reporting Requirements Included in the Affordable Care Act.

TIGTA's audit results to date illustrate the significant need for continued oversight of the IRS's administration of many of these tax-related provisions. For example, taxpayers erroneously received millions in Adoption Credits; the IRS did not require sufficient information to determine if taxpayers claiming Small Business Health Care Tax Credits filed required employment taxes when these taxpayers entered into a contractual relationship with professional employment organizations to manage human resources; and the IRS did not take adequate steps to ensure taxpayers potentially liable for the indoor tanning excise tax were aware of the new law, particularly after the number of taxpayers filing tax returns reporting the excise tax for tanning services was much lower than expected.

A provision in this law increased the Adoption Credit from $12,150 to $13,170 and made the tax credit refundable.[15] Although the IRS requires taxpayers to attach documentation to their tax returns supporting Adoption Credit claims, it does not have math error authority to deny the credits if documentation is not provided. As a result, tax returns without required documentation must be sent to the Examination function, increasing costs for the IRS and burden for the taxpayer. As of April 30, 2011, of the 72,330 Adoption Credit claims received, 41,591 (58 percent) either had no required documentation or the documentation was invalid or insufficient. Furthermore, as of April 30, 2011, 736 taxpayers had erroneously received more than $4 million in Adoption Credits.

American Recovery and Reinvestment Act

The *American Recovery and Reinvestment Act of 2009* (Recovery Act)[16] was enacted on February 17, 2009. The Recovery Act presented significant challenges to all Federal agencies to implement provisions quickly while attempting to minimize risk and meet increased standards for transparency and accountability. With its 56 tax provisions (20 related to individual taxpayers and 36 related to business taxpayers), the Recovery Act poses significant challenges to the IRS. TIGTA has issued numerous reports related to the IRS's efforts to implement Recovery Act tax provisions. Some examples include:

- A review of the Plug-in Electric and Alternative Motor Vehicle Credit identified 12,920 individuals who erroneously claimed $33 million in plug-in electric and alternative motor vehicle credits on electronically filed (e-filed) tax returns. Furthermore, 1,719 of the 12,920 individuals erroneously reduced the amount of the Alternative Minimum Tax owed by almost $5.3 million.[17]
- A review of the Residential Energy Credit identified that the IRS cannot verify whether individuals claiming Residential Energy Credits were entitled to them at the time their tax returns are processed. The IRS does not require individuals to provide any third-party documentation to verify eligibility.[18]
- A review of the IRS's compliance with requirements over procurements funded by the Recovery Act determined that the IRS did not always comply

[15] A refundable tax credit is a tax credit that is treated as a payment and can be refunded to the taxpayer. Refundable credits can create a Federal tax refund that is larger than the amount a person actually paid in taxes during the year.
[16] Pub. L. No. 111-5, 123 Stat. 115.
[17] TIGTA, Ref. No. 2011-41-011, *Individuals Received Millions of Dollars in Erroneous Plug-in Electric and Alternative Motor Vehicle Credits* (2011).
[18] TIGTA, Ref. No. 2011-41-038, *Processes Were Not Established to Verify Eligibility for Residential Energy Credits* (2011).

with the Recovery Act and its implementing guidance in planning and awarding those procurements.[19]

- A review of the IRS's use of compliance check questionnaires regarding Build America Bonds found that the questionnaires issued by the Tax Exempt Bonds office were appropriate for identifying indications of a high risk of potential noncompliance for Build America Bonds. However, the office did not have formal written procedures for developing and conducting compliance checks that would aid in the development of compliance check programs and provide added assurance the IRS does not exceed its authority when executing such programs.[20]

TIGTA continues to support the Recovery Accountability and Transparency Board (Recovery Board) in fulfilling its responsibilities for providing transparency for Recovery Act-related funds and for preventing and detecting fraud, waste, and mismanagement. We also continue to evaluate the IRS's compliance with Recovery Act and Office of Management and Budget guidance. Additionally, we have evaluated multiple Recovery Board leads that contain allegations of misuse of Recovery Act funds.

Other Tax Law Changes

Along with the usual required updates[21] for the 2011 Filing Season, the late passage of the *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010* (enacted December 17, 2010)[22] resulted in a need for the IRS to reprogram its computer systems to accommodate provisions extended by this law. As a result, taxpayers who claimed one or more of the three affected deductions or who itemized deductions were unable to file their tax returns until February 14, 2011. The IRS reported it had Electronic Return Originators hold approximately 6.5 million e-filed tax returns for transmission until February 14, 2011, and as of February 11, 2011, the IRS itself had received and held for processing approximately 100,000 paper tax returns.

In addition, more than 1.5 million taxpayers who purchased a home between April 9 and December 31, 2008, and claimed the First-Time Homebuyer Credit (Homebuyer Credit) were required to begin repaying the credit on their Tax Year 2010 tax return. The credit is intended to be repaid over 15 years, in equal annual installments. However, the IRS experienced difficulties in implementing the repayment process. As of April 30, 2011, we identified 26,649 taxpayers for whom the Homebuyer Credit was inaccurately processed, which resulted in the IRS not assessing more than $5.8 million in repayment amounts owed but not paid and erroneously assessing $675,063 as a repayment amount in excess of what was owed by the taxpayer.

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[19] TIGTA, Ref. No. 2011-11-132, *Procurements Were Not Processed in Compliance With the American Recovery and Reinvestment Act of 2009* (2011).
[20] TIGTA, Ref. No. 2011-11-053, *The Direct Pay Build America Bond Compliance Check Program Has Yet to Result in Wide-Scale Examinations* (2011).
[21] Each year, tax products must be updated to reflect current tax rates, exemption amounts, and cost of living adjustments as shown in Revenue Procedures.
[22] Pub. L. No. 111-312, 124 Stat. 3296.

These difficulties resulted in inaccurate processing of repayments and significant delays in providing refunds to taxpayers with repayment requirements.

FRAUDULENT CLAIMS AND IMPROPER PAYMENTS

The *Improper Payments Information Act of 2002*[23] defines an improper payment as any payment that should not have been made or that was made in an incorrect amount (both overpayments and underpayments) under statutory, contractual, administrative, or

other legally applicable requirements. Improper payments include any payment to an ineligible recipient or for an ineligible service, any duplicate payment, any payment for services not received, and any payment that does not account for credit for applicable discounts. The Administration has emphasized the importance of reducing improper payments, and on November 20, 2009, the President signed Executive Order 13520,[24] which included a strategy to reduce improper payments by increasing transparency, holding agencies accountable, and creating strong incentives for compliance. In addition, the *Improper Payments Elimination and Recovery Act of 2010*[25] placed additional requirements on Federal agencies to reduce improper payments. Erroneous and improper payments issued by the IRS generally involve improperly paid refunds, tax return filing fraud, or improper payments to vendors or contractors.

Refundable Credits

The IRS administers numerous refundable tax credits. These refundable credits allow individual taxpayers to reduce their tax liability to below zero and thus receive a tax refund even if no income tax was withheld or paid. Two significant refundable credits are the Earned Income Tax Credit (EITC) and the Additional Child Tax Credit. The Recovery Act also authorized several temporary refundable credits, examples of which include the Homebuyer Credit and the American Opportunity Tax Credit.

Our reviews have shown the need for appropriate controls to be established before refundable credits are issued. This includes requiring documentation to substantiate claims, implementing filters timely to identify erroneous claims, and entering key information into IRS computers so that it can be used to verify eligibility.[26]

The EITC remains the largest refundable credit, based on the total claims paid, and it continues to be vulnerable to a high rate of noncompliance, including incorrect or erroneous claims caused by taxpayer error or resulting from fraud. We recently assessed the IRS's efforts to implement Executive Order 13520, which requires the IRS to intensify its efforts and set targets to reduce EITC improper payments. It also requires the IRS to provide TIGTA with its plans and supporting analysis for meeting those targets. The IRS's report to TIGTA did not include any quantifiable targets to reduce EITC improper payments. Without targets to reduce EITC improper

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[23] Pub. L. No. 107-300, 116 Stat. 2350.

[24] Executive Order No. 13,520, 74 Fed. Reg. 62201 (Nov. 25, 2009), *Reducing Improper Payments and Eliminating Waste in Federal Programs.*

[25] Pub. L. No. 111-204, 124 Stat. 2224.

[26] TIGTA, Ref. No.2011-41-035, *Administration of the First-Time Homebuyer Credit Indicates a Need for Improved Controls Over Refundable Credits* (2011).

payments as required by the Executive Order, there is a lack of accountability for eliminating payment error, waste, fraud, and abuse.[27] As such, the risk remains high that the IRS will continue to pay billions of dollars in EITC improper payments annually. The IRS continues to report that 23 to 28 percent of EITC payments are issued improperly each year. In Fiscal Year 2009, this equated to $11 to $13 billion in EITC improper payments.

The Additional Child Tax Credit is the second largest refundable credit available to individuals. Refunds for the credit processed in Fiscal Year 2010 totaled $28.3 billion, and we have reported that the IRS paid $4.2 billion for this credit in Processing Year 2010 to individuals who were not authorized to work in the United States. Furthermore, the Examination function does not effectively and efficiently work Additional Child Tax Credit cases of those individuals filing with an Individual Taxpayer Identification Number. We have recommended that the IRS work with the Department of the Treasury to seek clarification in the law as to whether this and other refundable credits may be paid to individuals who are not authorized to work in the United States.

The Recovery Act amended the Hope Scholarship Credit to provide for a refundable tax credit called the American Opportunity Tax Credit to help taxpayers offset the costs of higher education. TIGTA identified 2.1 million taxpayers who appear to have received $3.2 billion in erroneous education credits. This includes 1.7 million taxpayers who received $2.6 billion in education credits for students for whom there was no supporting documentation in IRS files establishing that they attended an educational institution. This is further indication that the IRS needs to have processes in place to verify eligibility for refundable credits at the time a tax return is processed.

Contract and Other Payments

Federal contract spending has nearly doubled since 2002. In Fiscal Year 2010, the Federal Government spent approximately $538 billion to acquire goods and services. Similarly, contract spending by the IRS represents a significant outlay of funds. As of May 2011, the IRS administered more than 1,000 procurements, including 807 contracts of varying types and 201 Blanket Purchase Agreements and Interagency Contracts and Agreements. These 1,008 active contracts have a reported systems life value of approximately $39.2 billion. Numerous past TIGTA investigations and audits have identified millions of dollars in questioned costs and several instances of contractor fraud.

During Fiscal Years 2010 and 2011, court-ordered civil settlements directed $156 million and $113 million, respectively, to be paid back to the U.S. Treasury as a result of TIGTA criminal investigative efforts. During these investigations, two recurring trends emerged. Contracting Officer's Technical Representatives were frequently overwhelmed by their workloads, and current business practices have not enhanced the IRS's ability to identify anomalies warranting additional review.

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[27] TIGTA, Ref. No. 2011-40-023, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Credit Payments Each Year* (2011).

Further, in a recent review of the IRS Purchase Card Program, TIGTA determined that, while some purchase card controls were working as intended, overall management controls were inadequate to ensure the appropriate use of IRS purchase cards. TIGTA found violations of applicable laws and regulations that included purchases made without necessary approvals and verification of funding, purchases that were potentially split into two or more transactions to circumvent micro-purchase limits, and purchases made from improper sources.[28]

PROVIDING QUALITY TAXPAYER SERVICE OPERATIONS

The Department of the Treasury and the IRS recognize that the delivery of effective taxpayer service has a significant impact on voluntary tax compliance. Answering taxpayers' questions to assist them in correctly preparing their returns reduces the need to send notices and correspondence when taxpayers make errors. Taxpayer service also reduces unintentional noncompliance and shrinks the need for future collection activity. The IRS continues to focus on the importance of improving service by emphasizing it as a main goal in its strategic plan, including seeking innovative ways to simplify or eliminate processes that unnecessarily burden taxpayers or Federal Government resources.

In a review of the taxpayer experience during the 2011 Filing Season,[29] the overall experiences of TIGTA auditors who posed as taxpayers to obtain answers to tax law questions from the toll-free telephone assistance lines, IRS.gov, and Taxpayer Assistance Centers were generally positive. However, taxpayers were experiencing long wait times at Taxpayer Assistance Centers and on telephones. At Taxpayer Assistance Centers, our auditors waited an average of one hour to receive assistance and, in some cases, were turned away and told to return another day to obtain services. In addition, Taxpayer Assistance Centers do not always allow qualified taxpayers to schedule appointments and do not consistently apply new taxpayer screening guidelines and procedures.

Our recent review of the Taxpayer Advocate Service's process for selecting systems advocacy projects[30] determined it can improve the process used for identifying these projects. Specifically, we found that Taxpayer Advocate Service management primarily relies on IRS employees and external stakeholders to submit issues for consideration as potential projects. However, we found that Taxpayer Advocate Service could improve the research it performed during the screening process to better identify systemic problems affecting multiple taxpayers. Such improvements will assist management in identifying and resolving broad-based taxpayer problems, thereby preventing or reducing similar problems in the future.

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[28] TIGTA, Ref. No. 2011-10-075, *Controls Over the Purchase Card Program Were Not Effective in Ensuring Appropriate Use* (2011).
[29] TIGTA, Ref. No. 2011-40-070, *The Internal Revenue Service Provides Helpful and Accurate Tax Law Assistance, but Taxpayers Experience Lengthy Wait Times to Speak With Assistors* (2011).
[30] TIGTA, Ref. No. 2011-10-062, *The Identification and Evaluation of Systemic Advocacy Projects Designed to Resolve Broad-Based Taxpayer Problems Can Be Improved* (2011).

HUMAN CAPITAL

Human capital is the Federal Government's most critical asset. At a time when the Federal Government is preparing for increased retirements and taking on such new challenges as the implementation of health care reform, the recruitment of new employees and retention of existing employees is critical to ensuring the maintenance of a quality workforce capable of meeting the needs of the American public. Like many Federal agencies, the IRS is faced with the major challenge of replacing existing talent because of a large number of retirements expected over the next several years. This challenge is especially evident in the IRS's leadership ranks, where about one-third of all executives and almost 20 percent of managers are already retirement eligible. Within five years, nearly 70 percent of all IRS executives and almost 50 percent of managers are projected to be eligible for retirement.

The IRS's challenge of having the right people in the right place at the right time is made more difficult by many complex internal and external factors. The work performed by IRS employees continually requires greater expertise as tax laws become more complex, manual systems used to support tax administration become computer-based, and attempts by taxpayers and tax practitioners to evade compliance with the tax laws become more sophisticated. The IRS must also compete with other Federal, State, and local governmental agencies and the private sector for the same human resources, an effort that becomes more complicated as younger generations of employees move between jobs more frequently than employees in the past. Furthermore, budget constraints, legislative changes, and economic shifts can create unforeseen challenges for the IRS in addressing its long-term human capital issues.

The IRS is improving in its human capital management practices and has developed a comprehensive agency-wide recruitment strategy. However, there is still much work left to be done. For example, we recently determined that the IRS, like other Government agencies, was struggling to accomplish the basic tasks in acquisition workforce planning, including identifying its acquisition workforce, determining the number of acquisition workforce personnel it needs to accomplish its mission, and determining the skills its employees have compared to the skills it requires. If the IRS does not take action to improve its acquisition workforce planning, it: (1) may not be able to easily determine whether its acquisition workforce has enough people with the right skills to perform acquisition duties, (2) may be understaffed to handle the anticipated acquisition workload, and (3) may not have all the prerequisite skills to oversee procurements.[31]

The IRS also faces challenges to maintain the number of Revenue Officers needed, due to attrition and an increasing inventory. The IRS's Revenue Officer hiring initiative added 1,515 new Revenue Officers throughout the country between June 2009 and February 2010. The methodology to assign these new employees was effective in placing them in the Collection areas with the greatest need. However, even though 1,515 Revenue Officers were hired over a nine-month period, the net increase was only 580 Revenue Officers. The IRS has also projected that planned hiring for Fiscal

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[31] TIGTA, Ref. No. 2011-10-072, *Additional Actions and Data Are Needed to Further Analyze the Size and Skills of the Acquisition Workforce* (2011).

Years 2011 and 2012 will barely cover attrition losses. Meanwhile, the percentage of delinquent accounts closed has steadily decreased because of increasing inventory.

GLOBALIZATION

The scope, complexity, and magnitude of the international financial system present significant enforcement challenges for the IRS. International business holdings and investment in the United States have grown from nearly $188 billion in 1976 to over $14.5 trillion in 2007, while U.S. business and investment grew from nearly $368 billion to nearly $15 trillion over the same period. As technology continues to advance and cross-border transactions rise, the IRS is increasingly challenged by economic globalization. Technological advances have provided opportunities for offshore investments that were once only possible for large corporations and wealthy individuals.

The number of taxpayers that conduct international business transactions, including individuals, businesses, and tax-exempt organizations, continues to grow. The IRS is still challenged by a lack of information reporting on many cross-border transactions. In addition, the varying legal requirements imposed by different jurisdictions result in complex business structures that make it difficult to determine the full scope and effect of cross-border transactions.

Over the past few years, the Federal Government has taken actions to better coordinate international tax compliance issues. The IRS has developed a strategic plan specifically for international tax issues with two major goals: (1) enforce the law to ensure all taxpayers meet their obligation to pay taxes, and (2) improve service to make voluntary compliance less burdensome. The IRS continues to realign and expand its international efforts under its Large Business and International Division. The IRS expects that these efforts will improve international tax compliance by allowing it to focus on high-risk issues and cases with greater consistency and efficiency.

The IRS continues to work with the U.S. Department of Justice on tax evasion cases involving foreign countries with bank secrecy laws that prevent the United States from obtaining information on taxpayer transactions. In addition, the 2009 and 2011 Offshore Voluntary Disclosure Initiatives have encouraged taxpayers with hidden offshore assets and income to come back into the tax system using the IRS's Voluntary Disclosure Program. The Initiatives offer a uniform penalty structure for taxpayers who voluntarily disclose their hidden offshore assets and income to the IRS and, in return, ensure that the taxpayers receive consistent tax and penalty treatment. They also provide the opportunity to calculate, with a reasonable degree of certainty, the total cost of resolving all outstanding offshore tax issues related to the undisclosed foreign bank and financial accounts and assets. Taxpayers with undisclosed foreign accounts and assets who do not submit a voluntary disclosure run the risk of detection by the IRS. If caught, these taxpayers face the imposition of substantial penalties, including the fraud and foreign information return penalties, as well as an increased risk of criminal prosecution.

In addition, one of the biggest challenges currently facing the IRS is the implementation of the *Foreign Account Tax Compliance Act* (FATCA).[32] As capital markets become

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[32] Pub. L. No. 111-147, 124 Stat. 71 (2010) (codified in scattered sections of 26 U.S.C.).

increasingly globalized, U.S. investors may be able to benefit from a corresponding increase in international investment opportunities. The FATCA was enacted to combat tax evasion by U.S. persons holding investments in offshore accounts. Under this Act, a U.S. taxpayer with financial assets outside the United States will be required to report those assets to the IRS. In addition, foreign financial institutions will be required to report to the IRS certain information about financial accounts held by U.S. taxpayers or by foreign entities in which U.S. taxpayers hold a substantial ownership interest.

Foreign financial institutions that do not enter into an agreement to report this information to the IRS will be subject to withholding on certain types of payments, including U.S. source interest and dividends, gross proceeds from the disposition of U.S. securities, and pass-through payments. To avoid being withheld upon, foreign financial institutions will have to enter into an agreement with the IRS to:

- Identify U.S. accounts;
- Report certain information to the IRS regarding U.S. accounts; and
- Withhold a 30-percent tax on certain payments to nonparticipating foreign financial institutions and account holders who are unwilling to provide the required information.

According to the IRS Commissioner, "FATCA is an important development in U.S. efforts to combat offshore noncompliance. At the same time, the IRS recognizes that implementing FATCA is a major undertaking for financial institutions."[33] Based on the initial feedback from foreign financial institutions as well as foreign governments, the IRS will continue to face significant opposition from abroad in implementation of this Act.

TAXPAYER PROTECTION AND RIGHTS

The IRS must ensure that tax compliance activities are balanced against the rights of taxpayers to receive fair and equitable treatment. The IRS continues to dedicate significant resources and attention to implementing the taxpayer rights provisions of the *IRS Restructuring and Reform Act of 1998* (RRA 98).[34] Annual audit reports are mandated for the following taxpayer rights provisions:

- Notice of Levy;
- Restrictions on the Use of Enforcement Statistics to Evaluate Employees;
- *Fair Debt Collection Practices Act*[35] Violations;
- Notice of Lien;
- Seizures;
- Illegal Protestor Designations;

[33] IRS News Release IR-2011-76, *Treasury and IRS Issue Guidance Outlining Phased Implementation of FATCA Beginning in 2013* (July 14, 2011).
[34] Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).
[35] 15 U.S.C. §§ 1601 note, 1692-1692o (2006).

- Assessment Statute of Limitations;
- Collection Due Process Appeals;
- Denial of Requests for Information;
- Restrictions on Directly Contacting Taxpayers Instead of Authorized Representatives; and
- Separated or Divorced Joint Filer Requests.

In general, the IRS has improved its compliance with these statutory taxpayer rights provisions. The IRS has shown improvement over prior years when documenting that taxpayers were informed of their rights. However, the IRS did not fully comply with requirements concerning the use of records of tax enforcement results to evaluate employees[36] and did not always follow procedures for mailing notices to taxpayers or their representatives in Federal tax lien cases.[37] IRS management information systems do not track all cases that require mandatory annual audit coverage.[38] Thus, neither TIGTA nor the IRS could evaluate the IRS's compliance with certain RRA 98 provisions.

In addition, identity theft remains the single largest type of complaint submitted to the Federal Trade Commission's Consumer Sentinel Network. The Federal Trade Commission estimates that as many as 9 million Americans have their identities stolen each year. Identity theft affects the IRS and tax administration in two ways – fraudulent tax returns and misreporting of income. Both can potentially harm taxpayers who are the victims of the identity theft. The IRS is seeing a significant growth in identity theft cases. At a recent hearing[39] of the House Oversight and Government Reform Subcommittee on Government Organization, Efficiency, and Financial Management, identity theft victims testified that other individuals had filed fraudulent tax returns using their identities. The victims stated that the IRS withheld their tax refunds, sometimes more than once, and further stated that they had been treated unprofessionally by numerous IRS employees while they tried to resolve their problems.

ACHIEVING PROGRAM EFFICIENCIES AND COST SAVINGS

Given the current economic environment and the increased focus by the Administration, Congress, and the American people on Federal Government accountability and efficient use of resources, the American people must be able to trust that their Government is taking action to stop wasteful practices and ensure that every tax dollar is spent wisely. On June 13, 2011, President Obama signed an Executive Order[40] to cut waste,

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[36] TIGTA, Ref. No. 2010-30-076, *Fiscal Year 2010 Statutory Audit of Compliance With Legal Guidelines Restricting the Use of Records of Tax Enforcement Results* (2010).
[37] TIGTA, Ref. No. 2010-30-072, *Actions Are Needed to Protect Taxpayers' Rights During the Lien Due Process* (2010).
[38] TIGTA, Ref. No. 2010-30-026, *Fiscal Year 2010 Statutory Review of Disclosure of Collection Activity With Respect to Joint Returns* (2010) and TIGTA, Ref. No. 2010-30-060, *Fiscal Year 2010 Statutory Review of Restrictions on Directly Contacting Taxpayers* (2010).
[39] *IRS E-File and Identity Theft, Hearing Before the House Oversight and Government Reform Subcommittee on Government Organization, Efficiency, and Financial Management*, 112th Cong. (2011).
[40] Executive Order No. 13,576, 76 Fed. Reg. 35297 (June 16, 2011), *Delivering an Efficient, Effective, and Accountable Government.*

streamline Government operations, and reinforce the performance and management reform gains achieved by his Administration. In addition, the Government Accountability Office is now statutorily required to identify and report to the Congress those Federal programs, agencies, offices, and initiatives, either within departments or Government-wide, that have duplicative goals or activities.

While the IRS has made progress in using its data to improve program effectiveness and reduce costs, this area continues to be a major challenge. In a recent audit,[41] we reviewed the IRS's $88 million contract with a private vendor to provide support-service functions, including storage and management, throughout IRS facilities. We determined that the IRS should take additional steps to ensure support services are managed in a more cost-effective manner. Specifically, the IRS should evaluate whether it is cost effective to continue to move into storage rather than dispose of furniture and equipment that has not been clearly determined to be of future usefulness. As a result, the IRS may be paying more for its support services than is necessary.

The IRS is reducing publishing and mail costs, but recent reductions have resulted from budget cuts and were not part of a long-term strategy. In response to the cost savings proposed in the Fiscal Year 2011 budget request, the IRS formed task forces to identify ways to achieve cost savings.[42] A task force proposed 25 actions to reduce publishing and mail costs and lay the foundation for long-term implementation of cost reductions for Fiscal Year 2011 and beyond. However, the task force proposal did not include documentation to show the methodology used to make the proposals, the method used to calculate or validate its estimates, or the manner in which the IRS will measure the results or the cost savings of the proposals. As the IRS moves forward with the proposed cost savings or pursues other methods of saving publishing and mail costs, it needs to implement sufficient controls and procedures to ensure the methodology for the decisions are documented and that the data used are accurate and complete.

In a prior audit,[43] we reviewed the IRS's methodology to reasonably and accurately calculate the cost of Unemployment Trust Fund administrative expenses. This fund was established to provide a portion of extended unemployment benefits during periods of high unemployment. The IRS is reimbursed the costs of collecting and processing the taxes that are deposited to the fund. However, we determined that there were insufficient controls to ensure that expenses associated with the administration of the Unemployment Trust Fund are accurately calculated. Specifically, we found that the IRS overestimated the related expenses by $63 million during Fiscal Years 2005 through 2009. As a result, these funds were not available during this period to fund the Federal Government's share of unemployment benefit payments to eligible taxpayers.

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[41] TIGTA, Ref. No. 2011-10-086, *Controls Over Costs and Building Security Related to Outsourced Office Support Services Need to Be Improved* (2011).
[42] TIGTA, Ref. No. 2011-40-025, *Publishing and Mail Costs Need to Be More Effectively Managed to Reduce Future Cost* (2011).
[43] TIGTA, Ref. No. 2010-10-039, *Internal Accounting Errors Reduced the Federal Funding Available for Unemployment Benefits by $63 Million During Fiscal Years 2005 Through 2009* (2010).

CONCLUSION

This correspondence is provided as our annual summary of the most serious major management and performance challenges confronting the IRS in Fiscal Year 2012. TIGTA's *Fiscal Year 2012 Annual Audit Plan* contains our proposed reviews, which are organized by these challenges. If you have questions or wish to discuss our views on the challenges in greater detail, please contact me at (202) 622-6500.

cc: Deputy Secretary
Assistant Secretary for Management and Chief Financial Officer
Commissioner of Internal Revenue

**MANAGEMENT'S RESPONSE TO THE
MANAGEMENT AND PERFORMANCE CHALLENGES IDENTIFIED BY THE
TREASURY INSPECTOR GENERAL
AND
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION**

In their memoranda dated October 24 and 14, 2011, the Treasury Inspector General (IG) and Treasury Inspector General for Tax Administration (TIGTA), respectively, identified the major challenges facing management. The Department of the Treasury concurs with the IG and TIGTA on these challenges. These challenges do not necessarily indicate deficiencies in performance; rather, some represent inherent risks that must be monitored continuously. Moving forward, Treasury will continue to address these issues proactively. The following tables summarize the major management and performance challenges facing the Department of Treasury, and provide information on the actions taken by Treasury in fiscal year 2011 and planned for fiscal year 2012 and beyond.

Timothy F. Geithner
Secretary of the Treasury
November 15, 2011

RESPONSE TO OIG

OIG CHALLENGE NO. 1	SUMMARY OF MAJOR ISSUES
Transformation of Financial Regulation	• Implement and enforce the provisions of the Dodd-Frank Act and other federal consumer financial laws consistently • Identify risks to financial stability that could arise from the activities of large, interconnected financial companies; respond to emerging threats to the financial system; and promote market discipline • Assess and report on systemic risks • Monitor the insurance industry • Streamline and improve supervision of depository institutions and holding companies

Financial Stability Oversight Council (FSOC)

Fiscal Year 2011 Accomplishments

- Held nine meetings of the FSOC to discuss and analyze emerging market developments and financial regulatory issues
- Initiated monitoring for potential risks to U.S. financial stability, with a focus on significant financial market developments and structural issues within the financial system
- Issued an advance notice of proposed rulemaking and notice of proposed rulemaking on determination of nonbank financial companies for consolidated supervision by the Federal Reserve and enhanced prudential standards
- Issued a final rule on the designation of financial market utilities that will be subject to enhanced prudential standards and supervisory requirements
- Published the following studies and reports on:
  - Comprehensive view of financial market developments and potential threats to the financial system
  - Implementation of the Volcker Rule, which generally prohibits banking entities from engaging in proprietary trading and limits their investments in or sponsorship of hedge funds and private equity funds
  - Financial sector concentration limits established by the Dodd-Frank Act
  - Secured creditor haircuts, which evaluated the importance of maximizing U.S. taxpayer protections and promotion of market discipline for the treatment of fully secured creditors in the utilization of the orderly liquidation authority

  - Risk-retention requirements for asset-backed securities that will promote safe and efficient lending
  - Economic impact of possible financial services regulatory limitations intended to reduce systemic risk
- Continued to build out the FSOC's institutional framework, adopting rules of operation, releasing proposed regulations implementing FOIA obligations, adopting a transparency policy, and passing a budget for FSOC operations

Actions Planned or Underway

- Coordinate with FSOC member agencies to consult with the Federal Reserve on developing rules for establishing enhanced prudential standards
- Publish a final rule on the determination of nonbank financial companies for supervision by the Federal Reserve and begin identification of specific nonbank financial companies
- Coordinate issuance of final regulations implementing the Volcker Rule with member agencies and on credit risk retention for asset-backed securities with member agencies

Office of Financial Research (OFR)

Fiscal Year 2011 Accomplishments

- Gathered input from regulators, private stakeholders, and eminent researchers on the OFR's functions and strategic priorities
- Began delivery of data and research-related services to the FSOC and its committees, which included contracting with leading outside researchers and initiation of support for the FSOC Data Committee
- Worked with policymakers, regulators, and the private sector to allow for a mutually agreeable and effective global Legal Entity Identifier (LEI) solution which will fill a critical gap in financial sector data
- Initiated development of a comprehensive catalogue of existing financial and economic datasets among FSOC members
- Developed initial organizational structure, hiring procedures, and pay structures; recruited OFR leadership; and began to plan and design a target information technology architecture linked to achieving OFR's strategic priorities

Actions Planned or Underway

- Implement a comprehensive strategic framework to support the evolving needs for the OFR (including governance and procedures, program management and business systems, strategic budgeting, and performance measurement)
- Expand core analytic outputs for the FSOC and broader stakeholders, hold the first OFR-sponsored conference, and promote the continued build-up of a virtual community of researchers and academics on financial stability
- Implement the LEI solution to fill a critical gap in financial sector data and follow-up with the build of a robust data management solution for the FSOC and its members that avoids duplication and unnecessary burden
- Accelerate hiring across the full range of functions and further elaborate the human resource framework to serve the needs of the growing organization

Federal Insurance Office (FIO)

Fiscal Year 2011 Accomplishments

- Completed an inventory of insurance-related skill sets and expertise within all federal agencies with the objective of avoiding duplication of personnel
- Continued to gather input on FIO's functions, authorities, and strategic priorities

Actions Planned or Underway

- Further develop data collection and analyses processes with OFR
- Generate the studies and reports required by the Dodd-Frank Act

Office of the Comptroller of the Currency (OCC)

Fiscal Year 2011 Accomplishments

- Completed the transfer and integration of Office of Thrift Supervision (OTS) employees and brought federal savings associations under OCC supervision, creating a single regulator for national banks and federal thrifts
- Conducted 17 outreach sessions nationwide to over 1,000 thrift executives and issued several communications to thrift directors and executives

- Republished OCC rules to incorporate those OTS regulations that the OCC has authority to administer and enforce going forward
- Assisted in the development of the CFPB's procurement and personnel management processes and executed a memorandum of understanding to ensure the new agency has the supervisory and other confidential information it needs about the banks and thrifts it will supervise
- Continued to operate the Customer Assistance Group which handles consumer complaints about large banks now under CFPB supervision while the CFPB builds its own capacity to handle consumer complaints
- Participated in the interagency effort to establish the FSOC and in FSOC principal-level and deputy-level discussions

Actions Planned or Underway

- Continue to conduct on-site supervisory assessments of national banks and federal savings associations, focusing on the quality of credit risk management practices (including effective credit risk rating systems and problem loan identification), adequacy of loan-loss reserves, and effective loan work-out strategies
- Continue to perform individual bank examinations on a variety of other activities aimed at identifying and responding to systemic trends and emerging risks that could adversely affect asset quality or the availability of credit at national banks and the banking system, and fair access to financial services
- Work closely within Treasury and with other federal financial regulatory agencies to implement the Dodd-Frank Act reforms and to monitor and respond to any residual threats to a robust economic recovery of the U.S. financial system

OIG CHALLENGE NO. 2	SUMMARY OF MAJOR ISSUES
Management of Treasury's Authorities Intended to Support and Improve the Economy	• Protect the taxpayer from unnecessary risk associated with the implementation and administration of programs intended to support and improve the economy, including the provisions of the: - *Small Business Jobs Act of 2010* - *American Recovery and Reinvestment Act of 2009* - *Housing and Economic Recovery Act of 2008* - *Emergency Economic Stabilization Act of 2008*

Small Business Lending Fund (SBLF)

Fiscal Year 2011 Accomplishments

- Reviewed and evaluated 932 applications from community banks and loan funds in accordance with the terms and timetable of the Small Business Jobs Act of 2010
- Invested in approximately 300 community banks and loan funds for approximately $4.0 billion in funds intended to increase qualified small business lending across the country

Actions Planned or Underway

- Implement an asset management and compliance monitoring program to ensure the institutions participating in SBLF comply with the terms of the program and Treasury's investment is well-managed

State Small Business Credit Initiative (SSBCI)

Fiscal Year 2011 Accomplishments

- Approved 35 states and D.C. for $1.3 billion in SSBCI allocations; 30 states received their first of three disbursements of funds; conducted outreach to municipalities in the three eligible states that did not apply for SSBCI funding
- Conducted outreach to states through webinars and conference calls to increase awareness of the program, and provided intensive individualized technical assistance to states

Actions Planned or Underway

- Take final actions on the remaining state applications no later than the first quarter of fiscal year 2012
- Develop national compliance standards for states in response to OIG recommendations
- Create an on-line reporting system for states to submit quarterly and annual reports

Management of Recovery Act Programs

Fiscal Year 2011 Accomplishments

- Transitioned most programs from active/implementation phase to oversight and compliance monitoring phase, maintaining Treasury's 100 percent compliance rate with recipient reporting under Section 1512 and administration of more than 50 tax code changes through tax year 2010
- Performed site visits to review 37 of the 69 Recovery Act CDFI Program and Native American CDFI Assistance Program awardees (54 percent coverage), focusing on Recovery Act reporting and compliance issues
- Managed the low income housing and specified energy property programs, including the extension of the specified energy property program by one year under Section 707 of the *Job Creation Act*, by supplementing a small core staff in Departmental Offices with support from Treasury bureaus
- Continued an interagency agreement for the energy program with the Department of Energy to assist with the technical aspects of that program
- Implemented an annual reporting process for the low income housing program to ensure projects funded under the program remain qualified

Actions Planned or Underway

- Complete site visits and desk reviews of state housing agencies to ensure compliance with the low income housing program's terms and conditions
- Continue the compliance monitoring programs related to the low-income housing and specified energy property programs
- Continue to coordinate with the IRS to implement a compliance initiative project regarding the energy program
- Continue assessment of staffing needs

Management of the Housing and Economic Recovery Act (HERA) and the Emergency Economic Stabilization Act (EESA)

Fiscal Year 2011 Accomplishments

- Focused principally on exiting remaining TARP-related investments, maximizing the return for taxpayers, and continuing to help homeowners avoid preventable foreclosures
- Made substantial progress in recovering investments made in the Automotive Industry Financing Program and American International Group

Actions Planned or Underway

- Continue to focus on exiting remaining TARP-related investments, maximizing the return for taxpayers, and continuing to help homeowners avoid preventable foreclosures

OIG CHALLENGE NO. 3	SUMMARY OF MAJOR ISSUES
Anti-Money Laundering and Terrorist Financing/Bank Secrecy Act (BSA) Enforcement	• Prevent and detect money laundering and terrorist financing • Promote U.S. and international financial systems that are safe and transparent • Create safeguards over the use of BSA information

FinCEN

Fiscal Year 2011 Accomplishments

- Subjected providers and sellers of prepaid access products to more comprehensive BSA requirements
- Clarified money services business (MSB) definitions, including ensuring that foreign-located MSBs doing business in the United States are subject to BSA requirements
- Strengthened the confidentiality of suspicious activity reports (SARs) and provided accompanying guidance to financial institutions on sharing SAR information within their organizational structure
- Issued Notice of Proposed Rulemakings to apply anti-money laundering (AML) program and suspicious activity reporting rules to non-bank residential mortgage lenders and originators
- Conducted strategic analytical studies and published reports promoting greater awareness of emerging money laundering trends and vulnerabilities which included publishing analytic products:

- Assessments of suspicious activity reporting related to identify theft by depository institutions and securities and futures firms
- SARs-related reports on commercial real estate financing fraud, mortgage loan fraud, and loan modification fraud

- Studied suspicious activities involving title and escrow companies, prepaid access devices, remote deposit capture, and debt settlement and debt relief fraud
- Issued reports to state regulatory authorities on activities involving MSBs in addition to overall BSA filing trends within their jurisdictions
- Provided high level information on suspicious hedge fund activities and principals to the Securities and Exchange Commission
- Submitted monthly referrals to the Special Inspector General for the Troubled Asset Relief Program involving potential fraud against federal programs supporting the housing market
- Continued to work with the IRS on better risk targeting of non-bank financial institutions that the IRS examines under delegated authority from FinCEN, to better enable FinCEN to develop cases and pursue enforcement actions where warranted

Actions Planned or Underway

- Promote greater leveraging of resources between the IRS and state regulatory agencies, particularly with regard to non-bank financial institution examinations, and implementation of compliance strategies for industries that have been recently subject to BSA requirements
- Continue working toward finalizing rulemaking proposals, as well as proposed and/or final regulations related to BSA requirements for government-sponsored enterprises; reporting requirements on the international transport of prepaid access products; and AML program and suspicious activity reporting rules for investment advisers
- Pursue MOUs with additional state regulators, with specific focus on state insurance regulators
- Continue to exercise enforcement authorities for violations of BSA requirements

OCC

Fiscal Year 2011 Accomplishments

- Examined national banks to combat money laundering and terrorist financing, and to protect the integrity of the U.S. financial system through banks' compliance with the BSA, AML, and USA PATRIOT Act laws and regulations, taking enforcement actions when appropriate

Actions Planned or Underway

- Continue examination, enforcement activities, and cooperative efforts with FinCEN and other federal banking agencies

OIG CHALLENGE NO. 4	SUMMARY OF MAJOR ISSUES
Management of Capital Investments	Implement controls for effective use of taxpayer funds over large capital investments

Evaluation of IT Investments

Fiscal Year 2011 Accomplishments

- Created a new investment reporting process and launched development of an IT Capital Dashboard to improve transparency and provide management with timely and accurate information

Actions Planned or Underway

- Deploy first iteration of Treasury IT Capital Dashboard
- Incorporate measures on operational performance and non-major project cost and schedule into IT Capital Dashboard

Infrastructure Optimization/Data Center Consolidation and Shared Services

Fiscal Year 2011 Accomplishments

- Submitted strategy to OMB for reducing the number of Treasury data centers
- Continued to focus on data center consolidation and shared services as key strategies to better manage costs of IT investments

- Established a five year Telecommunications Improvement Plan concluding in September 2015, which includes milestones related to program management and governance, technology convergence, and implementation of Departmental telecommunications standards and common architecture

Actions Planned or Underway

- Implement plans to close an additional 12 data centers by 2015, and expand approach to integrate consolidation as an outcome of cloud service adoption or shared service adoption
- Establish a data management organization that integrates data sets from across Treasury to better inform management policy across the Department
- Establish Department-wide platforms for personal identity verification (PIV)-enabled authentication
- Benchmark and establish baseline performance metrics for ongoing monitoring of improvement initiatives with the Treasury-wide area network telecommunications vendor

RESPONSE TO TIGTA

TIGTA CHALLENGE NO. 1	SUMMARY OF MAJOR ISSUES
Security for Taxpayer Data and Employees	Promote measures for appropriate physical security and protection of financial, personal, and other information

Fiscal Year 2011 Accomplishments

- Established the Identity Theft Assessment and Action Group to identify new protections and to improve and expand existing protections for taxpayers who have had their identities compromised outside the tax system; launched an Identity Protection Personal Identification Number (IPPIN) pilot to ensure that taxpayers subject to identity theft in the past do not encounter delays in processing their tax returns
- Improved processing of taxpayer accounts impacted by identity theft by deploying additional account "markers" to (1) distinguish legitimate returns from fraudulent returns, (2) track taxpayers with identity theft-related tax problems and issues encountered by identity theft victims, and (3) prevent victims from facing the same problems every year; and protected $1.3 billion from leaving the U.S. Treasury as a result of the improved identity theft detection
- Implemented a 10-point security plan designed to strengthen physical security and incident reporting capabilities, stemming from the Austin tragedy in 2010
- Disabled over 10,000 fraudulent IRS-related scams using the IRS name or likeness to entice victims, including 9,272 phishing/malware websites (with a median takedown time of 67 minutes), 352 fax numbers, and 534 e-mail drop boxes

Actions Planned or Underway

- Use results from the fiscal year 2011 IPPIN pilot to improve and expand the program to additional taxpayers
- Deploy the enterprise Authorization (e-Auth) project to provide a framework to register individual identities and validate credentials for electronic access to IRS systems and applications

TIGTA CHALLENGE NO. 2 (tied)	SUMMARY OF MAJOR ISSUES
Tax Compliance Initiatives	Improve compliance and fairness in the application of the tax laws

Businesses and Individuals

Fiscal Year 2011 Accomplishments

- Completed testing an enhanced Automated Underreporter (AUR) case identification and selection analytics tool to be used in selection of tax year 2010 returns
- Continued testing soft notices as alternatives to conducting examinations, issuing 27,000 AUR soft notices
- Continued testing the effects of education, compliance notices, and telephone contacts on the accuracy of returns prepared for Earned Income Tax Credit (EITC) first-time and low-risk paid preparers
- Established a task group to expand IRS revenue protection and scheme detection capabilities, improving fraud detection at filing, before the refund is released

- Rolled out a series of "fresh start" programs specifically designed to assist business and individual taxpayers struggling with outstanding tax liabilities
- Launched multiple compliance analytics pilot projects to explore new methods of using data and analytics to improve compliance programs

Actions Planned or Underway

- Continue to modify examination case selection and modeling
- Continue to test soft notices as alternatives to conducting examinations in AUR
- Continue to promote the Compliance Assurance Process (CAP) as a model for how IRS and corporate taxpayers should interact

Tax-Exempt Entities

Fiscal Year 2011 Accomplishments

- Developed guidance on how to process, review, and monitor Voluntary Closing Agreements; followed-up on taxpayers whose rights were potentially violated; researched claims and took action to ensure future claims were worked properly; and improved inventory and case management controls
- Completed statutorily-required revocation of approximately 386,000 organizations whose tax exempt status was revoked based on rules established by the *Pension Protection Act of 2006*
- Developed a fraud report to identify fraud schemes and monitor operational effectiveness of fraud detection and mitigation methodologies

Actions Planned or Underway

- Improve compliance by identifying the needs of small exempt organizations and by performing post reviews of Form 990-N, *e-Postcard*, filers ineligible to file the e-Postcard
- Identify non-compliant exempt organizations based on data from the redesigned Form 990, *Return of Organization Exempt From Income Tax*

Tax Return Preparers

Fiscal Year 2011 Accomplishments

- Implemented Phase 1 of the Return Preparer Initiative (RPI), which required paid return preparers to register with the IRS and use a Preparer Tax Identification Number (PTIN) to sign returns; over 735,000 paid preparers registered in the first year
- Identified high risk tax return preparers using new risk based scoring, resulting in the issuance of more than 10,000 potential noncompliance letters and visits to more than 5,000 preparers to address multiple areas of concern including EITC filings, e-file, and questionable certified acceptance agents

Actions Planned or Underway

- Implement Phase 2 of the RPI requiring paid return preparers, except attorneys, certified public accountants, and enrolled agents, to pass a competency test and complete continuing professional education of 15 hours per year

TIGTA CHALLENGE NO. 2 (tied)	SUMMARY OF MAJOR ISSUES
Modernization	Improve taxpayer service and efficiency of operations

Fiscal Year 2011 Accomplishments

- Deployed current Customer Account Data Engine (CADE) Release 6.2 to deliver the 2011 filing season tax law changes affecting individual taxpayers, and to provide technical improvements to the infrastructure and availability of the current system
- Deployed Modernized e-File (MeF) Release 6.2 in January 2011 to deliver Business and Individual Master File returns; MeF accepted almost 18.5 million returns in 2011, a 262% increase compared to the same period in calendar year 2010
- Implemented a Remittance Strategy for Paper Check Conversion system, allowing paper checks to be converted into electronic transactions and processing nearly 3.6 million checks, totaling almost $7.8 billion
- Implemented an auto`mated transcript process allowing taxpayers to request mailing of account and return transcripts through IRS.gov, eliminating the need to contact IRS
- Completed logical and physical designs of CADE2 Transition State 1

Actions Planned or Underway

- Deploy Transition State 1 of CADE2 for filing season 2012, which will support daily versus weekly processing and a relational account database
- Commence "Send A Transcript" proof of concept which allows taxpayers to make an online request to send an official transcript to banks and other financial institutions, without the need to call or complete a paper Form 4506-T, *Request for Transcript of Tax Return*

TIGTA CHALLENGE NO. 4	SUMMARY OF MAJOR ISSUES
Implementing Major Tax Law Changes	Effectively implement new tax provisions, including tax-related health care provisions of the *Patient Protection and Affordable Care Act* (ACA), and the *American Recovery and Reinvestment Act* (Recovery Act)

ACA

Fiscal Year 2011 Accomplishments

- Implemented early provisions of the ACA, including the revision of approximately 60 tax products, creation of three new tax forms, and release of applicable guidance related to the:
  - Small employer tax credit
  - Excise tax on indoor tanning services
  - Adoption credit
  - Branded pharmaceutical fee
  - Qualified therapeutic discovery credit
  - New charitable hospital requirements

Actions Planned or Underway

- Partner with the Department of Health and Human Services on outreach, guidance, business processes, and IT deployment relating to the insurance market reforms and insurance exchange system
- Identify impacted stakeholders and commence outreach activities on all aspects of ACA implementation, including individuals, employers, states, insurers, tax professionals, and other third parties

Recovery Act

Fiscal Year 2011 Accomplishments

- Continued administration of numerous tax incentives included in the Recovery Act, including enhanced compliance procedures
- Published new Internal Revenue Manual provisions to clarify the processes for handling rebate refund cases for tax exempt bonds
- Implemented new voluntary compliance procedures for Build America Bonds and other direct-pay bonds to resolve tax law issues

Actions Planned or Underway

- Revise Form 5695, *Residential Energy Credits*, to request additional information to support eligibility requirements

Other Tax Law Changes

Fiscal Year 2011 Accomplishments

- Delivered a successful 2011 filing season, processing 144.7 million individual returns and issuing 109.3 million refunds totaling $419.5 billion
- Implemented procedures to process the first year of the required 15 year repayment for 2008 homebuyers who claimed the First-Time Home Buyer Credit (FTHBC), including use of the math error authority when the repayment was not identified on the return
- Promoted accurate self-reporting in anticipation of the filing season by sending approximately 1.5 million reminder notices to taxpayers who claimed the First-Time Home Buyer Credit for a home purchased in 2008

Actions Planned or Underway

- Administer any new tax law provisions that may be enacted in 2011 for filing season 2012

TIGTA CHALLENGE NO. 5	SUMMARY OF MAJOR ISSUES
Fraudulent Claims and Improper Payments	Effective use of taxpayer funds

Refundable Credits

Fiscal Year 2011 Accomplishments

- Required taxpayers to provide supporting documentation to verify eligibility for many refundable tax credits including the FTHBC
- Improved methods to identify erroneous FTHBC claims through better filters and the use of third party information for use in the 2012 filing season
- Protected over $3.7 billion in revenue through EITC enforcement efforts, including the examination of almost 484,000 original and amended returns claiming the EITC, over 1.2 million document matching reviews, and 300,000 math error process corrections
- Increased EITC paid preparer due diligence visits, resulting in a 100 percent increase in the number of preparers penalized over fiscal year 2010 and proposed due diligence and other penalties of more than $10.6 million
- Improved the accuracy of EITC returns by refining EITC paid preparer treatment activities, including doubling the number of due diligence audits, increasing visits by revenue and criminal investigation agents by 50 percent, and increasing educational and compliance notices to first-time and experienced preparers by 25 percent, to influence the accuracy of EITC returns filed
- Initiated a test on Additional Child Tax Credit (ACTC) returns with dependent issues not selected for examination to assist in developing the ACTC compliance strategy moving forward
- Required documentation to accompany returns claiming the Adoption Credit to reduce fraud, and developed new cross-functional procedures to minimize delays in return processing

Actions Planned or Underway

- Implement the requirement that EITC paid preparers attach Form 8867, *Paid Preparer's Earned Income Credit Checklist*, to their clients' returns to encourage preparer compliance with EITC due diligence requirements
- Continue to focus on EITC paid preparer treatments, including due diligence audits, visits, streamlined injunctions, and educational and compliance notices to first-time and experienced preparers to influence the accuracy of EITC returns filed
- Review results of the ACTC test and adjust compliance strategy, if necessary; expand outreach and education to taxpayers and preparers around ACTC requirements to reduce improper claims
- Implement robust compliance and outreach strategies related to the American Opportunity Tax Credit directed toward students, taxpayers, preparers, and educational institutions to address eligibility requirements; send soft educational notices as part of this strategy

Contracts and Other Payments

Fiscal Year 2011 Accomplishments

- Changed reviews of split-purchase transactions and expanded oversight reviews to include the use of contract vendors and preferred sources
- Revised policy and procedures to ensure distribution of Defense Contractor Audit Agency reports to all appropriate procurement staff, when appropriate, for use in determining whether to implement additional controls to monitor costs on contracts and task orders
- Revised reporting process to ensure that all agreed-to questionable charges are repaid by contractors and documented prior to closure of corrective actions

Actions Planned or Underway

- Provide guidance on oversight and enforcement responsibilities, develop examples and scenarios that constitute a split-purchase, evaluate whether current span of control provides appropriate oversight, and make changes, as appropriate
- Develop and provide clear guidance to Credit Card Services on performance of their oversight and enforcement responsibilities for compliance with Purchase Card Program procedures

TIGTA CHALLENGE NO. 6	SUMMARY OF MAJOR ISSUES
Providing Quality Taxpayer Service Operations	Improve taxpayer service

Fiscal Year 2011 Accomplishments

- Implemented a new toll-free number for taxpayer transcript requests and a new web application that allows taxpayers to order transcripts on IRS.gov
- Released the IRS2GO smartphone application, which lets taxpayers interact with the IRS using their mobile devices; IRS2Go averaged four out of five stars in hundreds of reviews and over 360,000 downloads
- Increased the number of Limited English Proficiency products, translating key notices into different languages and delivering an enhanced multilingual web site that offers an array of tax information
- Broadened awareness of accessible tax products that serve and support visually and hearing impaired taxpayers, through partnership with the Library of Congress and National Library Service for the Blind and Physically Handicapped
- Engaged partners and provided greater access to available services through Saturday service events and other special service days, e.g., EITC Awareness Days
- Participated in outreach events to educate partners and the public about the tax treatment of the 2010 Gulf Oil Spill payments; in the Gulf region, over 169,000 individuals and businesses received emergency advance payments for lost income or profits in 2010
- Implemented new quality initiatives at Taxpayer Assistance Centers (TACs) and volunteer return preparation sites using sampling reviews of selected returns to determine the accuracy of returns prepared
- Gathered feedback from professional organizations that represent external stakeholders (i.e., accountants, reporting agents, et al) to simplify forms and the tax filing process

Actions Planned or Underway

- Implement the changes necessary to support roll-out of CADE2
- Release an updated version of IRS2Go with improved functionality
- Continue to engage IRS partners to disseminate information and simplify forms and the tax filing process
- Continue to engage partners in support of special service days and outreach efforts with advocacy groups that serve and support the visually and hearing impaired
- Update IRS.gov and TAC telephone recordings to include more information for taxpayers seeking assistance at a TAC, including advising taxpayers they may be asked to provide valid photo ID and a Taxpayer Identification Number (TIN), such as a Social Security number (SSN), to receive services

TIGTA CHALLENGE NO. 7	SUMMARY OF MAJOR ISSUES
Human Capital	Enable the IRS to achieve its mission

Fiscal Year 2011 Accomplishments

- Implemented the Hiring Reform Initiative which included transitioning from a "reinvestigation" background investigation program to a "one-stop shop" with streamlined and efficient services, reducing the time required for background investigations by 30 days
- Improved technology and communication tools to enhance recruitment and deliver a more diverse applicant pool
- Continued an emphasis on veteran hiring, with veterans comprising 7 percent of total hires in fiscal year 2011
- Implemented the Warrior Intern Program, previously piloted in fiscal year 2010, and the Non-Paid Work Experience program, conducted in partnership with the Departments of Defense and Veteran Affairs, to provide qualified veterans with quantifiable work experience at the IRS through non-paid internship opportunities
- Established a Telework Program Office and expanded telework opportunities to over 36,000 employees to further enhance recruitment, development, and retention of employees

Actions Planned or Underway

- Educate internal and external IRS stakeholders on recruitment by providing the Careers Pathway website tool to assist applicants and career development outreach to enhance internal recruitment efforts

- Build a diverse talent management pipeline by deploying cost effective recruitment strategies
- Develop and document an IRS-wide approach to ensure effective monitoring of the adequacy of the acquisition workforce

TIGTA CHALLENGE NO. 8	SUMMARY OF MAJOR ISSUES
Globalization	Increase the outreach efforts to foreign governments on cross-border transactions

Fiscal Year 2011 Accomplishments

- Completed realignment of IRS international operations by integrating international expertise into the new Large Business and International organization
- Conducted examinations of taxpayers who applied under the Offshore Voluntary Disclosure Program
- Continued to combat international illicit money networks and professional money launderers via the Global Illicit Financial Team by further developing policies, targeting criteria, and case development procedures
- Coordinated joint audits and strengthened relations with foreign tax administrations, including seeking additional opportunities to improve and expand the Joint Audit Initiative with foreign administrations and taxpayers

Actions Planned or Underway

- Continue examinations of taxpayers who applied under both Offshore Voluntary Disclosure Initiatives
- Continue to enhance relationships with treaty partners and international organizations to improve international compliance
- Continue to identify and address emerging tax-exempt compliance issues, including ensuring that charities adhere to requirements for foreign bank accounts and expanding coordination of employment tax compliance with foreign countries
- Continue to combat international illicit money networks and professional money launderers via the Global Illicit Financial Team by further developing policies, targeting criteria, and case development procedures

TIGTA CHALLENGE NO. 9	SUMMARY OF MAJOR ISSUES
Taxpayer Protection and Rights	Apply the tax laws fairly

Fiscal Year 2011 Accomplishments

- Issued guidance to remind managers of Section 1204 and Reg. 801, which prohibit the use of Records of Tax Enforcement to evaluate and to impose or suggest production goals or quotas; updated appropriate training materials regarding the explanation of the retention standard
- Reviewed undelivered mail procedures to ensure consistency across the organization and to support the timely resolution of undeliverable notices
- Produced 104 redesigned/new notices, including the Taxpayer Delinquent Account collection notices, containing new language to help taxpayers more clearly understand the collection process and options available to them

Actions Planned or Underway

- Improve IRS assistance services to taxpayers who are victims of identity theft outside the tax system, but who encounter IRS issues because of that theft
- Continue to redesign notices and produce new notices containing language that clearly explains the collection process and options available to taxpayers
- Continue to reinforce culture of taxpayer protection and rights through leadership messages at all levels of the organization

TIGTA CHALLENGE NO. 10	**SUMMARY OF MAJOR ISSUES**
Achieving Program Efficiencies and Cost Savings	Use resources to focus on producing the best value for stakeholders

Fiscal Year 2011 Accomplishments

- Implemented a number of cost savings initiatives as part of the Postage and Printing cost reduction strategy, including the elimination of tax packages for individual taxpayers and the elimination/reduction of direct mailing of a number of tax packages to businesses; these eliminations/reductions have resulted in postage and printing cost savings in excess of $20 million
- Enhanced electronic receipt of background investigation cases through eDelivery, resulting in a cost savings of $820,621 and significant improvements in data communications with the Office of Personnel Management
- Closed the Atlanta Submission Processing center, the fifth such closure in recent years, reflecting the success of IRS's e-File program and reduced need for paper processing
- Deployed the paper check conversion technology to 401 TACs to process checks through electronic transmission, improving reporting systems, reducing the amount of time to process checks that TACs previously mailed to central locations for processing, and reducing the number of lost remittances from transshipments
- Expanded use of cost accounting information to improve program effectiveness, including analysis of programs within the CFO function, the notice process, the Combined Annual Wage Reporting/Federal Unemployment Tax Act and 6020(b) programs, and certain criminal investigation processes
- Started an initiative to develop standard operating procedures to address storage needs for property; these procedures will consider current and future budget constraints, the sustainability initiative to increase the re-use and recycling of furniture, costs to store versus to purchase new furniture, and transportation costs
- Updated procedures used by the business units to calculate their unemployment trust fund (UTF) administrative expenses; required retention of audit files for a minimum of three years; and instituted periodic Chief Financial Officer (CFO) reviews of the business units' UTF expense submissions and supporting documentation

Actions Planned or Underway

- Continue to review internal operations, conducting additional cost benefit analyses and development of performance measures to improve program evaluation and decision making

APPENDIX D: MATERIAL WEAKNESSES, AUDIT FOLLOW-UP, AND FINANCIAL SYSTEMS

This section provides detailed descriptions of Treasury's material weakness inventory, including summaries of actions taken and planned to resolve the weaknesses; tracking and follow-up activities related to Treasury's GAO, OIG, TIGTA, and SIGTARP audit inventory; an analysis of potential monetary benefits arising from audits performed by Treasury's three IGs; and an update on Treasury's financial management systems framework.

I. Treasury's Material Weaknesses

Management may declare audit findings or internal situations as a material weakness whenever a condition exists that may jeopardize the Treasury mission or continued operations. The FMFIA and FFMIA require agency reporting on material weaknesses.

FMFIA

The FMFIA requires agencies to establish and maintain internal controls. The Secretary must evaluate and report annually on the operations and financial reporting controls (FMFIA Section 2) and financial systems (FMFIA Section 4 and FFMIA) that protect the integrity of federal programs. The requirements of the FMFIA serve as an umbrella under which other reviews, evaluations, and audits should be coordinated and considered to support management's assertion about the effectiveness of internal control over operations, financial reporting, and compliance with laws and regulations.

On April 20, 2011, the IRS's FMC ESC recommended downgrade of the material weakness titled "Improve Modernization Management Controls and Processes." IRS provided documentation to both GAO and TIGTA that validated completion of corrective actions that addressed the identified internal management processes and control weaknesses. On August 5, 2011, the Assistant Secretary for Management and Chief Financial Officer concurred with the request to downgrade this material weakness to a control deficiency.

As of September 30, 2011, Treasury had three material weaknesses under Section 2 of the FMFIA, summarized as follows:

Summary of FMFIA and FFMIA Material Weaknesses	Section 2	Section 4	Total
Balance at the Beginning of FY 2011	4	0	4
Closures/Downgrades during FY 2011	1	0	1
Reassessed during FY 2011	0	0	0
New MW Declared during FY 2011	0	0	0
Balance at the End of FY 2011	3	0	3

Below are detailed descriptions of Treasury's three material weaknesses:

<table>
<tr><th colspan="2">Material Weakness Description</th></tr>
<tr><td colspan="2">Internal Revenue Service – Unpaid Tax Assessments

The IRS needs to improve its internal control over Unpaid Assessments. Original key elements:
• Subsidiary ledger does not track and report one Trust Fund Recovery Penalty (TFRP) balance
• Untimely posting of TFRP assessments and untimely review of TFRP accounts
• IRS' general ledger for its custodial activities does not use the standard federal accounting classification structure</td></tr>
<tr><th>Actions Completed</th><th>What Remains to be Done</th></tr>
<tr><td>✓ Implemented programming in the Custodial Detail Data Base in February 2011, to improve classification when either the business or related TFRP individual modules are removed from the Unpaid Tax Assessments inventory, and to reduce the amount of adjustments to the financial statements. The programming change improved classification of instances, where previously, multiple tax periods were rolled up into one module.</td><td>☐ Achievement of CADE 2 Transition State 2 target of a single, data-centric solution system which provides for daily processing of taxpayer accounts
☐ Targeted Downgrade/Closure: Fiscal year 2015</td></tr>
</table>

Material Weakness Description	
Internal Revenue Service - Computer Security The IRS has various computer security controls that need improvement. Original key elements: • Adequately restrict electronic access to and within computer network operational components • Adequately ensure that access to key computer applications and systems is limited to authorized persons for authorized purposes • Adequately configure system software to ensure the security and integrity of system programs, files, and data • Appropriately delineate security roles and responsibilities within functional business operating and program units, per FISMA • Appropriately segregate system administration and security administration responsibilities • Sufficiently plan or test the activities required to restore certain critical business systems where unexpected events occur • Effectively monitor key networks and systems to identify unauthorized activities and inappropriate system configurations • Provide sufficient technical, security-related training to key personnel • Certify and accredit 90 percent of all systems	
Actions Completed	**What Remains to be Done**
✓ Developed and executed implementation plans for systems/application access controls ✓ Documented security configuration standards and change control process in place; secure configuration baselines implemented and maintained; system software patched; processes in place for systems software configuration access controls ✓ Implemented back-up recovery capabilities for contingency planning ✓ Deployed Release 1 - Audit Trails	□ Develop application monitoring capability for Release 2 Supplement – Audit Trails □ Network and system monitoring for Release 3 – Audit Trails □ Deployment of Release 3 – Audit Trails □ Targeted Downgrade/Closure: Fiscal year 2012

Material Weakness Description	
Financial Management Service – Systems, Controls, and Procedures to Prepare the Government-wide Financial Statements The government does not have adequate systems, controls, and procedures to properly prepare the Consolidated Government-wide Financial Statements. Original key elements: • The government lacks a process to obtain information to effectively reconcile the reported excess of net costs over revenue with the budget deficit, and when applicable, a reported excess of revenue over net costs with the budget surplus • Weaknesses in financial reporting procedures in internal control over the process for preparing the Consolidated Financial Statements	
Actions Completed	**What Remains to be Done**
✓ Partially reconciled fiscal year 2010 operating revenues with budget receipts ✓ Refined analysis model for unreconciled transactions that affect the change in net position ✓ Accounted for intra-governmental differences through formal consolidating and elimination accounting entries using all reciprocal fund categories including the General Fund ✓ Completed closing package submitted to GAO by federal agencies ✓ Established traceability from agency footnotes to the Consolidated Financial Statements (CFS) for completeness	□ Complete reconciliation of operating revenues to budget receipts □ Complete reciprocal category for the Treasury General Fund □ Implement changes identified by the Office of the Fiscal Assistant Secretary as a result of its review of the Reporting Entity definitions per the Financial Accounting Standards Advisory Board criteria □ Include all disclosures as appropriate □ Include all loss contingencies as appropriate □ Targeted Downgrade/Closure: Fiscal year 2014

II. Audit Follow-up Activities

During fiscal year 2011, Treasury continued to place emphasis on both the general administration of internal control issues throughout the Department and the timely resolution of findings and recommendations identified by GAO, OIG, TIGTA, SIGTARP, external auditors, and management. During the year, Treasury continued to implement enhancements to the tracking system called the "Joint Audit Management Enterprise System" (JAMES). JAMES is a Department-wide, interactive, web-based system accessible to the OIG, TIGTA, SIGTARP, management, and others. The system tracks information on audit reports from issuance through completion of all corrective actions required to address findings and recommendations contained in an audit report. JAMES is the official system of record for Treasury's audit follow-up program.

Potential Monetary Benefits

The *Inspector General Act of* 1978, as amended, Public Law 95-452, requires the IGs and secretaries of executive agencies and departments to submit semiannual reports to the Congress on actions taken on audit reports issued that identify potential monetary benefits. The Department consolidates and analyzes all relevant information for inclusion in this report. The information contained in this section represents a consolidation of information provided separately by OIG, TIGTA, SIGTARP, and Treasury management.

In the course of their audits, the IGs periodically identify questioned costs, recommend that funds be put to better use, and identify measures that demonstrate the value of audit recommendations to tax administration and business operations. "Questioned costs" include a:

- Cost that is questioned because of an alleged violation of a provision of a law, regulation, contract, or other requirement governing the expenditure of funds
- Finding, at the time of the audit, that such costs are not supported by adequate documentation (i.e., an unsupported cost)
- Finding that expenditure of funds for the intended purpose is unnecessary or unreasonable

The Department regularly reviews progress made by the bureaus to realize potential monetary benefits identified in audit reports, and coordinates with the auditors as necessary to ensure the consistency and integrity of information on monetary benefit recommendations tracked in JAMES.

The statistical data in the following summary tables represent audit report activity for the period from October 1, 2010 through September 30, 2011. The data reflect information on OIG, TIGTA, and SIGTARP reports that identified potential monetary benefits. Fiscal year 2011 was the first year that SIGTARP issued reports containing monetary benefits.

Audit Report Activity With Potential Monetary Benefits for Which Management Has Identified Corrective Actions (OIG, TIGTA, and SIGTARP) October 1, 2010 through September 30, 2011 (Dollars in Millions)

	Disallowed Costs		Funds Put to Better Use		Revenue Enhancements		Totals	
	Reports	Dollars	Reports	Dollars	Reports	Dollars	Report Total	Total Dollars
Beginning Balance	4	$33.0	13	$2,822.6	17	$5,558.9	34	$8,414.5
New Reports	9	39.7	8	7,412.1	8	2,524.8	25	9,976.6
Total	13	72.7	21	10,234.7	25	8,083.7	59	18,391.1
Reports Closed	3	0.5	10	329.5	17	4,348.0	30	4,678.0
a. Realized or Actual[1]	2	0.1	6	142.3	6	402.1	14	544.5
b. Unrealized or Written off[1]	2	0.4	8	187.2[2]	14	3,945.9[3]	24	4,133.5
Ending Balance	**10**	**$72.2**	**11**	**$9,905.2**	**8**	**$3,735.7**	**29**	**$13,713.1**

[1] *Report numbers in categories a and b may not equal the Reports Closed. One report can be included in one or both categories.*

[2] *This figure includes one TIGTA report, with $18.3 million written off, for which IRS management did not concur with TIGTA's projected benefits; and three TIGTA reports with $132.9 million written off, for which TIGTA does not agree with the IRS that the benefits have not been realized.*

[3] *This figure includes ten TIGTA reports, with $2,124.5 million written off, for which IRS management did not concur with TIGTA's projected benefits; and two TIGTA reports, with $390.4 million written off, for which TIGTA does not agree with the IRS that the benefits have not been realized.*

The following table presents a summary of OIG, TIGTA, and SIGTARP audit reports with potential monetary benefits that were open for more than one year as of the end of fiscal years 2009, 2010, and 2011.

Number of Reports with Potential Monetary Benefits Open for More than One Year (Dollars In Millions)

	PAR/AFR Report Year	9/30/2009	9/30/2010	9/30/2011
OIG	No. of Reports	0	1	0
	$ Projected Benefits	$ 0	$ 10.5	$ 0
TIGTA	No. of Reports	10	12	11
	$ Projected Benefits	$ 673.8	$ 1,783.7	$ 4,384.6
SIGTARP	No. of Reports	0	0	0
	$ Projected Benefits	$ 0	$ 0	$ 0

The following table presents a summary of the audit reports containing potential monetary benefits, broken out by year of report issuance, on which management decisions were made on or before September 30, 2010, but the final actions had not been taken as of September 30, 2011.

Details of the Audit Reports with Potential Monetary Benefits on Which Management Decisions Were Made On or Before September 30, 2010, But Final Actions Have Not Been Taken as of September 30, 2011 (Dollars In Millions)

Bureau	Report No.	Report Issue Date	Brief Description	Dis-allowed Costs	Funds Put to Better Use	Revenue Enhance-ment	Total	Due Date
IRS	2006-1c-142	9/25/2006	The IRS Contracting Officer (CO) should use the results of the Defense Contract Audit Agency (DCAA) report to fulfill his/her duties in awarding and administering contracts.	$ 32.4	-	-	$ 32.4	10/15/2012 (delayed)
FY 2006	**1**			**$ 32.4**			**$ 32.4**	
FY 2007	**N/A**	**N/A**		-	-	-	-	N/A
FY 2008	**N/A**	**N/A**		-	-	-	-	N/A
IRS	2009-10-107	7/24/2009	IRS should develop procedures requiring that workstation sharing levels are included in space needs assessments. When implementing these procedures, IRS should adjust its space needs to reflect workstation sharing and take action to release any unneeded space identified, where appropriate.	-	30.0	-	30.0	1/15/2014 (delayed)
IRS	2009-40-137	9/24/2009	IRS should develop processes to identify erroneous Health Coverage Tax Credit claims based on criteria used to select taxpayers for examination and reject e-filed tax returns or forward paper-filed tax returns to the Error Resolution function at the time the tax return is filed.	-	9.0	-	9.0	12/15/2012 (delayed)

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Bureau	Report No.	Report Issue Date	Brief Description	Dis-allowed Costs	Funds Put to Better Use	Revenue Enhance-ment	Total	Due Date
IRS	2009-40-138	9/23/2009	IRS should discontinue providing the option to taxpayers of self-identifying by annotating a tax return with "Combat Zone" and continue to provide individuals the option of self-identifying by telephone or electronically.	-	-	1.1	1.1	1/15/2012
IRS	2009-1c-134	9/28/2009	The IRS CO should use the results of the DCAA report to fulfill his/her duties in awarding and administering contracts.	0.1	-	-	0.1	10/15/2012
FY 2009	**4**			**$ 0.1**	**$ 39.0**	**$ 1.1**	**$ 40.2**	
IRS	2010-20-044	5/07/2010	IRS should ensure policies and procedures are established to evaluate and determine which best practices to implement to improve data center energy efficiency	3.2	-	-	3.2	12/15/2011
IRS	2010-30-025	3/23/2010	IRS should ensure that paper and electronically filed returns with Forms 8919 attached are compared to filed Forms SS-8 through a post-filing compliance program, and ensure that paper returns flagged during processing are reviewed and any noncompliance addressed.	-	-	131.1	131.1	1/15/2012
IRS	2010-30-104	9/17/2010	IRS should explore the feasibility of making greater use of Currency Transaction Reports to pursue additional nonfilers and underreporters for audit.	-	-	1,300.0	1,300.0	6/15/2013
IRS	2010-40-043	3/29/2010	IRS should ensure a Service-wide strategy is developed to address retirement provision noncompliance. This strategy should include the development of processes to identify individuals who do not comply with retirement provisions along with compliance efforts to address the noncompliance.	-	-	405.1	405.1	10/15/2012
IRS	2010-40-062	7/13/2010	IRS should use the authority already provided in the law to (1) freeze refunds while contacting those taxpayers with potentially invalid EITC claims or questionable information on their tax returns, (2) require a valid response from the taxpayers before allowing the EITC, and (3) adjust the return if the taxpayer does not respond within a specified time period.	-	1,175.0	-	1,175.0	1/15/2012

Table continued on the next page

Bureau	Report No.	Report Issue Date	Brief Description	Dis-allowed Costs	Funds Put to Better Use	Revenue Enhance-ment	Total	Due Date
IRS	2010-40-117	9/14/2010	IRS should revise the criteria used to determine who will receive a notice to include individuals identified by the Duplicate TIN Use database when (1) a TIN is used as a secondary taxpayer on one tax return and as a dependent and/or for the EITC on another tax return, and (2) a TIN is used as a qualifying child for the child and dependent care credit, adoption credit, education credits, and child tax credit.	-	1,297.6	-	1,297.6	1/15/2013
FY 2010	**6**			**$ 3.2**	**$ 2,472.6**	**$ 1,836.2**	**$ 4,312**	
Total	**12**			**$ 35.7**	**$ 2,511.6**	**$ 1,837.3**	**$ 4,384.6**	

The following table provides a snapshot of OIG and TIGTA audit reports with significant recommendations reported in previous semiannual reports for which corrective actions had not been completed as of September 30, 2010 and September 30, 2011, respectively. OIG and TIGTA define "significant" as any recommendation open for more than one year. There were no "Undecided Audit Recommendations" during the same periods.

Audit Reports with Significant Unimplemented Recommendations				
	9/30/2010		9/30/2011	
	OIG	TIGTA	OIG	TIGTA
No. of Reports	6	24	7	12

SIGTARP issued its first report on TARP-related activity in April 2009. The following table provides a snapshot of the number of recommendations made in SIGTARP audit reports and quarterly reports for which corrective actions had not been completed as of September 30, 2010, and September 30, 2011, respectively. SIGTARP defines a recommendation as "unimplemented" if it is listed as "partially implemented," "in process," or "not implemented" in SIGTARP's quarterly report.

Unimplemented SIGTARP Recommendations		
	9/30/2010	9/30/2011
No. of Unimplemented Recommendations	30	12

III. FINANCIAL MANAGEMENT SYSTEMS FRAMEWORK

Overview

The Department of the Treasury's financial management systems structure consists of financial and mixed systems maintained by the Treasury bureaus and the Department-wide Financial Analysis and Reporting System (FARS). The bureau systems process and record the detailed financial transactions and submit summary-level data to FARS on a scheduled basis. FARS maintains the key financial data necessary for consolidated financial reporting. In addition, the FARS modules also maintain data on the status of audit-based corrective actions. Under this systems structure, the bureaus are able to maintain financial management systems that meet their specific business requirements. On a monthly basis, the required financial data submitted to FARS to meet Departmental analysis and reporting requirements. The Department uses FARS to produce its periodic financial reports as well as the annual Agency Financial Report. This structured financial systems environment enables Treasury to receive an unqualified audit opinion and supports its required financial management reporting and analysis requirements.

The FARS structure consists of the following components:

- Bureau core and financial management systems that process and record detailed financial transactions
- Treasury Information Executive Repository (TIER) - consolidates bureau financial data

- CFO Vision - produces monthly financial statements and performs financial analysis
- JAMES - tracks information on audit findings, recommendations, and planned corrective actions

Bureaus submit summary-level financial data to TIER on a monthly basis, within three business days of the month-end. These data are then used by CFO Vision to generate financial statements and reports on both a Department-wide and bureau-level basis. This structure enables the Department to produce its audited annual financial statements and monthly management reports. During fiscal year 2011, Treasury continued to upgrade its FARS applications to take advantage of technology improvements such as information security and the technical environment.

As part of the Department's enhancement effort, 14 Treasury bureaus and reporting entities are cross-serviced for financial systems by the Bureau of the Public Debt's (BPD) Administrative Resource Center (ARC). Cross-servicing enables these bureaus to have access to core financial systems without having to maintain the necessary technical and systems architectures. BPD/ARC also provides administrative services in the areas of accounting, travel, payroll, human resources, and procurement to Treasury bureaus and offices and to other federal entities to support core business activities. In an ongoing effort to streamline its financial systems environment, Treasury continues to work with the bureaus to evaluate plans for continuous improvement to their financial management systems structure.

Continued Improvement

Treasury's target financial management systems structure continues to build upon the current FARS foundation. Treasury has enhanced FARS to support new financial and performance requirements and continues to provide management with the appropriate tools needed to align the Department's goals and objectives.

In fiscal year 2011, the TIER Focus Group continued to meet to improve communication with the bureaus and coordinate changes impacting financial management systems and financial operations. Treasury enhanced the FARS applications to be Section 508 compliant, which assists users with disabilities in accessing reports and performing data entry. In addition, Treasury upgraded the FARS servers to improve performance.

The IRS continued to modernize its tax administration systems, improving the speed in which the IRS processes tax returns. In fiscal year 2011, the Customer Account Data Engine (CADE) posted over 40 million tax returns and over 35.1 million refunds. The Account Management Services System, which stores taxpayer information, has been enhanced to eliminate the processing of paper and reduce case cycle time from 14 days to zero (real-time); and IRS upgraded the servers which host the financial management system. In fiscal year 2012, CADE is expected to be a single integrated tax processing environment, resulting in even faster refunds, improved customer service, elimination of notices based on out-of-date information, faster resolution of taxpayer account issues, and better online tools and services for taxpayers.

In fiscal year 2011, BPD/ARC upgraded the core financial management systems platform to increase its responsiveness in producing financial management reports and to align with new financial reporting governance standards. BPD/ARC also began implementing the Internet Payment Platform system to convert a paper-based process to an electronic centralized invoice payment information service for use by their customers and suppliers.

In fiscal years 2012 and 2013, the Department and BPD/ARC plan to develop their financial management system to transition to the Common Government-wide Accounting System and plan to meet compliance expectations. In addition, the Department and BPD/ARC are developing projects which will capture business analytics data at a high level to gain insight on business performance and assist with business planning.

The Bureau of Engraving and Printing (BEP) completed the first phase of replacing its legacy core manufacturing system to a fully integrated system and converted the general ledger, accounts receivable, and fixed assets modules to the new manufacturing system in fiscal year 2011. The second phase will be implemented early in fiscal year 2012, and will include the conversion of supply chain management, manufacturing management, project accounting, and contract lifecycle management modules to the new system.

APPENDIX E: GLOSSARY OF ACRONYMS

Glossary of Acronyms	
ABS	Asset-Backed Securities
ACA	Patient Protection and Affordable Care Act
ACD	Advanced Counterfeit Deterrent
ACH	Automated Clearing House
AD	Audit Division
ADR	Alternative Dispute Resolution
AFR	Agency Financial Report
AGI	Adjusted Gross Income
AGP	Asset Guarantee Program
AIFP	Automotive Industry Financing Program
AIG	American International Group, Inc.
AML	Anti-money laundering
AMS	Account Management Services
APR	Annual Performance Report
ARC	Administrative Resource Center
ASM/CFO	Assistant Secretary for Management & Chief Financial Officer
ATFC	Afghanistan Threat Finance Cell
AUR	Automated Underreporter
BCPO	Bureau Chief Procurement Officer
BEP	Bureau of Engraving and Printing
BPD	Bureau of the Public Debt
BSA	Bank Secrecy Act
BSM	Business Systems Modernization
CADE	Customer Account Data Engine
CAP	Capital Assistance Program
CAP	Compliance Assurance Process
CAR	Collection Activity Report
CBP	U.S. Customs and Border Patrol
CBLI	Consumer and Business Lending Initiative
CBO	Congressional Budget Office
CCMM	Collections and Cash Management Modernization
CDCI	Community Development Capital Initiative
CDFI	Community Development Financial Institutions
CDS	Credit Default Swaps
CFPB	Consumer Financial Protection Bureau
CFO	Chief Financial Officer
CFS	Consolidated Financial Statements
CFTC	Commodity Futures Trading Commission
CHCO	Chief Human Capital Officer
CHIPRA	Children's Health Insurance Program Reauthorization Act of 2009
CI	Criminal Investigation (or Investigator)

Glossary of Acronyms	
CIF	Climate Investment Fund
CIGFO	Council of Inspectors General on Financial Oversight
CIO	Chief Information Officer
CMBS	Commercial Mortgage Backed Securities
CMF	Capital Magnet Fund
CO	Contracting Officer
COBRA	Consolidated Omnibus Budget Reconciliation Act of 1985
COP	Congressional Oversight Panel
COSO	Committee of Sponsoring Organizations of the Treadway Commission
CPP	Capital Purchase Program
CRA	Community Reinvestment Act
CRE	Commercial Real Estate
Credit CARD Act	Credit Card Accountability, Responsibility, and Disclosure Act of 2009
CSI	Customer Service Index
CSR	Customer Service Representative
CSRS	Civil Service Retirement System
CTF	Clean Technology Fund
DASHR/CHCO	Office of the Deputy Assistant Secretary for Human Resources/Chief Human Capital Officer
DASMB	Deputy Assistant Secretary for Management and Budget
DASPTR	Deputy Assistant Secretary for Privacy, Transparency, and Records
DCAA	Defense Contract Audit Agency
DCFO	Deputy Chief Financial Officer
DCIA	Debt Collection Improvement Act of 1996
DCP	Office of D.C. Pensions
DIP	Debtor-in-Possession
DISC	Discontinued
DMAS	Debt Management Account System
DO	Departmental Offices
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010
DOJ	Department of Justice
EBRD	European Bank for Reconstruction and Development
ECM	Enterprise Content Management
EEO	Equal Employment Opportunity
EESA	Emergency Economic Stabilization Act of 2008
EFT	Electronic Funds Transfer
EFTPS	Electronic Federal Tax Payment System
EGTRRA	Economic Growth and Tax Relief Reconciliation Act
EITC	Earned Income Tax Credit
EO	Executive Order

Glossary of Acronyms	
ERP	Economic Recovery Payment
ESC	Executive Steering Committee
ESF	Exchange Stabilization Fund
ETD	Error Tracking Database
EU	European Union
FAET	Firearms and Ammunition Excise Tax
Fannie Mae	Federal National Mortgage Association
FARS	Financial Analysis and Reporting System
FASAB	Federal Accounting Standards Advisory Board
FATCA	Foreign Account Tax Compliance Act
FATF	Financial Action Task Force
FCDA	Foreign Currency Denominated Assets
FCRA	Federal Credit Reform Act
FDIC	Federal Deposit Insurance Corporation
FECA	Federal Employees' Compensation Act
FEGLI	Federal Employees Group Life Insurance
FEHBP	Federal Employees Health Benefits Program
FFB	Federal Financing Bank
FFETF	Financial Fraud Enforcement Task Force
FFIEC	Federal Financial Institutions Examination Council
FFMIA	Federal Financial Management Improvement Act
FHA	Federal Housing Administration
FHFA	Federal Housing Finance Agency
FHLB	Federal Home Loan Bank
FinCEN	Financial Crimes Enforcement Network
FinTRACA	Financial Transactions and Reports Analysis Center of Afghanistan
FIO	Federal Insurance Office
FISMA	Federal Information Security Management Act
FIRST	Financial Information and Reporting Standardization
FIST	Fraud Investigative Strike Team
FIU	Financial Intelligence Unit
FMFIA	Federal Managers' Financial Integrity Act
FMIS	Financial Management Information System
FMS	Financial Management Service
FOIA	Freedom of Information Act
FONL	Formulas Online
FR	Consolidated Financial Report of the United States Government
FRB	Federal Reserve Bank
FRBNY	Federal Reserve Bank of New York
Freddie Mac	Federal Home Loan Mortgage Corporation
FSB	Financial Stability Board
FSOC	Financial Stability Oversight Council
FST	Floor Stocks Tax
FTD	Federal Tax Deposit
FTHBC	First-Time Homebuyer Credit

Glossary of Acronyms	
FTO	Fine Troy Ounce
FY	Fiscal Year
G-7	Group of Seven
G-20	Group of Twenty
GAAP	Generally Accepted Accounting Principles
GAB	General Arrangement to Borrow
GAFSP	Global Agriculture and Food Security Program
GAIS	Government Agency Investment Services
GAO	Government Accountability Office
GEF	Global Environmental Facility
GFRA	General Fund Receipt Account
Ginnie Mae	Government National Mortgage Association
GM	General Motors Company
GMAC	General Motors Acceptance Corporation
GPRA	Government Performance and Results Act
GSA	General Services Administration
GSE	Government Sponsored Enterprise
GWA	Government-wide Accounting
HAMP	Home Affordable Modification Program
HCTC	Health Coverage Tax Credit
HEAT	Health Care Fraud Prevention and Enforcement Action Team
HECM	Home Equity Conversion Mortgage
HERA	Housing and Economic Recovery Act
HFA	Housing Finance Agency
HFFI	Healthy Food Financing Initiative
HHF	Hardest Hit Fund
HHS	Department of Health and Human Services
HIRE	Hiring Incentives to Restore Employment Act of 2010
HRF	Haitian Reconstruction Fund
HSPD	Homeland Security Presidential Directive
HUD	Department of Housing and Urban Development
I&E	Inspections and Evaluations
IAP	International Assistance Programs
IDB	Inter-American Development Bank
IEEPA	International Emergency Economic Powers Act
IFI	International Financial Institution
IFSR	Iranian Financial Sanctions Regulations
IG	Inspector General
IMF	International Monetary Fund
IPERA	Improper Payments Elimination and Recovery Act of 2010
IPIA	Improper Payments Information Act of 2002
IPP	Internet Payment Platform
IPPIN	Identify Protection Personal Identification Number
IRC	Internal Revenue Code
IRIS	Integrated Revenue Information System

Glossary of Acronyms	
IRISL	Islamic Republic of Iran Shipping Lines
IRS	Internal Revenue Service
ISO	International Organization for Standardization
IT	Information Technology
ITA	Interactive Tax Law Assistant
ITR	Iranian Transactions Regulations
JAMES	Joint Audit Management Enterprise System
Kingpin Act	Foreign Narcotics Kingpin Designation Act
LIBOR	London Interbank Offered Rate
LIC	Low-Income Community
MBS	Mortgage-Backed Security
MDB	Multilateral Development Bank
MeF	Modernized Electronic File
MHA	Making Home Affordable Program
MOU	Memorandum of Understanding
MRADR	Market Risk Adjusted Discount Rate
MSB	Money Services Business
MV&S	Modernization, Vision, and Strategy
NAB	New Arrangement to Borrow
NDIC	National Drug Intelligence Center
NEI	National Export Initiative
NOL	Net Operating Loss
NPRM	Notice of Proposed Rulemaking
NRC	National Revenue Center
NTDO	Non-Treasury Disbursing Office
OA	Office of Audits
OCC	Office of the Comptroller of the Currency
ODM	Office of Debt Management
OECD	Organization for Economic Co-operation and Development
OFAC	Office of Foreign Assets Control
OFAS	Office of the Fiscal Assistant Secretary
OFIT	Office of Financial Innovation and Transformation
OFP	Office of Fiscal Projections
OFPP	Office of Federal Procurement Policy
OFR	Office of Financial Research
OFS	Office of Financial Stability
OI	Office of Investigations
OIA	Office of Intelligence and Analysis
OID	Original Issue Discount
OIG	Office of Inspector General
OMB	Office of Management and Budget
OPCL	Office of Privacy and Civil Liberties
OPE	Office of the Procurement Executive
OPEB	Other Post-Employment Benefits
OPM	Office of Personnel Management

Glossary of Acronyms	
ORB	Other Retirement Benefits
OTC	Over-the-Counter
OTS	Office of Thrift Supervision
PACT Act	Prevent All Cigarette Trafficking Act of 2009
PAM	Payments Application Modernization
PAR	Performance and Accountability Report
PB	President's Budget
PCA	Planned Corrective Action
PII	Personal Identifiable Information
P.L.	Public Law
PONL	Permits Online
PP&E	Property, Plant, and Equipment
PPIF	Public-Private Investment Fund
PPIP	Public-Private Investment Program
PSPA	Preferred Stock Purchase Agreements
PTIN	Preparer Tax Identification Number
QEO	Qualified Equity Offering
QFI	Qualified Financial Institution
QTDP	Qualified Therapeutic Discovery Project
Recovery Act	American Recovery and Reinvestment Act of 2009
RMBS	Residential Mortgage Backed Securities
RRACS	Redesign Revenue Accounting Control System
S&ED	Strategic and Economic Dialogue
S.A.F.E. Act	Secure and Fair Enforcement for Mortgage Licensing Act of 2008
SAR	Suspicious Activity Report
SAS	Statement on Auditing Standards
SBA	Small Business Administration
SBLF	Small Business Lending Fund
SBR	Statement of Budgetary Resources
SCAP	Supervisory Capital Assessment Program
SCF	Strategic Climate Fund
SCMA	Strategic Cash Management Agreements
SDR	Special Drawing Rights
SEC	Securities and Exchange Commission
SES	Senior Executive Service
SFFAS	Statement of Federal Financial Accounting Standards
SFP	Supplementary Financing Program
SIG	Special Inspector General
SIGTARP	Special Inspector General for TARP
SME	Small and Medium-sized Enterprise
SNC	Statement of Net Cost
SOI	Statistics of Income
SOMA	System Open Market Account
SPSPA	Senior Preferred Stock Purchase Agreements
SPV	Special Purpose Vehicle

Glossary of Acronyms	
SSBCI	State Small Business Credit Initiative
SSG	Senior Supervisors' Group
SSP	Shared Service Provider
SSP	Stable Share Price
STR	Suspicious Transaction Report
TAC	Taxpayer Assistance Center
TAIFF	Troubled Asset Insurance Finance Fund
TALF	Term Asset-Backed Securities Loan Facilities
TARP	Troubled Asset Relief Program
TCE	Tax Counseling for the Elderly
TCLP	Temporary Credit and Liquidity Program
TE/GE	Tax Exempt and Government Entities
TEOAF	Treasury Executive Office for Asset Forfeiture
TFF	Treasury Forfeiture Fund
TFFC	Office of Terrorist Financing and Financial Crimes
TFI	Terrorism and Financial Intelligence
TFR	Thrift Financial Reports
TFTP	Terrorist Finance Tracking Program
TIER	Treasury Information Executive Repository
TIGTA	Treasury Inspector General for Tax Administration
TIP	Targeted Investment Program
TIN	Taxpayer Identification Number
TIPS	Treasury Inflation-Protected Securities
TOP	Treasury Offset Program
TPP	Trans-Pacific Partnership
TRIA	Terrorism Risk Insurance Act
TTB	Alcohol and Tobacco Tax and Trade Bureau
TWEA	Trading with the Enemy Act
UN	United Nations
UNSCR	United Nations Security Council Resolution
UP	Unemployment Program
USA PATRIOT Act	Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001
USDA	United States Department of Agriculture
USC	United States Code
USPS	United States Postal Service
USSGL	United States Standard General Ledger
UTF	Unemployment Trust Fund
VA	Department of Veterans Affairs
VITA	Volunteer Income Tax Assistance
WHBAA	Worker, Homeownership, and Business Assistance Act of 2009
WMD	Weapons of Mass Destruction
WTO	World Trade Organization

Website Information

Treasury	www.treasury.gov
Alcohol and Tobacco Tax and Trade Bureau	www.ttb.gov
Bureau of Engraving & Printing	www.bep.gov
Bureau of the Public Debt	www.publicdebt.treas.gov
Community Development Financial Institutions Fund	www.cdfifund.gov
Financial Crimes Enforcement Network	www.fincen.gov
Financial Management Service	www.fms.treas.gov
Internal Revenue Service	www.irs.gov
Office of the Comptroller of the Currency	www.occ.gov
U.S. Mint	www.usmint.gov
The Financial Stability Plan	www.financialstability.gov
Making Home Affordable Program	www.makinghomeaffordable.gov
The Recovery Act	www.recovery.gov
Office of Inspector General	www.treasury.gov/oig
Treasury Inspector General for Tax Administration	www.tigta.gov
Office of the Special Inspector General for the Troubled Asset Relief Program	www.sigtarp.gov