United States Government Accountability Office

GAO

Report to the Secretary of the Treasury

November 2006

FINANCIAL AUDIT

IRS's Fiscal Years 2006 and 2005 Financial Statements

Redesign of Form 1040 and other steps toward reducing tax complexity: See p. 58 of report (P.78 in PDF pagination)

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GAO-07-136

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Highlights

Highlights of GAO-07-136, a report to the Secretary of the Treasury

November 2006

FINANCIAL AUDIT

IRS's Fiscal Years 2006 and 2005 Financial Statements

Why GAO Did This Study

Because of the significance of Internal Revenue Service (IRS) collections to overall federal receipts and, in turn, to the consolidated financial statements of the U.S. government, which GAO is required to audit, and Congress's interest in financial management at IRS, GAO audits IRS's financial statements annually to determine whether (1) the financial statements are reliable and (2) IRS management maintained effective internal controls. GAO also tests IRS's compliance with selected provisions of significant laws and regulations and its financial systems' compliance with the Federal Financial Management Improvement Act of 1996 (FFMIA).

What GAO Recommends

In prior audits, GAO made numerous recommendations to IRS to address issues comprising the material weaknesses and reportable condition and compliance matters that persisted during fiscal year 2006. GAO will continue to monitor IRS's progress in implementing the 72 recommendations that remain open as of the date of this report. IRS agreed with the report's findings and that it fairly presents IRS's progress and challenges. IRS said it had made significant progress in addressing financial management issues and noted that it had a strong management team to continue improving financial management with an increased focus on internal controls and information security.

www.gao.gov/cgi-bin/getrpt?GAO-07-136.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Steven J. Sebastian at (202) 512-3406 or sebastians@gao.gov.

What GAO Found

In GAO's opinion, IRS's fiscal years 2006 and 2005 financial statements are fairly presented in all material respects. Because of serious internal control and financial management systems deficiencies, IRS again had to rely extensively on resource-intensive compensating processes to prepare its financial statements. Because of these serious internal control and financial management deficiencies, IRS did not, in GAO's opinion, maintain effective internal controls over financial reporting (including safeguarding of assets) or compliance with laws and regulations, and thus did not provide reasonable assurance that losses, misstatements, and noncompliance with laws material in relation to the financial statements would be prevented or detected on a timely basis.

IRS has continued to make great strides in addressing its financial management challenges and has substantially mitigated several material weaknesses in its internal controls. IRS made significant progress in developing its cost accounting module, which was part of the first phase of the Integrated Financial System (IFS), implemented in fiscal year 2005. IRS also improved the reliability of its property and equipment records, and we no longer consider this issue to be a reportable condition. However, because of budgetary concerns and advances in automated financial management system technologies, IRS is no longer committed to the future releases of IFS that were once intended to resolve many of its most serious financial management issues, and is currently considering alternatives. IRS has not yet committed to an alternative approach nor has funding been appropriated. Additionally, IRS has not determined how to resolve issues related to the lack of integration between IFS and its tax processing systems. Consequently, it is unclear how or when these issues will be resolved. GAO continues to consider issues related to IRS's controls over financial reporting, management of unpaid assessments, collection of revenue and issuance of tax refunds, and information security to be material weaknesses. Although IRS continued to make progress in addressing weaknesses in controls over hard-copy taxpayer receipts and data, GAO concluded that remaining issues related to this activity constituted a reportable condition. In addition, IRS was not always in compliance with a law concerning the timely release of tax liens.

IRS management faces serious challenges from its continued use of obsolete financial management systems that do not substantially comply with FFMIA requirements. These challenges adversely affect IRS's ability to fulfill its responsibilities as the nation's tax collector because it is unable to obtain comprehensive, timely, accurate, and useful information for day-to-day decision making. Solving IRS's financial management problems depends largely on the ultimate success of IRS's ongoing systems modernization efforts.

Contents

Abbreviations

CADE	Customer Account Data Engine
CDDB	Custodial Detailed Database
CFO	chief financial officer
EFDS	Electronic Fraud Detection System
EITC	earned income tax credit
FFMIA	Federal Financial Management Improvement Act of 1996
FFMSR	*Federal Financial Management System Requirements*
FIA	Federal Managers' Financial Integrity Act of 1982
FISMA	Federal Information Security Management Act of 2002
IFS	Integrated Financial System
IPIA	Improper Payments Information Act of 2002
IRS	Internal Revenue Service
JFMIP	Joint Financial Management Improvement Program
OMB	Office of Management and Budget
P&E	property and equipment
PAR	performance and accountability report
SGL	*U.S. Government Standard General Ledger*

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Comptroller General
of the United States

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

November 9, 2006

The Honorable Henry M. Paulson, Jr.
The Secretary of the Treasury

Dear Mr. Secretary:

The accompanying report presents the results of our audits of the financial statements of the Internal Revenue Service (IRS) as of, and for the fiscal years ending, September 30, 2006 and 2005. We performed our audits in accordance with the Chief Financial Officers (CFO) Act of 1990, as expanded by the Government Management Reform Act of 1994. This report contains our (1) unqualified opinions on IRS's financial statements, (2) opinion that IRS's internal controls were not effective as of September 30, 2006, and (3) conclusion that IRS was not in compliance with one provision of the laws and regulations we tested and that IRS's financial management systems were not in substantial compliance with the requirements of the Federal Financial Management Improvement Act of 1996.

Our unqualified opinions on IRS's fiscal years 2006 and 2005 financial statements were made possible in part by the continued extraordinary efforts of IRS senior management and staff to compensate for serious internal control and financial management systems deficiencies. IRS is currently in the midst of a major business systems modernization effort that is ultimately intended to resolve its most serious financial systems challenges. However, it is unclear when this effort will be completed or if it will be successful. In the interim, preparing reliable financial statements will continue to be a difficult challenge for IRS, requiring continued use of extraordinary compensating measures. To date, these measures have proved successful: for the seventh consecutive year, IRS has received an unqualified opinion on its financial statements and, for the fifth consecutive year, the audit was completed and the report issued by November 15.

IRS has made great strides over the last several years in addressing its financial management challenges and has resolved or substantially mitigated several material weaknesses and other reportable conditions in its internal controls. For example, during fiscal year 2006, IRS improved the accuracy and reliability of its property and equipment (P&E) accounting records by making enhancements to accounting code definitions that make it easier for users to select the proper accounting codes for recording a transaction, improving coordination among units involved in processing P&E activity, and streamlining its analysis of P&E transactions most susceptible to misclassification. These improvements, combined with progress we reported last year, enabled us to conclude that remaining issues related to P&E no longer constitute a reportable condition.

During fiscal year 2006, IRS continued to expand its use of the capabilities contained in the first phase, or release, of its Integrated Financial System (IFS), which was implemented in fiscal year 2005. For example, IRS has populated the system's cost module with 2 years of data and made significant progress in defining how costs will be allocated to various internal organizations, and it has successfully used IFS to generate its statement of net cost for the first time. This release of IFS provides for improved audit trails and more timely information for such activities and transactions as travel, purchases of goods and services, and budgetary activities.

However, IRS cannot fully address the financial management issues caused by the limitations of its automated systems without successful implementation of the additional capabilities that were originally planned to be provided by future releases of IFS, such as procurement and workload management. Because of ongoing technological advances and budgetary constraints, IRS is no longer committed to implementing additional releases of IFS, but rather is considering other options available to provide these capabilities, including utilizing a private shared service provider or a federal center of excellence.[1] However, IRS has not decided what approach it will take or obtained approval for the necessary funding. It is therefore unclear how or when IRS will resolve the remaining related financial management systems limitations. In formulating its strategy for dealing with these issues, IRS will also need to address how IFS will ultimately be integrated with the systems that support financial management of its tax administration functions as well as addressing the limitations of those systems if it is to fully resolve many of its long-standing financial management challenges.

[1]A shared service provider is an organization that performs a service, such as electronic data processing, for multiple customers from a central location. A federal center for excellence is a federally owned shared service provider that serves multiple federal organizations.

To resolve these problems, IRS is depending on its ongoing systems modernization effort, which is intended to address the full range of problems caused by its outdated legacy information systems. In 1995, we designated financial management and systems modernization at IRS as high-risk areas.[2] We continue to consider these issues as high risk and include them in our Business Systems Modernization high-risk area.[3]

Among the most serious financial management issues still remaining to be addressed is the continued material weakness in IRS's information security. As IRS continues its efforts to modernize its financial and operational systems, it is critical that IRS take actions to establish and maintain more effective information security controls on a continuing basis, through an ongoing cycle of risk management activities, to protect the processing, storage, and transmission of financial and sensitive data. Until IRS successfully manages its information security risks, management will not have assurance over the integrity and reliability of the information generated from the new financial management system, and IRS's opportunities for further improvements in financial management will be limited.

We commend IRS for the improvements it has continued to make in its financial processes and operations. Nonetheless, IRS management and staff will continue to be challenged to sustain the level of effort needed to produce reliable financial statements until the agency is able to fully address the underlying systems and internal control issues that have made this process so time consuming and resource intensive. IRS continues to lack accurate, useful, and timely financial information and sound controls with which to make fully informed decisions and to ensure ongoing accountability, which is a primary objective of the CFO Act. IRS has made significant progress in addressing its serious control and systems deficiencies and improving financial management during the past 10 years. It is important that these financial management initiatives continue in order to achieve comprehensive and lasting financial management reform.

The agency also continues to face a significant challenge in strengthening its enforcement of the nation's tax laws, another challenge at IRS that we

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

[3]GAO, *High-Risk Series: An Update*, GAO-05-207 (Washington, D.C.: January 2005).

have designated as high risk.[4] As we have previously reported, the resources IRS has been able to dedicate to enforcing the tax laws have not kept pace with the increases it has seen in its enforcement workload. At the same time, IRS continues to face significant compliance-related issues, including combating abusive tax shelters and tax schemes, on which it is placing a high priority. Critical to IRS's efforts in improving enforcement and, ultimately, taxpayer compliance, is the need to have current information on the rate of compliance, both overall and by type of taxpayer. IRS has completed a study of the rate of compliance with the nation's tax laws by individuals and some small business taxpayers, and has begun a study of S-corporations' compliance.[5] However, IRS has no approved plans to repeat its study on individual taxpayers, or to conduct research on other significant components of the tax gap.[6] As we have noted before, it is critical that such efforts be continued as, without current information on noncompliance, the challenge of targeting IRS enforcement resources to areas where they would prove most effective is problematic.

The accompanying report also discusses other significant issues that we considered in performing our audit and in forming our conclusions, which we believe should be brought to the attention of IRS management and users of IRS's financial statements.

We are sending copies of this report to the Chairmen and Ranking Minority Members of the Senate Committee on Appropriations; Senate Committee on Finance; Senate Committee on Homeland Security and Governmental Affairs; Subcommittee on Taxation and IRS Oversight, Senate Committee on Finance; House Committee on Appropriations; House Committee on Ways and Means; and House Committee on Government Reform. We are also sending copies of this report to the Chairman and Vice Chairman of the Joint Committee on Taxation, the Commissioner of Internal Revenue, the Director of the Office of Management and Budget, the Chairman of the IRS Oversight Board, and other interested parties. Copies will be made

[4]GAO-05-207.

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

[6]The tax gap is an estimate of the amount of taxes for a given tax year that are owed to the federal government but have not been paid by taxpayers. IRS estimates the fiscal year 2006 tax gap to be about $345 billion.

available to others upon request. In addition, the report is available at no charge on GAO's Web site at http://www.gao.gov.

This report was prepared under the direction of Steven J. Sebastian, Director, Financial Management and Assurance, who can be reached at (202) 512-3406 or sebastians@gao.gov. If I can be of further assistance, please call me at (202) 512-5500. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report.

Sincerely yours,

David M. Walker
Comptroller General
of the United States

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Comptroller General of the United States

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

To the Commissioner of Internal Revenue

In accordance with the Chief Financial Officers (CFO) Act of 1990, as expanded by the Government Management Reform Act of 1994,[1] this report presents the results of our audits of the financial statements of the Internal Revenue Service (IRS) for fiscal years 2006 and 2005. The financial statements report the assets, liabilities, net position, net costs, changes in net position, budgetary resources, financing, and custodial activity related to IRS's administration of its responsibilities for implementing federal tax legislation. The financial statements do not include an estimate of the amount of taxes that are owed the federal government but have not been paid by taxpayers, often referred to as the tax gap,[2] nor do they include information on tax expenditures.[3]

In its role as the nation's tax collector, IRS has a demanding responsibility in collecting taxes, processing tax returns, and enforcing the nation's tax laws. IRS is a large and complex organization, adding unique operational challenges for management. IRS employs tens of thousands of people in 10 service center campuses, 3 computing centers, and numerous other field offices throughout the United States. In fiscal years 2006 and 2005, IRS collected about $2.5 trillion and $2.3 trillion, respectively, in tax payments; processed hundreds of millions of tax and information returns; and paid about $277 billion and $267 billion, respectively, in refunds to taxpayers.

One of the largest obstacles continuing to face IRS management is the agency's lack of an integrated financial management system capable of producing the accurate, useful, and timely information IRS managers need to assist in making day-to-day decisions, which is a primary objective of the CFO Act. While progress continues to be made to modernize its financial

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

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

[3] Tax expenditures are revenue losses—the amount of revenue that the government forgoes—resulting from federal tax provisions that grant special tax relief for certain kinds of behavior by taxpayers or for taxpayers in special circumstances. Under U.S. generally accepted accounting principles, tax expenditure amounts are not required to be disclosed as part of federal agencies' financial statements, but certain information on tax expenditures can be included as other accompanying information to the financial statements.

management capabilities, IRS nonetheless confronted many of the pervasive internal control weaknesses that we have reported each year since we began auditing its financial statements in fiscal year 1992,[4] though it continued to make strides in addressing its financial management challenges. In fiscal year 2006, for the seventh consecutive year, IRS was able to produce financial statements covering its tax custodial and administrative activities that are fairly stated in all material respects. Moreover, for the fifth consecutive year, IRS was able to issue its final audited financial statements only a month and a half after the end of the fiscal year. However, until its systems are replaced, IRS will continue to be challenged to sustain the level of effort needed to produce reliable financial statements timely.

Throughout fiscal year 2006, IRS continued to make significant progress in its efforts to address its weaknesses in controls over several areas, including accountability over property and equipment (P&E), management and reporting of unpaid assessments, reliability of financial reporting, and security over hard-copy taxpayer receipts and data. For example, IRS improved the accuracy and reliability of its P&E accounting records by (1) enhancing the accounting code definitions in its new financial management system to make it easier for users to select the proper accounting codes for recording transactions, (2) improving coordination among units involved in processing P&E activity, and (3) streamlining its analysis of P&E transactions most susceptible to misclassification. These improvements, combined with the progress reported in our prior year audit, enabled us to conclude that remaining issues related to P&E no longer constitute a reportable condition.[5]

IRS also successfully implemented the first phase of the Custodial Detailed Database (CDDB), which is intended to ultimately serve as a link between IRS's master files[6] and its general ledger for tax administration activities. The first phase contains programs to analyze and classify for financial reporting purposes related taxpayer accounts associated with unpaid

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

[5]Reportable conditions are matters coming to our attention that in our judgment, should be communicated because they represent significant deficiencies in the design or operation of internal controls that could adversely affect IRS's ability to meet the objectives described in this report.

[6]IRS's master files contain detailed records of taxpayer accounts.

payroll taxes.[7] Although IRS's use of CDDB in fiscal year 2006 improved its process for deriving estimates of its various unpaid assessment categories, IRS continues to lack a subsidiary ledger for unpaid assessments and must still use a labor-intensive manual compensating process to estimate the year-end balances of those various unpaid assessment categories for external reporting. Full operational capability of CDDB is several years away and depends on the successful implementation of future system releases. Additionally, CDDB continues to rely on IRS's master files for the information it contains.

During fiscal year 2006, IRS continued to expand processing of the less complex individual tax returns through its Customer Account Data Engine (CADE), the system being implemented to replace IRS's master files. In its fiscal year 2006 Management Discussion and Analysis, IRS reported that during the fiscal year 2006 tax filing season,[8] CADE processed over 7.3 million individual returns and over $3.4 billion in refunds. This represents an increase of nearly 6 million returns and $3 billion in refunds processed by CADE compared to the same period last year. However, IRS's detailed plans for completion of the CADE project only extend through release 7, which is intended to replace the master file for individual tax returns.[9] However, these plans do not include plans or schedules for additional CADE release(s) to replace the master file for business tax returns, and it is unclear when CADE will be fully implemented.

IRS also improved its financial reporting capabilities in fiscal year 2006 through expanded use of the capabilities of the Integrated Financial System (IFS), the first release of which was implemented in fiscal year 2005. IFS was originally intended to resolve many of the issues discussed in this

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[7]When a company does not pay the taxes it withholds from employees' wages, such as Social Security or individual income tax withholdings, IRS has the authority to assess all responsible officers individually for the taxes withheld from employees. Although assessed to multiple parties, the liability need only be paid once. Thus, IRS may record assessments against each of several individuals for the employee-withholding component of the payroll tax liability of a given business in an effort to collect the total tax liability of the business. The assessments made against business officers are known as trust fund recovery penalties. See 26 U.S.C. § 6672 and implementing IRS guidance in the Internal Revenue Manual at § 4.23.9.13, Trust Fund Recovery Penalty (Mar. 1, 2003).

[8]The tax filing season for individuals primarily occurs from January 1 through April 15 of each year.

[9]Department of the Treasury, Internal Revenue Service, *Business Systems Modernization Fiscal Year 2006 & 2007 Expenditure Plan* (August 2006).

report and replace the outdated financial management system IRS used previously to process and report administrative transactions, such as procurement and utilization of budgetary resources. During fiscal year 2006, IRS improved its financial reporting capabilities by populating the cost accounting module of IFS with another year of cost data, and by establishing a new cost allocation methodology to take advantage of the system's cost allocation capacity and defining how those costs will be allocated to various IRS units. However, opportunities for further improvement in IRS's financial reporting in the near term will be limited as IRS is not committed to future releases of IFS and is currently reevaluating its approach to achieving the objectives originally envisioned through implementation of these additional releases. IRS has not decided what approach it will take or obtained approval for the related funding necessary to bring it to fruition. In addition, IRS has not addressed how IFS will ultimately be integrated with those systems that support financial management of IRS's tax administration functions, including its collection of tax revenue receipts; disbursement of tax refunds; and identification, management, and collection of outstanding federal taxes. It is therefore unclear how or when IRS will resolve its remaining related financial management systems limitations.

While notable improvements were made throughout fiscal year 2006, control deficiencies over financial reporting, management of unpaid assessments, and collection of revenue and issuance of tax refunds continued to represent material weaknesses.[10] These weaknesses are caused primarily by IRS's continued reliance on outdated automated systems to provide the financial information that management needs to make decisions, and similar weaknesses and problems will continue to exist until its systems are replaced. In addition, we continue to consider issues related to information security to be a material weakness. The persistent, serious deficiencies in information security increase the risk that confidential IRS and taxpayer information will be compromised and have serious implications related to the reliability of financial management information produced by IRS's systems. Additionally, while we continued to note significant improvement, we still consider control deficiencies in physical security over taxpayer receipts and data to be a reportable condition requiring further attention by IRS management.

[10]A material weakness is a reportable condition that precludes the entity's internal controls from providing reasonable assurance that material misstatements in the financial statements would be prevented or detected on a timely basis.

Opinion on IRS's Financial Statements

IRS's financial statements, including the accompanying notes, present fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, IRS's assets, liabilities, net position, net costs, changes in net position, budgetary resources, financing, and custodial activity as of, and for the fiscal years ended, September 30, 2006, and September 30, 2005.

However, misstatements may nevertheless occur in other financial information reported by IRS as a result of the internal control weaknesses described in this report.

IRS's financial statements include tax revenues collected during the fiscal year as well as the total unpaid taxes for which IRS and the taxpayers or courts agree on the amounts owed. Cumulative unpaid tax assessments for which there is no future collection potential or for which there is no agreement on the amounts owed are not reported in the financial statements. Rather, they are reported as write-offs and compliance assessments, respectively, in supplemental information to IRS's financial statements. Also, in conformity with U.S. generally accepted accounting principles, to the extent that taxes owed in accordance with the nation's tax laws are not reported by taxpayers and are not identified through IRS's various enforcement programs, they are not reported in the financial statements nor in supplemental information to the financial statements. Additionally, in conformity with U.S. generally accepted accounting principles, tax expenditures, which represent the amount of revenue the government forgoes resulting from federal tax provisions that grant special tax relief for certain kinds of behavior by taxpayers or for taxpayers in special circumstances, are not reported in the financial statements.

Opinion on Internal Controls

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

Despite its material weaknesses in internal controls and its systems deficiencies, IRS was able to prepare financial statements that were fairly stated in all material respects for fiscal years 2006 and 2005. Nonetheless, IRS continues to face the following key issues that represent material weaknesses in internal controls:

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

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

- weaknesses in controls over the identification and collection of tax revenues due the federal government and over the issuance of tax refunds, resulting in lost revenue to the federal government and potentially billions of dollars in improper payments; and

- weaknesses in information security controls, resulting in increased risk of unauthorized individuals being allowed to access, alter, or abuse proprietary IRS programs and electronic data and taxpayer information.

The material weaknesses in internal controls noted above may adversely affect any decision by IRS's management that is based, in whole or in part, on information that is inaccurate because of these weaknesses. In addition, unaudited financial information reported by IRS, including performance information, may also contain misstatements resulting from these weaknesses.

In addition to the material weaknesses discussed above, we identified one reportable condition, which, although not a material weakness, represents a significant deficiency in the design or operation of internal controls that could adversely affect IRS's ability to meet the internal control objectives described in this report. This condition involves deficiencies in controls over hard-copy tax receipts and taxpayer data, which increase the government's and taxpayers' risk of loss or inappropriate disclosure of taxpayer data.

We have reported on these material weaknesses and the reportable condition in prior audits and have provided IRS recommendations to address these issues. Seventy-two of these recommendations were still open as of the date of this report.[11] IRS continues to make strides in resolving these matters. We will follow up in future audits to monitor IRS's progress in implementing these recommendations. For more details on these issues, see appendix I.

As part of our fiscal year 2006 financial audit, we evaluated IRS's implementation of OMB's revised Circular No. A-123, *Management's Responsibility for Internal Control*, which became effective on October 1, 2005. Circular No. A-123 provides updated internal control standards and new requirements for the 24 major executive branch departments and agencies to follow in conducting management's assessment of the effectiveness of internal control over financial reporting. Based on this assessment, agency management is required to prepare an assurance statement on the effectiveness of internal controls over financial reporting to be included in the agency's performance and accountability report (PAR). These requirements are applicable to the 24 CFO Act agencies, including the Department of the Treasury (Treasury), of which IRS is a significant component. The objective of our review was to determine whether IRS appropriately planned and implemented the requirements of OMB Circular No. A-123, and to verify that IRS performed sufficient work to support its related assurance statement to Treasury, upon which Treasury would rely as a basis for its own assurance statement to be included in its fiscal year 2006 PAR. We found that IRS's assurance statement was adequately supported by the underlying work and appropriately reflected the state of its internal controls. However, we did identify opportunities for improvement in the execution and documentation of this work that we communicated to IRS during the course of the audit and that we will be reporting on separately.

Compliance with Laws and Regulations and FFMIA Requirements

Our tests of compliance with selected provisions of laws and regulations disclosed one area of noncompliance that is reportable under U.S. generally accepted government auditing standards and OMB guidance. This area relates to IRS not timely releasing federal tax liens against taxpayers'

[11]This number does not include open recommendations related to information security. These recommendations, because of their sensitive nature, are contained in a series of Limited Official Use Only reports that we have issued to IRS over the past several years.

property.[12] Except as noted above, our tests for compliance with laws and regulations disclosed no other instances of noncompliance that would be reportable under U.S. generally accepted government auditing standards or OMB audit guidance. However, the objective of our audit was not to provide an opinion on overall compliance with laws and regulations. Accordingly, we do not express such an opinion.

We also found that IRS's financial management systems did not substantially comply with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA).[13]

For more details on these issues, see appendix I.

Consistency of Other Information

IRS's Management Discussion and Analysis and required supplemental and other accompanying information contain a wide range of data, some of which are not directly related to the financial statements. We did not audit and do not express an opinion on this information. However, we compared this information for consistency with the financial statements and discussed the methods of measurement and presentation with IRS officials. Based on this limited work, we found no material inconsistencies with the financial statements or nonconformance with OMB guidance. Under OMB guidance for the financial statements of federal agencies, agencies are asked to strive to develop and report objective measures that to the extent possible, provide information about the cost-effectiveness of their programs. We found, however, that because of the noted internal control and systems limitations, IRS cannot report reliable cost-based performance measures relating to its various programs consistent with the Government Performance and Results Act of 1993.[14]

[12]Tax law requires IRS to release a federal tax lien within 30 days after the date the tax liability is satisfied or has become legally unenforceable, or the Secretary of the Treasury has accepted a bond for the assessed tax.

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

[14]Pub. L. No. 103-62, § 4(b), 107 Stat. 285, 287 (Aug. 3, 1993) (*codified at* 31 U.S.C. § 1115).

Objectives, Scope, and Methodology

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

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

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

We are also responsible for (1) testing whether IRS's financial management systems substantially comply with the three FFMIA requirements, (2) testing compliance with selected provisions of laws and regulations that have a direct and material effect on the financial statements and laws for which OMB audit guidance requires testing, and (3) performing limited procedures with respect to certain other information appearing in these annual financial statements. For more details on our methodology and the laws and regulations we tested, see appendix II.

We did not evaluate all internal controls relevant to operating objectives as broadly defined by FIA, such as controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to testing controls over financial reporting and compliance with laws and regulations. We did not test compliance with all laws and regulations applicable to IRS. We limited our tests of compliance to those laws and regulations that had a direct and material effect on the financial statements or that were required to be tested by OMB audit guidance that we deemed applicable to IRS's financial statements for the fiscal years ended September 30, 2006 and 2005. We caution that noncompliance may occur and not be detected by these tests and that such testing may not be sufficient for other purposes. We performed our work in accordance with U.S. generally accepted government auditing standards and OMB audit guidance.

Agency Comments and Our Evaluation

In responding to this report, IRS agreed that the report fairly presents its financial management progress and remaining management and systems challenges. IRS noted its significant accomplishments in addressing financial management issues while also successfully implementing Appendix A of the revised OMB Circular No. A-123, *Management's Responsibility for Internal Control.* IRS affirmed its dedication to continuing to improve its financial management, and noted significant achievements including: (1) improvements in accountability over property and equipment that enabled us to eliminate it as a reportable condition through implementation of a first level procurement review, revision of material group codes, and implementation of a materiality threshold for capital asset review, (2) significant reductions in the numbers of matters for further consideration related to both safeguarding of taxpayer receipts and controls over administrative accounts, (3) acceleration of the quarterly excise tax certifications to the Department of the Treasury by 2 months, and (4) improvements to its cost allocation methodology and use of Integrated Financial System to generate its statement of net cost for fiscal year 2006.

IRS also agreed with our findings concerning information security, and indicated that it is improving protection of sensitive information by expanding the use of encryption, increasing employee education and awareness, and improving IRS information security policies and procedures to ensure protection of taxpayer, employee, and IRS sensitive information. IRS also noted that it has established a Security Services and Privacy Executive Steering Committee to coordinate information security improvements and to leverage subject matter experts from the areas of information technology security, physical security, and privacy and identify theft. In addition, IRS recognized that while challenges remain, it has established its ability to consistently produce reliable financial statements, and believes it has a solid management team in place to continue to improve financial management.

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

David M. Walker
Comptroller General
of the United States

October 31, 2006

Management Discussion and Analysis

I. Introduction

The Internal Revenue Service (IRS) administers America's tax laws and collects the revenues that fund government operations and public services. The IRS' Taxpayer Service and Enforcement programs generate more than 96 percent of the total federal revenue collected for the United States Government. In Fiscal Year (FY) 2006, the IRS collected more than $2.5 trillion in revenue, an 11 percent increase from FY 2005.

The IRS annually processes over 220 million tax returns and over 1.3 billion information items related to tax returns, such as W-2s and 1099s. The IRS provides a wide range of taxpayer assistance through the internet, telephone service, and Taxpayer Assistance Centers, making it easier for taxpayers to fulfill their tax obligations. The IRS continues to pursue opportunities to improve service to the taxpayer by simplifying tax filing processes and expanding options for electronic filing and payment.

Of the more than $2.5 trillion the IRS collected during FY 2006, $48.7 billion was collected through enforcement activities including individual and small business audits, collection contacts, corporate audits, settlement initiatives aimed at deterring the use of abusive tax shelters, and criminal prosecutions. Over the past decade, the IRS has steadily improved its performance by refining its workload selection criteria, implementing streamlined and centralized work processes, increasing managerial involvement in casework, and reducing the time it takes from "start to finish" for its key examination and collection activities.

The IRS' mission, to "provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all," is best demonstrated in the level of commitment and professionalism exhibited by the 100,000+ employees comprising the IRS workforce. The IRS was one of six federal agencies featured in Business Week magazine's "50 Best Places to Launch a Career" report (September 2006), and IRS retention rates were highlighted as being among the best in the country.

In June 2004, the IRS published its Strategic Plan for FYs 2005 through 2009. The Strategic Plan is a roadmap that reflects the priorities and direction of the IRS, setting its course for achieving measurable results that reduce the tax gap and balance service and enforcement. The FY 2006 performance summary and results sections in this document link to the Strategic Plan goals and objectives, and highlight the quantifiable performance measures and results the IRS uses to gauge its performance.

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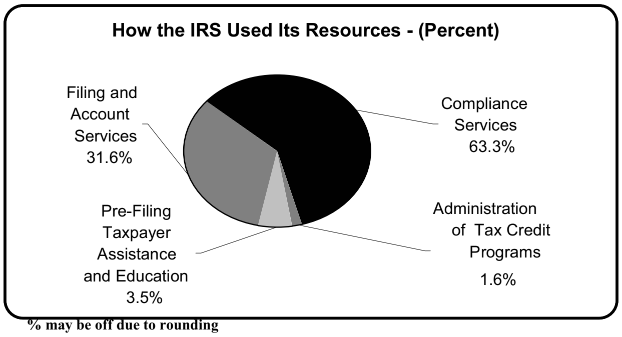
In FY 2006, the IRS made significant progress in achieving its three strategic goals: improving taxpayer service; enhancing enforcement of the tax law; and modernizing the IRS through its people, processes, and technology. The following chart presents the portion of the IRS' FY 2006 budget used to fund programs that fulfill the IRS' three strategic goals:



FY 2006 brought many unanticipated and unprecedented challenges to the IRS. The IRS responded quickly to assist the victims of the 2005 hurricanes by providing assistance and information regarding tax responsibilities and by postponing filing and payment deadlines for all affected taxpayers in the hardest hit areas. The IRS set up a dedicated toll-free disaster assistance line to provide "one-stop" help on tax issues and answered over one million assistance calls for Federal Emergency Management Agency (FEMA). Also, in June 2006, severe flooding forced closure of the IRS headquarters building in Washington, D.C. The Commissioner and the top-level executives immediately resumed business at alternate IRS locations, and within thirty days, over 2,200 displaced employees returned to their normal duties. There was no impact on service to the public.

IRS' financial statements, including the accompanying notes, present fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, IRS' assets, liabilities, net position, net costs, changes in net position, budgetary resources, reconciliation of net costs to budgetary activity, and custodial activity as of, and for the fiscal years ended, September 30, 2005, and September 30, 2004.

With its highly-skilled workforce dedicated to balancing service and enforcement, the IRS will continue to make progress on achieving its goals, accomplishing its mission, and meeting the public's expectation.

Mission and Goals

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

In fulfilling its mission, the IRS focuses on achieving three overarching strategic goals:

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- Improve Taxpayer Service
- Enhance Enforcement of the Tax Law
- Modernize the IRS through Its People, Processes and Technology

Each strategic goal is supported by operational objectives and annual performance measures. The operational objectives reflect IRS' business priorities; the performance measures reflect the IRS' plans to evaluate its ongoing success in meeting its stated objectives.

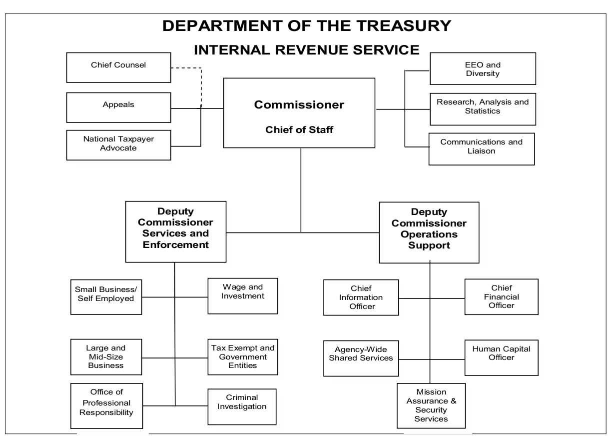
The following list summarizes the guiding principles that the IRS follows:

- Understand and solve problems from taxpayers' point of view
- Enable IRS managers to be accountable to taxpayers
- Use balanced measures of performance to evaluate progress in taxpayer satisfaction, business results, and employees' satisfaction
- Foster open, honest communications
- Insist on total integrity

Organization

The IRS continues to transform its programs and activities to keep pace with the changing environment, taxpayer demands, and new mandates. The IRS' primary operations are supported by four business units focused on unique groups of taxpayers: individual taxpayers, small business owners, large corporations and tax-exempt and government entities. The IRS Commissioner and two Deputy Commissioners have oversight for all agency operations, as described on the following pages.

- *The organizational chart below shows these reporting relationships.



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Commissioner of the Internal Revenue Service

A number of functions support the IRS Commissioner. They set policies, provide leadership and direction for the IRS, and provide support for strategic decision-making activities needed to fulfill the IRS' mission in administering the nation's tax laws.

- **The Office of Appeals** resolves tax controversies between taxpayers and the IRS without litigation on a basis that is fair and impartial to both. Appeals provides an independent channel for taxpayers who wish to dispute a recommended enforcement action, enhancing voluntary compliance and public confidence in the integrity and efficiency of the IRS.

- **Taxpayer Advocate Service (TAS)** helps taxpayers with problems that have not been resolved through regular IRS channels. TAS is an independent function headed by the National Taxpayer Advocate. Each state and IRS Service Center have at least one local Taxpayer Advocate who operates independently and reports directly to the National Taxpayer Advocate. Local Taxpayer Advocates work directly with operating divisions to identify and recommend solutions to systemic problems.

- **Communication and Liaison (C&L)** oversees and manages the IRS' external communications activities with the news media, members of Congress and their staffs, tax professionals and practitioners, as well as internal communications with employees. C&L also coordinates marketing and advertising activities on behalf of the IRS and establishes policies and guidelines governing communications throughout the IRS.

- **The Office of Chief Counsel** is the chief legal advisor to the IRS Commissioner responsible for providing correct and impartial interpretation of the Internal Revenue laws and the highest quality legal advice and representation for the IRS. The Chief Counsel's principal customers are the IRS Commissioner, the operating divisions, the functional units, the Department of the Treasury, and the Department of Justice. Litigation and legal advice are the largest programs provided by Chief Counsel field office attorneys and support staff. Published guidance, advance case resolution, and legal advice are the largest programs provided by attorneys and support staff in the National Office.

- **Research, Analysis, and Statistics (RAS)** supports IRS senior management, operating divisions, functional units, other research organizations, the Department of the Treasury, and the general public by producing studies, program evaluations, and statistical analyses of taxpayer trends and data. RAS also provides research and reference tools for front line IRS employees.

- **Equal Employment Opportunity and Diversity (EEO&D)** educates IRS employees about diversity and helps them understand their EEO rights and responsibilities, ensuring that the IRS applies civil rights laws with integrity and fairness to all.

Deputy Commissioner for Services and Enforcement

The IRS tax operations are aligned into four Operating Divisions, Criminal Investigations, and the Office of Professional Responsibility, each focusing on specific taxpayer constituencies and business issues. They report to the Deputy Commissioner for Services and Enforcement.

- **Wage and Investment Division (W&I)** manages tax processing and customer service for all individual and business taxpayers and provides compliance services to individual taxpayers. Employees at eight campuses perform tax processing services. Twenty-five sites provide account management services. Employees at five campuses perform compliance services, including examinations and automated underreporter matches, which focus on dependent exemptions, credits, filing status, and personal deductions. W&I Compliance also collects delinquent accounts through automated collection system (ACS) call sites and performs other collection work, including securing delinquent returns, by corresponding with taxpayers. W&I also provides face-to-face information, support and assistance to taxpayers in fulfilling their tax obligations at over 400 Taxpayer Assistance Centers.

- **Small Business and Self Employed Division (SB/SE)** serves individuals with income from rents, royalties, pensions, annuities, partnerships, estates, and trusts; small businesses, including corporations and partnerships, with assets up to $10 million; and others who file employment, excise, estate, gift, fiduciary, and international tax returns. SB/SE has the largest compliance and enforcement presence in the IRS, allocating 94 percent of its resources to compliance activities. SB/SE is aligned along functional lines of Examination, Collection, Specialty Tax Programs, Compliance Services/Campus Operations, and the Fraud/Bank Secrecy Act Program. This structure provides a more focused approach to program delivery by efficient use of existing knowledge and experience, ensuring end-to-end accountability and specialized expertise of the workforce.

- **Large and Mid-Size Business Division (LMSB)** administers taxes for the largest businesses in the United States, including corporations, sub-chapter S-Corps and partnerships with assets greater than $10 million, including over 6,100 publicly traded companies. LMSB taxpayers annually file approximately 176,000 income tax returns. LMSB workforce is structured around five industry groupings that include Communications; Technology and Media; Financial Services; Heavy Manufacturing and Transportation; Natural Resources and Construction; and Retailers, Food, Pharmaceuticals, and Healthcare. Operating within this structure, LMSB provides taxpayers with specialized, focused support on specific tax issues. LMSB's workforce consists largely of field-based employees, including revenue agents, international examiners, field specialists, technical experts and support personnel. Collectively, they deal with tax issues ranking among the most complex addressed by any division in the

IRS.

- **Tax-Exempt and Government Entities Division (TE/GE)** serves a broad array of entities with special tax status, including tax-exempt organizations, employee retirement plans, and government entities. The entities that comprise this customer base are subject to unique rules and have diverse needs, ranging from small community organizations and municipalities to major universities, pension funds, state and tribal governments, and tax-exempt bond issuers. TE/GE administers and enforces a complex body of law governing these entities to ensure that they properly adhere to the statutes applicable to their status.

- **Criminal Investigation (CI)** investigates potential criminal violations of the Internal Revenue Code and related financial crimes in a manner that fosters confidence in the tax system and compliance with the law. Tax investigations encompass a wide variety of sophisticated schemes including abusive tax schemes, employment tax fraud, refund crimes, and the failure to file required returns. Further, CI's unique statutory jurisdiction and expertise enable it to investigate diverse crimes including money laundering, corporate fraud, narcotics related crimes, and terrorist financing. Successful prosecutions are important to the success of the Service's overall compliance strategies.

- **Office of Professional Responsibility (OPR)** fosters excellence in tax professional services to taxpayers by setting, communicating, and enforcing standards of competence, integrity, and conduct.

Deputy Commissioner for Operations Support

The IRS support functions are aligned into five support organizations. Each organization provides specific services, systems, and processes that support tax operations. Support units facilitate efficiency improvements and implementation of best practices throughout the IRS. The support units report to the Deputy Commissioner for Operations Support.

- **Modernization and Information Technology Services (MITS)**, headed by the Chief Information Officer (CIO), delivers information technology solutions that anticipate and meet enterprise-wide needs by delivering customer-centered, systems, products, services, and support. The CIO advises all heads of offices on strategic technology planning, data administration, technology standards and privacy assurance, and telecommunications issues.

- **Agency-Wide Shared Services (AWSS)** develops procedures and implements policy for the IRS' internal real estate and facilities management, Equal Employment Opportunity and Diversity, personnel, procurement, and customer support activities.

- **Chief Human Capital Officer (HCO)** provides human capital strategies and tools for recruiting, hiring, developing, retaining, and transitioning a highly skilled and high performing workforce needed to support the IRS' mission, goals, and objectives.

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- **Chief Financial Officer (CFO)** oversees the IRS budget, financial management, financial systems, strategic planning, performance measurement, and internal controls. The CFO accounts for over $2 trillion in taxpayer receipts and the IRS $10 billion annual operating budget.

- **Mission Assurance and Security Services (MA&SS)** is responsible for the protection of taxpayer data and information systems and the continuing security of IRS personnel, facilities, and assuring the security and resilience of critical agency functions and business processes.

II. Performance Goals and Results

The IRS uses performance measures to evaluate its effectiveness in meeting its three strategic goals. The IRS achieved an overall success rate of more than 68 percent for the second consecutive year, meeting the target for 15 of its 22[1] performance measures. Of the seven IRS measures that did not meet targets; two related to electronic filing where performance set records for the second consecutive year, with individual electronic filing coming within 98 percent and business within 89 percent of meeting the target; and two related to delivery of tax products resulted from delayed by hurricane legislation. The fifth missed measure dealt with determination case closures in which inventory did not materialize. The sixth measure, examination coverage for businesses, was missed by one percent because the IRS was prevented from taking enforcement action on a significant number of partnership return examinations involving a tax shelter promoter. Also, partnership audits were not as productive as expected. As a result, the IRS has stopped opening these audits until the examination selection methodology is improved. The seventh measure, an efficiency measure which dealt with contacts resolved per staff year, came within less than one percent of being met. The performance information that follows highlights successes and challenges during FY 2006.

Strategic Goal 1: Improve Taxpayer Service

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

Major Results, Accomplishments, and Challenges

The IRS serves a constituency of more than 220 million filers. Improved service options for taxpayers and simplifying the tax process are key strategies under the IRS strategic goal to improve taxpayer service. The IRS allocates resources to education and outreach services to ensure taxpayers understand their obligations and voluntarily participate in the tax system.

Filing Season

The IRS delivered a successful 2006 filing season in the midst of a very challenging year. Despite natural disasters that impacted a large number of taxpayers and required an unprecedented response, the IRS met or exceeded 50 percent (five out of ten) of its performance goals related to taxpayer service. The following highlights the IRS' performance in FY 2006:

- Processed more that 134.7 million individual returns and issued more than 100 million refunds totaling over $277 billion during the 2006 filing season (Tax Year 2005).
- Processed 46.9 million returns for partnerships, corporations, employment taxes, and exempt organizations.

[1] In addition to the 22 measures, data to estimate the Earned Income Tax Credit measure will be available late in 2007 and five measures were baselined in FY 2006.

- Increased use of the IRS.gov website and "Where's My Refund?," up more than 9.8 percent and 11.8 percent, respectively.

Despite not meeting its aggressive electronic filing targets in FY 2006, the IRS set another record for the number of returns filed electronically. For the second year in a row, more than half (72.8 million) of all individual returns were filed electronically, representing a 6.6 percent increase over FY 2005. The IRS' most recent American Customer Satisfaction Index (ACSI) scores from 2005 also reflected higher satisfaction from e-filers (77) over paper filers (50). The 2006 ACSI scores will be available in December. The following highlights the IRS' performance related to electronic filing:

- Home computer use to prepare and e-file tax returns increased 18.5 percent to more than 20.2 million returns.
- Tax preparation professional use of e-file increased 9.4 percent, with 52.1 million filing electronically. In its fourth year of operation, the Free File Alliance, the partnership between the IRS and a consortium of tax preparation software companies, had approximately four million taxpayers use the free service, a 22.6 percent decrease from last year due to a change in the eligibility requirements.
- Nearly 14,000 large corporate taxpayers subject to the electronic filing mandate successfully e-filed their returns. The largest corporate taxpayers transmitted their returns predominately without delay or back log. The IRS processed this volume of very complex returns, and accepted and acknowledged receipt well within its 24-hour turnaround standard.
- Customer use of on-line services continued to increase:
  - More than 1.3 billion web pages were viewed on the IRS.gov website, a four percent increase over FY 2005.
  - More than 24.7 million taxpayers used the web application "Where's my Refund?" to check the status of their refunds, an 11.8 percent increase from last year.
- More than two million tax practitioners took advantage of the electronic services provided by the IRS' e-Services project. e-Services is a modernization project providing electronic services to promote the goal of conducting electronic transactions between the IRS and tax practitioners to reduce burden. In FY 2006:
  - Over one million participants used a new Internet-Employer Identification Number service,
  - One million requests for transcripts were processed through the IRS' Transcript Delivery System, and
  - More than 168,000 practitioners enrolled in the IRS e-file program.

Millions of taxpayers and tax professionals that visited IRS.gov during the 2006 filing season benefited from many of the features the IRS provides to simplify tax filing. Redesigned in November 2005, IRS.gov's search and navigation tools were completely revamped to make it easier and quicker for taxpayers to get information and answers to many of their questions while preparing their returns. As a result, customer satisfaction with the website increased five percentage points based on the ACSI. In addition to improved customer satisfaction, the e-Gov Institute awarded IRS.gov the 8th Annual Government Solutions Center Pioneer Award for "Innovative Use of Technology in a Government Program." IRS.gov improvements came from listening to customers concerns, conducting usability studies, and translating feedback into a cohesive list of requirements.

Education & Outreach

Helping the public to understand their tax reporting and payment obligations remains a vital part of maintaining public confidence in administering the tax laws. The IRS expanded its outreach by relying on partner organizations such as state taxing authorities and a cadre of volunteer groups to serve taxpayer needs. Through its 12,300 Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) sites, the IRS provided free tax assistance to the elderly, disabled, and limited English proficient individuals and families. The 69,000 volunteers located at the sites prepared approximately 2.3 million returns, a 7 percent increase over FY 2005.

In addition to conducting its own outreach and education activities, the IRS participates in private partner education and outreach programs. During FY 2006, the IRS provided resources and support for over 290 Partner Coalitions, resulting in the electronic filing of 1.9 million returns. One of the larger partnerships, Connect America, provides free tax assistance to disabled veterans and free tax preparation and asset building strategies for low-income families. The IRS was recognized in 2006 as the Connect America's Partner of the Year for 2005 for its efforts to provide free tax assistance to disadvantaged groups. The IRS is the first federal agency to receive this award.

The IRS' nationwide marketing and education campaign, aimed at reducing Earned Income Tax Credit (EITC) error, reached a wide audience including taxpayers, tax practitioners, members of the media, and partner organizations. The IRS held grassroots events in New Orleans and Houston to focus on hurricane victims and in Denver and New York for certain limited English proficiency communities. These events provided information and free tax preparation to over 1,000 people and, through the help of volunteers, nearly 300 returns were prepared. Over 1.5 million people viewed the EITC pages on IRS.gov. A million people used the EITC Assistant, a web-based application to help taxpayers determine eligibility, filing status, and estimate their EITC amount. Also, the IRS provided answers to more than 160,000 EITC questions through telephone assistance.

The IRS implemented a communication strategy to educate taxpayers and employees about significant identity theft issues. Communication channels included DVDs, public service announcements, and presentations at the IRS' Tax Forums to educate tax professionals on requirements to secure taxpayer data. The IRS also provided similar educational services to persons with limited English proficiency.

Customer Service

The IRS continues to improve quality, efficiency, and service delivery through increased service coverage to taxpayers and improved business processes. In October 2005, the IRS e-Services Project won the Government Computer News 2005 Agency award for innovation. Winners are chosen for their innovation, support of program or policy requirements, and improvement of service delivery. IRS e-Services provide a set of web-based business products for practitioners and other third parties. IRS e-Services such as the new Internet-Employer Identification Number (1.3 million) and Transcript Delivery Service (1.1 million), experienced significant usage.

In December 2005, 43 state tax agency representatives, legally authorized to receive federal tax information for state tax purposes, were granted access to and trained on e-Services Transcript Delivery Service. This reduced the number of transcript requests from state agencies by 150,000. All 153 Low Income Tax Clinics were also given access to e-Services and incentive products to better serve their taxpayer customers.

The IRS developed processes and procedures for administering telecommunications excise tax refunds (TETR) to more than 150 million taxpayers. To do this, the IRS modified all individual and business tax return forms to include TETR information; created a new form to be used by individuals who want to request a refund but who have no other tax filing requirement; and drafted a new form to be used by taxpayers who choose to request refunds based on their actual payments rather than use a standard amount set by the IRS. The IRS also launched an outreach campaign to external stakeholder groups, programmed IRS systems to accept form changes, developed TETR-related internal procedures (IRMs), and trained employees who will interact with taxpayers on the phone and at Taxpayer Assistance Centers. In addition, the IRS is developing a methodology that can be used by businesses and non-profits to estimate their TETR claims.

Telephone assistance calls decreased as more taxpayers opted to use automated phone and Internet services. In FY 2006, the IRS answered 32.7 million assistor telephone calls, compared to 33.4 in FY 2005, and completed more than 24.3 million automated calls, compared to 25.7 in FY 2005. With the availability of improved online service options to taxpayers, taxpayer visits to the Taxpayer Assistance Centers (TACs) were down 10 percent from 2005, while the usage of the IRS.gov website and the “Where’s My Refund?” application were up 9.8 percent and 11.8 percent, respectively. Also, productivity improvements reduced the resources needed to address account workload and taxpayer correspondence cases. The IRS correctly responded to 91 percent of tax law questions and 93 percent of account questions received via the telephone, and achieved an 82 percent level of service answering calls from taxpayers.

All 400 TACs remained open and services were consistent with the 2005 filing season. Additionally, wait time at the TACs was minimized with more than 80 percent of customers being served in 30 minutes or less. The accuracy of responses to tax law questions increased to 83 percent, compared to 75 percent in FY 2005. Approximately 12,300 VITA and TCE sites provided free tax assistance to the elderly, disabled, and limited English proficient individuals and families. The 69,000 volunteers located at the sites prepared approximately 2.3 million returns, a 7 percent increase over FY 2005.

In response to the hurricanes of 2005, emergency supplemental appropriations were enacted that required over 230 changes to 78 tax products. Despite passage late in the tax year, 83 percent of the critical filing season tax products and over 61.2 percent of other tax products were delivered to the public on time. The IRS plans to continue its efforts to simplify its tax forms and publications making them more user-friendly with the ultimate goal of providing all of its published products in electronic format.

Burden Reduction

The IRS provides help to taxpayers to file accurate and timely tax returns in order to reduce burden. In addition, the IRS pursues tax form simplification and an increased effort to provide forms more suitable for a computer-based system. Taxpayer burden is measured by the amount of time and out-of-pocket expense taxpayers incur in meeting their tax responsibilities. The estimated FY 2006 burden was 6.7 billion hours, compared with 6.4 billion hours in FY 2005, an increase of approximately 250 million hours. This increase reflects new forms and changes to existing forms dictated by the ten different pieces of legislation enacted in 2005.

The IRS also partnered with external stakeholders, including taxpayers, practitioners, citizens and industry groups, software developers, and state and federal agencies to receive suggestions for reducing taxpayer burden. As a result, in FY 2006, the IRS launched a number of new forms and procedures designed to reduce burden without compromising the tax administration objectives. The following highlights some of these initiatives:

- Redesigned unemployment tax returns (Form 940 and a new Form 944) to reduce filing burden for 950,000 small business owners and governmental entities. The new forms allow certain employment tax filers to file annually rather than quarterly and to make a single payment with the annual return.

- Revised Schedule K-1 for Form 1041 to provide streamlined instructions for beneficiaries. The revised form can be scanned and will reduce the number of transcription errors. The new Schedule K-1 is expected to reduce 4.27 million hours of burden for 3.5 million taxpayers.

- Launched an Alternative Minimum Tax (AMT) Calculator to assist taxpayers in determining whether they are subject to the AMT and if they need to complete the tax form (Form 6251). The AMT is calculated separately, eliminates many deductions and credits, and creates a tax liability for an individual who would otherwise pay little or no tax. By 2010, the AMT is expected to affect nearly 32 million taxpayers.

- Simplified the process for requesting an extension of time to file an individual return on the original Form 4868 (extension request) and now automatically grants an additional six month extension to file. The redesign of the extension process allowed an additional two million taxpayers the ability to e-file/e-pay and eliminated five million duplicate filings. Similar changes were made to the extension process for corporate taxpayers. The automated process affected 15.5 million submissions, reduced taxpayer burden by nine million hours, and reduced processing costs by 50 percent.

The IRS also provided assistance to corporate taxpayers in identifying and resolving potentially controversial disputes earlier in the examination process through its Pre-filing Agreement (PFA) and the Industry Issue Resolution programs. These programs reduce costs, burden, and delays because they enable corporations and the IRS to reach agreement on a contentious issue through a cooperative effort before a return is filed. In FY 2006, the IRS received over 230 PFA requests and accepted 152. Of these, 55 percent were closed with an agreement and 20 percent were withdrawn (either by the taxpayer or the IRS). Taxpayers reported an overall level of satisfaction with these programs of 4.7 and 4.6, respectively (on a 5 point scale).

Disaster Assistance and Response

The IRS provided unprecedented tax relief in the wake of the hurricanes that occurred along the Gulf Coast in August and September of 2005. Within days of the storms, the IRS assisted FEMA with taking registrations on their toll-free line and provided emergency equipment to support four FEMA call sites to handle the increased call volume. From the end of August through October 31, 2005, the IRS responded to a total of 948,814 FEMA calls and assigned 5,000 IRS employees to augment staffing at FEMA call centers. In addition, the IRS provided assistance to the Small Business Administration (SBA) and the Department of Labor to expedite income verification for disaster loans and unemployment benefits. The IRS processed more than 1.3 million requests for tax information from the SBA, expediting the disaster claims process.

The IRS responded to 49 disaster declarations, providing assistance and relief to the needs of disaster victims. Within 24 hours of the Presidential disaster declaration in the wake of Hurricane Katrina, the IRS formed a multi-functional policy group which worked closely with key federal agencies and external stakeholders to develop a number of substantive legislative proposals. The new legislative provisions included in the emergency supplemental appropriations to address hurricanes in the Gulf of Mexico were designed to provide broad relief to impacted taxpayers by postponing filing and payment deadlines, allowing penalty free withdrawals from retirement accounts, and claiming casualty losses. The legislation required changes to 78 tax products. Despite the passage of the statute late in the tax year, 83 percent of the critical tax products and over 61.2 percent of other tax products were delivered to the public on time.

To help disaster victims understand the numerous tax law provisions enacted as a result of the hurricanes, the IRS developed and distributed 424,147 Disaster Relief Kits to individuals and businesses and distributed more than 85,382 copies of Publication 4492. The IRS assisted over 288,000 taxpayers on the toll-free telephone lines providing hurricane victims with help on tax issues, provided substantial disaster information and resources on IRS.gov, and issued 60 news releases and legal guidance documents announcing details on relief made available to hurricane victims. The IRS secured agreements with seven tax professional organizations to jointly provide assistance at local disaster relief centers and secured additional agreements with several practitioner organizations to provide free casualty loss tax return preparation for low income taxpayers. In addition, at least 257 VITA sites remained open after April 17, 2006, to help disaster impacted taxpayers.

In the aftermath, the IRS continued to provide assistance and education on administrative and legislative tax relief to individual and business taxpayers and practitioners. The IRS held more than 70 local outreach events to assist disaster victims and has planned additional events.

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IRS measures reported in the IRS' annual performance budget and included in the Treasury Performance Reporting System are discussed below.

1. Customer Service Representative (CSR) Level of Service

Description: The relative success rate of taxpayers that call IRS toll-free services seeking assistance from a CSR.

CSR Level of Service				
FY 2003 Actual	FY 2004 Actual	FY 2005 Actual	FY 2006	
			Plan	Actual
80.0%	87.0%	82.6%	82.0%	82.0%

FY 2006 Performance: Target Achieved. The IRS met/exceeded the FY 2006 target.

Future Plans: The IRS will continue to maintain CSR Level of Service at 82 percent in FY 2007. The IRS expects an increase in telephone demand in FY 2007 from the Telecommunications Excise Tax Refund (TETR) initiative, and plans to increase staffing to meet the expected demand.

2. Customer Contacts Resolved per Staff Year

Description: The number of Customer Contacts resolved in relation to time expended based on staff usage.

Customer Contacts Resolved per Staff Year				
FY 2003 Actual	FY 2004 Actual	FY 2005 Actual	FY 2006	
			Plan	Actual
8,318	8,015	7,585	7,477	7,414

FY 2006 Performance: Target Not Achieved. Despite answering 2.7 million more contacts than planned, the IRS did not meet this target. Efficiencies expected from the reduction of Toll-free telephone service operating hours (from 15 to 12 hours per day) did not occur because the service operating hours were not reduced due to reduction in service concerns expressed by Congress. Staffing for the 15 hours required an additional 482 Full Time Equivalents (FTE) over plan. Overall, the IRS came within 99 percent of the goal, answering almost 2 million additional automated calls, 564,000 assistor calls, and completing over 750,000 additional Web Services. Completing a web service is defined as providing a service requested by a taxpayer or tax practitioner through self-assist internet-based applications such as Internet Refund Fact of Filing ("Where's My Refund"), Transcript Delivery System, Preparer Tax Identification Number, Internet-EIN, Prior Year Earned Income Option, and Disclosure Authorizations.

Future Plans: The IRS is expecting efficiency to increase as more taxpayers choose to use automated means to contact the IRS instead of traditional, labor intensive methods.

3. Percent of Eligible Taxpayers Who File for EITC

Description: The number of taxpayers who claimed the Earned Income Tax Credit (EITC) compared to the number of taxpayers who appear to be eligible for the EITC.

Percent of Eligible Taxpayers Who File for EITC				
CY 2003 Actual	CY 2004 Actual	CY 2005 Estimate	CY 2006	
			Plan	Actual
--	80.0%*	80.0%*	80.0%*	Not Yet Available

*The participation rate is an estimate based on a methodology which includes underlying assumptions about the potential EITC eligible population.

CY 2006 Performance: Data to estimate the participation rate will be available late in 2007.

Future Plans: The methodology for estimating the EITC participation rate is being validated using Census data in an effort to improve the accuracy of estimates.

4. Customer Accuracy –Tax Law Phones

Description: The percentage of correct tax law answers provided by a telephone assistor. The measure indicates how often customers receive the correct answer to their tax law inquiry based upon all available information and Internal Revenue Manual required actions.

Customer Accuracy – Tax Law Phones				
FY 2003 Actual	FY 2004 Actual	FY 2005 Actual	FY 2006	
			Plan	Actual
82.0%	80.0%	89.0%	90.0%	90.9%

FY 2006 Performance: Target Exceeded. The IRS met/exceeded the FY 2006 target.

Future Plans: Incremental improvement in the performance is expected in FY 2007 and beyond from the completion of the Contact Recording project, a program to record customer contacts for quality review to help employees improve their skills, ease manager burden, and raise quality for customers.

5. Customer Accuracy – Accounts (Phones)

Description: The percentage of correct answers provided by a telephone assistor. The measure indicates how often customers receive the correct answer to their account inquiry and/or had their case resolved correctly based upon all available information and Internal Revenue Manual required actions.

Customer Accuracy – Accounts (Phones)				
FY 2003 Actual	FY 2004 Actual	FY 2005 Actual	FY 2006	
			Plan	Actual
88.2%	89.3%	91.5%	92.0%	93.2%

FY 2006 Performance: Target Exceeded. The IRS met/exceeded the FY 2006 target.

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Future Plans: Incremental improvement in performance is expected in FY 2007 and beyond from continued improvement efforts such as the development of new online tools for assistors to research taxpayer questions.

6. Timeliness of Critical Filing Season Tax Products to the Public

Description: The percentage of Critical Filing Season tax products made available to the public in a timely fashion. Critical Filing Season tax products are forms, schedules, instructions, publications, tax packages, and certain notices normally filed between January 1 through April 15 that are mailed to taxpayers. This measure contains two components: (1) percentage of paper tax products shipped no later than December 20 (December 27 for tax packages), and (2) the percentage of scheduled electronic tax products available on the Internet no later than the first five business days of January 2006.

Timeliness of Critical Filing Season Tax Products to the Public				
FY 2003 Actual	FY 2004 Actual	FY 2005 Actual	FY 2006 Plan	FY 2006 Actual
--	76.0%	91.4%	92.0%	83.0%

FY 2006 Performance: Target Not Achieved. The IRS did not meet the FY 2006 target. In FY 2006, the IRS shipped 166 of 200 (83 percent) Critical Filing Season tax products timely. Shipment of the remaining products was delayed intentionally to incorporate changes mandated in legislation enacted late in 2005, P.L. 109-73, Katrina Emergency Tax Relief Act of 2005 (KETRA) and P.L. 109-135, Gulf Opportunity Zone Act of 2005 (GOZONE).

Future Plans: The IRS expects to resume timely delivery of all tax products in FY 2007.

7. Timeliness of Critical Other Tax Products to the Public

Description: The percentage of Critical Other Tax Products, paper and electronic, made available to the public timely. Critical Other Tax Products include business, Tax Exempt and Government Entities, and miscellaneous tax products. This measure contains two components: (1) percentage of paper tax products that meet the scheduled ship date within five business days of the actual date, and (2) percentage of scheduled electronic tax products that is available on the Internet within five business days of the scheduled print date. The intent is to have the tax products available to the public at least 30 days before the form is required to be filed.

Timeliness of Critical Other Tax Products to the Public				
FY 2003 Actual	FY 2004 Actual	FY 2005 Actual	FY 2006 Plan	FY 2006 Actual
--	76.0%	80.0%	85.0%	61.2%

FY 2006 Performance: Target Not Achieved. The IRS did not meet the FY 2006 target. Production schedules required modification to accommodate the delay in completion of the critical filing season tax products (discussed in measure 6. above), necessitating changes to the scheduled modification and ship dates for these non-critical tax products. Monthly timeliness results during early FY 2006 reflected this shift to the workplans. The IRS could not recover the lost production days, and as a result, could not meet the target.

Future Plans: The IRS expects to resume timely delivery of all tax products in FY 2007.

8. Percent Individual Returns Processed Electronically

Description: The number of electronically filed individual tax returns divided by the total individual returns filed.

Percent Individual Returns Processed Electronically				
FY 2003 Actual	FY 2004 Actual	FY 2005 Actual	FY 2006	
			Plan	Actual
40.0%	46.5%	51.1%	55.0%	54.1%

FY 2006 Performance: Target Not Achieved. The IRS did not meet the FY 2006 target. Although the January through June performance was at 55 percent, a higher percentage of paper returns were received during July through September causing the fiscal year percentage of electronically filed returns to drop.

The plan number is derived from semiannual filing projections prepared by the IRS Research organization, incorporating changes in filing patterns, economic and demographic trends, legislative requirements, and IRS administrative processes. The projections provide a basis for IRS workload estimates.

Future Plans: E-file participation rates are projected to increase to 58.2 percent in 2007 based on current experience, historical growth, increased advertising, marketing, and expanded e-file programs and do not reflect gains from any mandates.

9. Percent Business Returns Processed Electronically

Description: The number of electronically filed business returns divided by the total business returns filed.

Percent Business Returns Processed Electronically				
FY 2003 Actual	FY 2004 Actual	FY 2005 Actual	FY 2006	
			Plan	Actual
--	17.4%	17.8%	18.6%	16.6%

FY 2006 Performance: Target Not Achieved. The IRS did not meet the FY 2006 target. The plan number is derived from semiannual filing projections prepared by the IRS Research organization semiannually, incorporating changes in filing patterns, economic and demographic trends, legislative requirements, and IRS administrative processes. The projections provide a basis for IRS workload estimates.

Future Plans: The IRS expects the percentage of business filers to increase in the future due to increased marketing and expanded business e-file programs, including the acceptance of new forms and schedules attached to employer, estates and trusts, and partnership filings, acceptance of amended returns, and acceptance of the new annualized employment tax return. The IRS will continue to pursue additional mandates for businesses to file electronically similar to the one recently imposed for corporations.

10. Taxpayer Self Assistance Rate

Description: The percent of contacts that are resolved by automated self-assistance applications.

Taxpayer Self Assistance Rate				
FY 2003	FY 2004	FY 2005	FY 2006	
Actual	Actual	Actual	Plan	Actual
51.0%	46.4%	42.5%	45.7%	46.8%

FY 2006 Performance: Target Exceeded. The IRS met/exceeded the FY 2006 target.

Future Plans: The IRS expects performance to continue to increase as more taxpayers choose to use automated applications to resolve issues and questions instead of more traditional methods such as contact with the IRS by telephone and correspondence.

11. Refund Timeliness – Individual (Paper)

Description: The percentage of refunds resulting from processing Individual Master File paper returns issued within 40 days or less.

Refund Timeliness – Individual (Paper)				
FY 2003	FY 2004	FY 2005	FY 2006	
Actual	Actual	Actual	Plan	Actual
98.8%	98.3%	99.2%	99.2%	99.3%

FY 2006 Performance: Target Exceeded. The IRS met/exceeded the FY 2006 target.

Future Plans: The IRS expects its performance for refund timeliness to remain stable under the current processing system and within resource constraints.

Strategic Goal 2: Enhance Enforcement of the Tax Law

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

Major Results, Accomplishments, and Challenges

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 for Tax Year (TY) 2001, based on updated FY 2006 estimates, represents the amount of noncompliance with the tax laws. Underreporting tax liability accounts for 83 percent of the gap, with the remainder almost evenly divided between non-filing (eight percent) and underpaying (nine 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 uses its enforcement authority to assess and collect taxes that are due from people who do not fulfill their tax obligations, thus improving compliance. Noncompliance may not be deliberate and can stem from a wide range of causes, including lack of knowledge, confusion, poor recordkeeping, differing legal interpretations, unexpected personal emergencies, and temporary cash flow problems. However, some noncompliance is willful, even to the point of criminal tax evasion. For example, certain taxpayers invest in tax shelters, trusts, and other structured products knowing that the promised tax benefits are not in conformity with the law. The IRS has and will continue to enforce the law across all sectors, but is focusing on corrosive activities of corporations, high income taxpayers, and other major violators of the tax code. These efforts are having a positive impact on collecting additional tax revenue. Enforcement revenue from all sources was at a record level of $48.7 billion in FY 2006, a three percent increase. Targeting high-risk taxpayers improves IRS efficiency, reduces the burden on compliant taxpayers, and concentrates enforcement presence where it is most needed.

In FY 2006, enhancing the IRS' enforcement presence remained a top priority. At the same time, the IRS focused its efforts on improving business processes and modernizing its information systems, both powerful enablers of the IRS business goals. For FY 2006, ten of the twelve enforcement performance targets were met. Focusing on more limited scope examinations and productivity enhancements, including improved analytics, workload identification, and selection systems that targeted high-risk cases resulted in:

- 7 percent improvement in individual audits
- 18 percent increase in high income audits

- 8 percent increase in small-business audits
- 10 percent increase in automated underreporter closures
- 15 percent increase in collection case closures
- 9 percent increase in revenue received from collection activities
- 66 percent overall increase in the use of substitute for return authority (substitute for return authority allows the IRS to file a tax return for an individual or business when it does not file a required return), examiners prepared and filed 665,000 returns for individuals and 182,000 returns for businesses classified as non-filers

The IRS also met its coverage, efficiency, and embedded quality annual targets. Improvements in inventory management, decreases in cycle time, and enhanced training all contributed to increase productivity. Improved quality controls measuring critical elements of the examination, a reinforced focus on case quality to drive improvement efforts, and the delivery of business results, led to improved performance for the third consecutive year. Future efforts to reduce the tax gap will include strategies to ensure optimum balanced audit coverage, and improve resource allocation.

In FY 2006, the IRS continued its efforts in streamlining and improving its examination process, resulting in considerably shortened cycle time for large corporate audits. By doing better analysis to focus on high risk issues, and planning jointly with the taxpayers on the audit cycle and information document requests, the cycle time was reduced substantially. In FY 2006, the time from assigning a large corporate return to a revenue agent until the final closing decreased more than 18 percent, from 17.5 months to 14.3 months. The improvements to the examination process ultimately increased inventory turnover and closures.

The IRS also implemented a new compliance assurance process where large corporate taxpayers and IRS work together to examine transactions in "real time" during the taxable year to: (1) reach agreement on the taxpayer's tax liability before the tax return is filed; and (2) fast track the appeal process by bringing the examination team and the taxpayer to the table to expedite the settlement of remaining issues of controversy. Under this new process, the IRS is able to determine the tax liability within months of filing. The process is beneficial to the taxpayer and the IRS because it reduces the taxpayers' compliance burden while increasing currency and allows for more efficient use of IRS resources. Tax Year (TY) 2006 was a pilot year with
34 participants; 19 new and 15 carried over from TY 2005. With full implementation, however, the impact on compliance and the reduction in taxpayer burden is expected to be substantial.

The IRS has developed a nationally coordinated program to combat abusive tax schemes. The primary focus is on the identification and investigation of the tax scheme promoters as well as those who play a substantial or integral role in facilitating, aiding, assisting, or furthering the abusive tax scheme (e.g., accountants, lawyers). Secondarily, but equally important, is the investigation of investors who participate in abusive tax schemes. The following highlights some of the initiatives:

- The Partnership Option Portfolio Securities (POPS) initiative challenges the tax benefits derived from manipulating portions of the Internal Revenue Code for the purpose of generating permanent non-economic tax losses. To date, closing agreements have been received from 63 of the 107 partners agreeing to a settlement, totaling $556 million in tax, penalties, and interest.

- The Personal Investment Corp initiative challenged tax benefits derived from a type of transaction related to S-Corps rules. The transaction attempts to allocate the loss side of a foreign currency transaction to a tax shelter investor, but not the gain. Closing Agreements have been received from 103 of the 141 shareholders, totaling $592 million in tax, penalties, and interest.

- Select Tax Shelter Promoters were given an opportunity to make an election agreeing to concede 100 percent of their allocable share of the penalty imposed for failing to register a tax shelter. In exchange, penalties for failing to maintain investor lists were waived, and the IRS agreed not to refer selected promoters for prosecution related to the transactions. The settlement initiative allowed faster case resolution, earlier receipt of investor and co-promoter information, and ensured future compliance by taxpayers. The settlement initiative is being offered in waves, beginning with 36 promoters in FY 2006.

In the retirement plans arena, a global settlement initiative dealt with abusive transactions where taxpayers attempted to exclude business income using a combination of schemes that concentrate benefits among a small number of persons. Examinations of 182 potentially abusive plans are in process. In FY 2006, the IRS also started examinations on 262 potentially abusive plans involving questionable life insurance policies.

The IRS has a robust, balanced, and comprehensive plan to help reduce improper payments that include base compliance activities and redesign efforts. In FY 2006, the IRS conducted over 500,000 examinations, issued over 600,000 math error notices (math or other statistical irregularities are systemically identified during processing), and matched 300,000 information documents (e.g. W-2s, 1099s) from employers with information on the tax return. Collectively, these three enforcement activities prevented nearly $2 billion from being paid out erroneously.

The IRS redesigned portions of its examination process. Improvements include: a process to score and select amended returns for examination; a risk-based scoring strategy to identify and select cases for examination that ensures the IRS works the most egregious and productive examination cases; systemic assignment of examination cases to campuses using new data such as capacity and risk-based scores; and integration of a decision support tool which automates issue identification, increases consistency in case documentation, and eliminates duplicative data entry when the case is closed.

Focusing efforts in key areas improved the IRS' ability to address complex strategies employed by taxpayers to avoid payment of their taxes and contributed to meeting or exceeding all of the FY 2006 collection performance targets:

- Enhancing training to improve the skill sets needed to work complex issues;
- Leveraging automation including securing new technology to help streamline collection processes;
- Improving the support structures or business processes to improve efficiency and effectiveness of collection personnel; and
- Improving employee engagement and customer satisfaction to impact positively on reducing the underpayment portion of the tax gap.

Enforcement of criminal statutes is an integral component of the IRS' efforts to enhance voluntary compliance of the tax laws. In FY 2006, abusive tax schemes and shelters remained a high investigative priority due to egregious corporate fraud and tax avoidance of high-income individuals. The IRS used parallel proceedings, one of its most effective tools, to combat abusive tax schemes. This tool enables the IRS to prevent promoters of abusive schemes from engaging in further promotion activity while the criminal investigation is proceeding.

The IRS improved its fraud referral acceptance rate while working high quality cases. The FY 2006 referral acceptance rate of 71.8 percent exceeded the five-year high achieved in FY 2005 of 68.8 percent and the total number of referrals accepted (445) also was higher than last year. The IRS completed 4,157 criminal investigations, exceeding the IRS' FY 2006 target of 3,945. The incarceration rate of individuals sentenced for cases originating from a fraud referral was 81.7 percent in FY 2006, and the significant prison sentences (on average 20 months) handed down in cases originating from fraud referrals reflect their overall quality. The IRS continued to increase the publicity on tax prosecutions because of the positive effect on compliance. In FY 2006, the publicity rate on legal source tax cases remained high at 81.3 percent with an overall publicity rate for all prosecutions of 75.6 percent.

The IRS also provides financial investigation expertise to the Federal Bureau of Investigation's Joint Terrorism Task Forces and the U.S. Attorney's Anti-Terrorism Advisory Council in disrupting and dismantling terrorist financing. The IRS works closely with Treasury to investigate and freeze accounts controlled by individuals and "charitable" organizations suspected of raising or facilitating the movement of funds used to support terrorism. In FY 2006, the IRS had 212 terrorism related investigations in inventory, a 31 percent increase from last year. Fifty-two cases were recommended for prosecution to the Department of Justice, resulting in 44 indictments.

The IRS also participated on the Joint International Tax Shelter Information Centre (JITSIC). The JITSIC, which consists of tax officials from the U.S., United Kingdom, Canada, and Australia, is scrutinizing tax arbitrage by multinational corporations. The combined detection and analytical capabilities of the JITSIC will better enable the IRS and other participating tax agencies to take action against those who plan, facilitate, or engage in abusive tax transactions in other countries.

The IRS committed to strengthen its enforcement presence among those entities with special benefits that may attract fraud and abuse. The purpose of this scrutiny is to ensure the entity is legitimate when established, the operation remains compliant and the entity is not being misused by third parties for tax avoidance or other unintended purposes. In FY 2006, the IRS focused on:

- *Consumer credit counseling* – Because of the changes in the way the credit counseling industry now operates, the IRS examined 63 tax-exempt credit counseling organizations, representing 56 percent of industry revenues. These examinations resulted in the revocation or proposed revocation of exempt status (under which a business can continue to operate as a for-profit corporation), for organizations comprising 41 percent of the revenue in this industry. In addition to its vigilant examination program, the IRS halted the growth of abusive credit counseling organizations. Of more than 110 recently reviewed applications, only three met the requirements for tax-exempt status. The IRS also conducted compliance checks of the more than 700 remaining organizations to determine whether they are operating compliant credit counseling programs.

- *Pension funding* – In the wake of several prominent bankruptcies which resulted in seriously under-funded pension plans, the IRS increased interagency coordination with the Department of Labor (DOL) and the Pension Benefit Guaranty Corporation (PBGC). A closing agreement in FY 2006 with an employer in bankruptcy resulted in payment of $23 million and established a precedent for renewed assertion of claims. The IRS, DOL, and PBGC agreed to meet weekly to coordinate administrative actions on such plans.

- *Political activity* – As a result of findings from examinations conducted during the 2004 election cycle, the IRS increased its vigilance concerning political campaign intervention by tax exempt 501(c) (3) charitable organizations. Some level of prohibited political activity was found in three-quarters of the cases reviewed including violations such as distributing improper voting guides or printed materials favoring particular candidates, endorsing or opposing candidates from the pulpit, criticizing or supporting candidates on a charity's website, permitting certain candidates to speak at official functions, and making contributions to campaigns. In February 2006, the IRS issued new procedures for the 2006 election season to ensure that all referrals are reviewed expeditiously and consistently. The IRS also expanded its educational effort to ensure that charities understand what constitutes prohibited political intervention and how to stay in compliance with the tax law.

- *Down payment assistance* – The IRS found that organizations claiming to be charities are funneling down-payment assistance from sellers to buyers through self-serving, circular financing arrangements. As a result, in FY 2006, an active outreach effort was launched and a vigorous audit program established to identify potential abusers. The IRS also issued formal guidance that shows the difference between a down-payment assistance organization operating in a manner consistent with requirements for qualifying as a charity with seller-financed arrangements that do not. In addition to its ongoing examination program, the IRS denied applications for exemption from 53 seller-financed down-payment assistance organizations. The revenue ruling and increased enforcement activity garnered considerable media attention and support from the Chairman of the Senate Finance Committee.

IRS measures reported in the IRS' annual performance budget and included in the Treasury Performance Reporting System are discussed below.

1. Examination Coverage – Individual (Revised Measure)

Description: The sum of all individual returns closed by SB/SE, W&I, and LMSB (Field Examination and Correspondence Examination) divided by the total individual return filings for the prior calendar year.

Examination Coverage – Individual				
FY 2003 Actual	FY 2004 Actual	FY 2005 Actual	FY 2006	
			Plan	Actual
--	0.8%	0.9%	0.9%	1.0%

Note: In FY 2005, Automated Underreported (AUR) cases were included as part of this measure. In FY 2006, AUR is covered as a separate measure (see measure 7. – AUR Coverage). The new methodology was applied to prior year actual and the FY 2006 plan number.

FY 2006 Performance: Target Exceeded. The IRS met/exceeded the FY 2006 target.

Future Plans: The IRS will continue to balance its audit coverage to emphasize reduction of the tax gap. Specific areas targeted for improvement include the workload identification processes, the audit selection criteria, and restructured examination training classes.

2. Field Examination Embedded Quality (EQ) (Replaces Examination Quality – Field)

Description: The number of EQ quality attributes that are scored as "met" by an independent centralized review staff divided by the total attributes measured ("mets" + "not mets") in a sample of closed Field Examination cases. All measured attributes have the same weight when calculating the score. Pending full implementation in FY 2007, only like attributes corresponding to those in the prior Examination Quality Measurement System (EQMS) (quality system preceding EQ) reviews were used in FY 2006.

Field Examination Embedded Quality				
FY 2003 Actual	FY 2004 Actual	FY 2005 Actual	FY 2006	
			Plan	Actual
N/A	N/A	N/A	Baseline	Not Yet Available

FY 2006 Performance: In FY 2006, a baseline year, the IRS converted to the EQ system of measuring quality by the national independent centralized review staff. Baseline data will be available December 1, 2006.

Future Plans: The IRS will complete the full implementation of EQ with the addition of the front-line manager phase. This phase directly links Critical Job Elements to the quality measurement system, improving the relationship between individual performance and organizational objectives. Full implementation of EQ is expected to help identify potential problem areas in need of process improvements or focused training, and ultimately, lead to reductions in examination cycle time.

3. Office Examination Embedded Quality (EQ) (Replaces Examination Quality – Office)

Description: A percentage representing the number of EQ quality attributes that are scored as "met" within SBSE divided by the total attributes measured ("mets" + "not mets") in a sample of closed Office Examination cases. All measured attributes have the same weight when calculating the score. Pending full implementation in FY 2007, only like attributes corresponding to those in the prior EQMS reviews were used in FY 2006.

Office Examination Embedded Quality				
FY 2003 Actual	FY 2004 Actual	FY 2005 Actual	FY 2006	
			Plan	Actual
N/A	N/A	N/A	Baseline	Not Yet Available

FY 2006 Performance: In FY 2006, the baseline year, the IRS converted to the EQ system of measuring quality at the national independent centralized review staff within SBSE level. Baseline data will be available December 1, 2006.

Future Plans: The IRS will complete the full implementation of EQ with the addition of the front-line manager phase. This phase directly links employees' Critical Job Elements to the quality measurement system, improving the relationship between individual performance and organizational objectives. Full implementation of EQ is expected to help identify potential problem areas in need of process improvements or focused training and, ultimately, lead to reductions in examination cycle time.

4. Examination Coverage – Business (Corps. >$10M)

Description: The number of Large and Mid-Size Business customer returns with assets greater than $10 million examined and closed during the current fiscal year, divided by filing of the same type returns from the preceding calendar year.

Examination Coverage – Business (Corps. >$10M)				
FY 2003 Actual	FY 2004 Actual	FY 2005 Actual	FY 2006	
			Plan	Actual
--	7.5%	7.8%*	7.5%	7.4%

*Revised FY 2005 actual reflects updated case closure information from the Automated Inventory Management System (AIMS)

FY 2006 Performance: Target Not Achieved. The IRS did not meet the FY 2006 target. The target was missed by .1 percentage point due to the IRS being prevented from taking enforcement action on a significant number of partnership return examinations involving a tax shelter promoter. Also, partnership audits were not as productive as expected so the IRS stopped opening these audits until improvement of the examination selection methodology.

Future Plans: The IRS will continue to focus on the issues that pose the greatest compliance risk and to identify enterprises that appear to be non-compliant. The IRS' emphasis on streamlining and improving the examination process, coupled with better risk analysis, will continue to provide for early resolution of post-filing examination issues and enhance large business examination coverage.

5. Examination Efficiency – Individual (Revised Measure)

Description: The sum of all individual returns closed by SB/SE, W&I, and LMSB (Field Examination and Correspondence Examination) divided by the Total Full Time Equivalents (FTE) expended in examining those individual returns. In FY 2005, Automated Underreporter (AUR) cases were included as part of this measure. In FY 2006, AUR Efficiency is covered as a separate measure (see measure 6. – AUR Efficiency). The new methodology was applied to prior year actual and the FY 2006 plan number.

Examination Efficiency – Individual				
FY 2003 Actual	FY 2004 Actual	FY 2005 Actual	FY 2006	
			Plan	Actual
N/A	N/A	121	121	128

FY 2006 Performance: Target Exceeded. The IRS met/exceeded the FY 2006 target. Record closures and stable FTE enabled the IRS to exceed its plan.

Future Plans: The IRS will continue to provide balanced examination coverage for those individual return categories with the highest risk of non-compliance, focusing on both understatement of income and overstatement of offsets to income. Newly designed training supports this emphasis, with its focus on auditing techniques.

6. Automated Underreporter (AUR) Efficiency

Description: The total number of W&I and SB/SE contact closures (a closure resulting from a case where the IRS made contact with the taxpayer) divided by the total FTE.

AUR Efficiency				
FY 2003 Actual	FY 2004 Actual	FY 2005 Actual	FY 2006	
			Plan	Actual
--	1,514	1,701	1,759	1,832

FY 2006 Performance: Target Exceeded. The IRS met/exceeded the FY 2006 target.

Future Plans: The IRS will leverage the process improvements implemented in FY 2006 to improve workload selection and productivity, and reduce the number of cases closed without taxpayer contact.

7. Automated Underreporter (AUR) Coverage

Description: Total number of W&I and SB/SE contact closures (a closure resulting from a case where IRS made contact) divided by the total return filings from the prior year.

AUR Coverage				
FY 2003 Actual	FY 2004 Actual	FY 2005 Actual	FY 2006	
			Plan	Actual
--	1.9%	2.2%	2.3%	2.4%

FY 2006 Performance: Target Achieved. The IRS met/exceeded the FY 2006 target.

Future Plans: The IRS plans to leverage the process improvements implemented in FY 2006 to improve workload selection and productivity, reducing the number of cases closed without taxpayer contact.

8. Examination Quality – Industry

Description: The average of the percentage of critical quality attributes passed on Industry cases (corporations, S-Corps (pass through corporations), and partnerships with assets over $10 million reviewed.

Examination Quality – Industry				
FY 2003 Actual	FY 2004 Actual	FY 2005 Actual	FY 2006	
			Plan	Actual
74.0%	74.0%	77.0%	80.0%	85.0%

FY 2006 Performance: Target Exceeded. The IRS met/exceeded the FY 2006 target.

Future Plans: The IRS plans to identify areas that warrant further attention and improvement through its quality reviews. All examination training courses will expand modules on the identified improvement targets and incorporate pertinent information about the auditing standards used to measure case quality. The IRS will also continue its work with the Case Quality Improvement Council (CQIC) and its Industry contacts to drive quality improvement efforts.

9. Examination Quality – Coordinated Industry

Description: The average of the percentage of critical quality attributes passed on Coordinated Industry (the 900 largest corporations) cases reviewed.

Examination Quality – Coordinated Industry				
FY 2003 Actual	FY 2004 Actual	FY 2005 Actual	FY 2006	
			Plan	Actual
89.0%	87.0%	89.0%	92.0%	96.0%

FY 2006 Performance: Target Exceeded. The IRS met/exceeded the FY 2006 target.

Future Plans: The IRS plans to identify areas that warrant further attention and improvement through its quality reviews. All examination training courses will expand modules on the identified improvement targets and incorporate pertinent information about the auditing standards used to measure case quality. The IRS will also continue its work with the CQIC and its Industry contacts to drive quality improvement efforts.

10. Collection Coverage – Units (Revised Measure)

Description: The volume of collection work closed compared to the volume of collection work available. The new methodology for FY 2006 includes balance due and delinquent return cases still in notice status whereas, the FY 2005 methodology only considered those accounts or investigations in delinquent status (Taxpayer Delinquent Account (TDA) and Taxpayer Delinquent Investigation (TDI) statuses). The new methodology was applied to recalculate the prior actual and the FY 2006 plan number.

Collection Coverage – Units				
FY 2003 Actual	FY 2004 Actual	FY 2005 Actual	FY 2006	
			Plan	Actual
--	--	53.0%	52.0%	54.0%

FY 2006 Performance: Target Achieved. The IRS met/exceeded the FY 2006 target.

Future Plans: The IRS plans to continue to facilitate the process for allocating its resources and planning for program delivery through the Collection Governance Council. This will ensure enterprise-wide coordination of case selection and delivery decisions.

11. Collection Efficiency (Revised Measure)

Description: Total work (delinquent accounts, investigations, offer-in-compromise, automated substitution for return) divided by the total Full Time Equivalent (FTE) realized in field collection and in campus collection. The new methodology for FY 2006 includes balance due and delinquent return cases still in notice status whereas, the FY 2005 methodology only considered accounts or investigations in delinquent status (Taxpayer Delinquent Account (TDA) and Taxpayer Delinquent Investigation (TDI) statuses). The new methodology was applied to recalculate the prior actual and the FY 2006 plan number.

Collection Efficiency				
FY 2003 Actual	FY 2004 Actual	FY 2005 Actual	FY 2006	
			Plan	Actual
--	--	1,514	1,650	1,677

FY 2006 Performance: Target Exceeded: The IRS met/exceeded the FY 2006 target.

Future Plans: The IRS plans to continue its practice of allocating resources and planning for program delivery through the Collection Governance Council to ensure enterprise-wide coordination of case selection and program delivery decisions.

12. Field Collection Embedded Quality (EQ) – (Replaces Field Collection Quality of Cases Handled in Person)

Description: This measure was baselined in FY 2006 and replaces the "Field Collection Quality of Cases Handled in Person" measure. The number of EQ quality attributes that are scored as "met" by an independent centralized review staff divided by the total attributes measured (mets + not mets) in a sample of closed cases. All measured attributes have the same weight when calculating the score.

Field Collection Embedded Quality				
FY 2003	FY 2004	FY 2005	FY 2006	
Actual	Actual	Actual	Plan	Actual
N/A	N/A	N/A	Baseline	84.2%

FY 2006 Performance: In FY 2006, the baseline year, the IRS converted to the EQ system of measuring quality at the national independent centralized review staff level.

Future Plans: The IRS will complete the full implementation of EQ with the addition of the front-line manager phase. This phase directly links employees' Critical Job Elements to the quality measurement system, improving the relationship between individual performance and organizational objectives. Full implementation of EQ is expected to help identify potential problem areas in need of process improvements or focused training and ultimately, lead to reductions in collection cycle time.

13. Automated Collection System (ACS) Accuracy

Description: Percent of taxpayers who receive the correct answer to their ACS question.

ACS Accuracy				
FY 2003	FY 2004	FY 2005	FY 2006	
Actual	Actual	Actual	Plan	Actual
--	87.8%	88.5%	88.0%	91.0%

FY 2006 Performance: Target Exceeded. The IRS met/exceeded the FY 2006 target.

Future Plans: The IRS will leverage the process improvements made to its Electronic Automated Collection Service Guide, a tool designed to further increase response accuracy. Also, the IRS will trend accuracy statistics to better focus managerial reviews.

14. Criminal Investigations Completed

Description: The total number of subject criminal investigations completed during the fiscal year, including those that resulted in prosecution recommendations to the Department of Justice as well as those discontinued due to a lack of prosecution potential.

Criminal Investigations Completed				
FY 2003	FY 2004	FY 2005	FY 2006	
Actual	Actual	Actual	Plan	Actual
3,766	4,387	4,104	3,945	4,157

FY 2006 Performance: Target Exceeded. The IRS met/exceeded the FY 2006 target.

Future Plans: The IRS will continue to monitor Criminal Investigation's performance and adjust program focus as necessary to ensure efforts garner the greatest deterrent effect possible.

15. TE/GE Determination Case Closures

Description: Cases established and closed on the Employee Plans-Exempt Organizations Determination System (EDS) includes all types of tax exempt and employee plan application cases.

TEGE Determination Case Closures				
FY 2003 Actual	FY 2004 Actual	FY 2005 Actual	FY 2006	
			Plan	Actual
171,812	143,877	126,481	112,400	107,761

FY 2006 Performance: Target Not Achieved. The IRS did not meet the FY 2006 target. The implementation of the new staggered amendment filing process for employee plans changed the FY 2006 inventory mix. Over 40 percent of the 25,000 receipts were prototype plans that require more extensive review as they will subsequently be adopted by thousands of individual employers. These cases will not close until FY 2007, resulting in the closure of 3,600 fewer cases than originally planned. Additionally, recent increases in user fees for employee plan determinations resulted in a slight decrease in determination applications and ultimately 1,500 fewer projected closures.

Future Plans: To stabilize the flow of determination receipts and mitigate the significant swings in workload experienced prior to FY 2006, the IRS will continue its roll-out of the staggered amendment process. The IRS also plans to test and pilot (with external partners) a new interactive software application for preparing determination applications designed to improve the quality of determination requests and establish the foundation for future electronic filing of these applications.

Strategic Goal 3: Modernize the IRS through its people, processes and technology

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

Major Results, Accomplishments, and Challenges

The IRS must strategically manage its resources, business processes, and technology systems to effectively and efficiently support its service and enforcement mission. "Modernization" includes technology projects with which taxpayers are not directly involved, such as replacement of the master file system, upgrading accounting systems, and enhancing the modernized technological infrastructure on which existing and all future applications will depend. Modernization also applies to the work processes and preparing the IRS workforce to meet the challenges of the 21st century, including replenishing a maturing workforce, improving workforce skills, and ensuring a continual leadership cadre for the future. The IRS strives to become a “first choice” employer where talented people want to work and can excel in a culture of high performance, empowerment, and a quality work environment.

Human Capital Accomplishments

To ensure the IRS builds a highly productive and engaged workforce, the Human Capital Strategic Implementation Plan was introduced in FY 2006. The plan aligns Treasury’s Human Capital (HC) Strategic Goals, the IRS’ Strategic Goals, and the IRS’ HC Strategic Goals, and establishes performance monitoring against objectives, processes, and projects.

Throughout FY 2006, the IRS ensured the appropriate and necessary investments were made in human capital, its most valuable resource. A multi-year recruitment and marketing plan was developed to target a diverse applicant pool. A comprehensive assessment strategy to identify applicants with the knowledge, skills, and abilities (competencies) necessary to support core job responsibilities positioned the IRS to meet its current, and plan to meet its future, business needs. Additionally, the IRS increased the use of workforce planning tools to develop a more robust link between business plans (i.e., examination plan) and workforce replenishment. More directly, the following areas were targeted:

- Linking pay with performance to maximize the workforces’ contributions to the IRS core mission and goals. About 5,700 front-line managers transitioned to a new pay band and 2,000 senior managers and department managers transitioned to a redesigned, step-less pay band.
- Developing an IRS-wide pay for performance framework to move 90,000 employees into a performance-based pay environment.

- Delivering customized training electronically. For example, electronic delivery of mandatory briefings (computer security, unauthorized access) saved the IRS $1.6 million for 75,000 employees.
- Assembling a highly trained cadre of recruiters responsible for maintaining an IRS recruiting presence at educational institutions, particularly for the IRS' enforcement occupations. The cadre established partnerships with over 200 colleges and universities and attended 800 campus and commercial events across the country.

The IRS used competition as an incentive to improve IRS business processes, reshape its workforce, and further its strategic goals. The IRS conducted its first full and open standard competition to evaluate work performed at three Area Distribution Centers (ADCs) and to recommend improvements. ADCs provide warehousing, inventory, and management services for more than 12,000 publications and process about five million customer orders annually. The ADCs occupy 550,000 square feet of combined leased warehouse space and employ 400 FTE positions. A bid solicitation for the competition, developed in partnership with the National Treasury Employees Union, resulted in seven proposals: six from well-known private sector organizations and one from the in-house team, called the Most Efficient Organization, which won the competition.

The competitive sourcing competition for the Submission Processing Files function resulted in a decision to award a contract to an experienced vendor. The IRS reached its award decision after evaluating all proposals including the Government's Most Efficient Organization proposal, private vendor proposals, and public reimbursable proposals. After careful and accurate technical and cost evaluations, the IRS found the vendor's proposal to be the lowest-priced, technically acceptable proposal, and awarded a five-year contract consisting of a base period of one year and four optional years.

Business Systems Modernization

The Business Systems Modernization (BSM) program combines best practices and expertise in business solutions and internal management from IRS, business, and technology sectors to develop a world-class tax administration system that fulfills the revenue collection requirements of the United States as well as taxpayer's needs and expectations.

The IRS executed its BSM projects with a degree of sustained success not seen since program inception. Successful program delivery during the past two years demonstrates that the IRS' BSM program has established a foundation of disciplined project delivery and accomplishment. Overall, the program delivered within the target of +/- 10 percent variance for both cost and schedule components for major release and sub-release milestones, a significant achievement that validates BSM program management effectiveness. This accomplishment is especially noteworthy in that the program achieved this while transitioning from a contractor-led program to an IRS-led program.

A key success factor has been the IRS' increased focus managing contractor performance and leveraging IRS resources. This approach was outlined in the Modernization Vision & Strategy (MV&S) efforts, a comprehensive vision for IRS' future operations. The MV&S establishes a plan that drives investment decisions, addressing the priorities for modernizing front-line tax administration, and establishes technical capabilities provided by infrastructure and security.

The MV&S reflects the priorities across the IRS and serves as a guide for focusing investment by mandating development of a prioritized list of proposed IRS modernization projects for a given year. Whenever possible, the MV&S approach leverages existing systems, and, as necessary, the program includes new development to optimize capacity, manage program costs, and deliver functionality in smaller and more frequent releases. The IRS expects this approach to deliver business value sooner and at a lower risk.

Information technology solutions are the most effective and efficient means of increasing the number of IRS contacts with taxpayers and offers faster alternatives for taxpayers to meet their tax obligations. Information technology solutions also enhance the IRS' ability to identify non-compliance and to combat tax avoidance schemes that contribute to the tax gap. The following highlights the IRS' efforts in FY 2006:

- Stabilized and institutionalized program management improvements, meeting scope expectations for implemented functional and technical capability. The BSM program expanded its financial and schedule management capabilities to include greater detail and controls than previously available in past expenditure plans.

- Implemented Release 3.2 of its Modernized e-File (MeF) project, which expanded the electronic filing of both federal and state (Forms 1120 and 1120-S) Corporate Income Tax Returns and is mandatory for certain corporations. Corporate tax returns typically include hundreds, or even thousands, of pages and receiving the data electronically from these voluminous and complex returns speeds the examination process. Electronic capture of return information allows the IRS to quickly deliver the data to analysts and agents for compliance risk assessment and action. MeF processed 375,000 corporate returns. The IRS plans to expand the MeF taxpayer base to include Partnership Income tax returns (Form 1065), eventually enabling nearly 2.7 million small business and self-employed taxpayers to benefit from electronic filing.

- Introduced new Customer Account Data Engine (CADE) capabilities for the 2006 filing season. CADE supported faster refunds to taxpayers, issuing direct deposit refunds between one and seven days faster and paper refunds four to thirteen days faster than refunds generated by the legacy system. CADE processed over 7.3 million returns – more than a 400 percent increase over the previous year, and issued 7 million refunds totaling in excess of $3.4 billion. CADE improved taxpayer service by allowing access to current information up to seven days sooner, increasing the likelihood of single telephone call resolution and allowed faster issue detection and more timely account settlement. CADE is expected to process an estimated 33 million returns in 2007.

- Completed the first release of the Filing and Payment Compliance (F&PC) strategy. F&PC functionality analyzes tax collection cases and separates cases that require direct IRS involvement from those that can be handled by Private Collection Agencies (PCAs). The introduction of PCAs is expected to:
  - Assist the IRS by addressing the volume of delinquent taxpayers that exceeds the IRS' capacity to work, approximately 250,000 cases per year.
  - Eliminate backlogs in the large number of outstanding tax liabilities, which have grown by 118 percent over the last 12 years, increasing tax revenue and reducing the tax gap.

- Allow the IRS to close 2.4 million more collection cases each year, improving the collection case closure rate from 53 percent (as of FY 2005) to 97 percent by 2016.

Business Process Reengineering

The IRS continued to improve quality, efficiency, and service delivery through a wide-range of initiatives designed to increase service coverage to taxpayers and implemented new and improved business processes. Processes were put in place to better integrate business and technology strategies and manage out-of-cycle information technology requests and budget changes. Examples of successful initiatives include:

- Reengineered the examination function to streamline the process, increase effectiveness and timeliness in examining returns, resolve taxpayer issues, and reduce and redirect resources to improve operational results.

- Reengineered collection functions to improve workload selection, reduce cycle time, improve casework quality, and improve customer and employee satisfaction. The focus on collection activities yielded positive results, ensuring timely initial contacts by Revenue Officers and reduced activity lapses in casework.

- Implemented the Desktop Integration (DI) System, replacing the old Integrated Case Processing system. DI allows call center assistors to determine the status of a taxpayer's account reducing the amount of time needed for account resolution, and allows the assistor to provide timely, quality responses to the taxpayer. The DI System was successfully deployed to over 30,000 users.

- Developed and implemented a Phishing Web Site to provide guidance to internal and external stakeholders. "Phishing" is the act of sending an e-mail to a user falsely claiming to be a legitimate enterprise in an attempt to scam the user into surrendering private information that could be used for identity theft. The IRS phishing e-mail box at phishing@irs.gov was established so internal and external stakeholders could send phishing e-mails to the IRS for evidence gathering and developing countermeasures.

- Completed the development phase of Contact Recording Release 4.0 for use in IRS Taxpayer Assistance Centers (TACs). Contact Recording provides functionality to record a taxpayer call for training purposes and is expected to increase quality and accuracy of taxpayer responses and improve productivity. Deployment added an additional 33 sites to the existing 14 sites. By January 2007, the IRS plans to have contact recording deployed to approximately 130 TACs representing an assortment of small, medium, and large sites in 37 of the 50 states. Contact Recording will be deployed to all 400 TACs by early FY 2009.

- Designed an imaging network to scan and electronically warehouse, paper tax returns for large and mid-size businesses. This "just-in-time" inventory of returns will reduce the examination start time from 12 -18 months from filing date, to under 90 days. The benefits of reduced cycle times include earlier identification of emerging issues, faster closing of returns at the completion of an audit, and reduction of taxpayer burden.

- Launched an on-line installment agreement tool for taxpayers (individual return filers) via the IRS.gov website. Taxpayers can now, at their convenience, self qualify for an installment agreement and apply for and receive notification of approval during an on-line session. The IRS processing costs are also reduced.

- Implemented an Enterprise Queue of toll-free calls in the Automated Collection System (ACS), Examination and Automated Underreporter call sites. Enterprise queuing allows toll-free callers to be placed in a central queue for an available representative anywhere in the IRS enterprise system. Customers can now be assisted by the first available assistor trained in their specific topic.

Security and Protection of Data

In response to the challenge of protecting the taxpayer and employee, the IRS took steps to improve protection of sensitive information. The issuance of Memorandum M-06-16, Protection of Sensitive Agency Information, issued by the Office of Management and Budget, established requirements the IRS put in place to increase protection for networks, laptops, and other mobile computing devices. Additional policies and procedures are being implemented to bring the IRS in line with the requirements of the memorandum. The IRS is deploying a three-pronged strategy focusing on technology solutions (encryption), employee education and awareness, and critical analysis of IRS policies and procedures. The IRS also established a Security Services and Privacy Executive Steering Committee to coordinate efforts and to leverage subject matter experts from the areas of information technology security, physical security, privacy, and identify theft.

During FY 2006, the IRS developed Information Protection Training for employees and stakeholders. The training integrated the domains of privacy, computer security, disclosure, and unauthorized access (UNAX). In the future, the IRS education and awareness programs will be expanded to focus attention on enhancing information protection practices in daily operations.

The IRS continued progress toward the implementation of Business Resumption Plans (BRP) at all IRS facilities. In FY 2006, the IRS deployed business resumption plans during recovery from the Gulf Coast hurricanes and again when operations were quickly resumed after heavy rains late in June 2006 caused severe flooding and forced closure of the IRS headquarters building in Washington, D.C. The Commissioner and all of the top level executives immediately resumed business at an alternate IRS location. Through extraordinary coordination, within thirty days, over 2,200 displaced employees returned to their normal duties. There was no impact on service to the public. In all of the recent instances, BRPs were fully executed and Incident Commanders received support from designated organizations to stand up operations quickly and in priority order.

Safety of Employees

During FY 2006, the IRS Continuity of Operations (COOP) Plan was updated to maintain compliance by adding annexes that address surrender of power to local authorities by the Federal Government, and pandemic influenza. The IRS participated in the planning and execution of the government-wide COOP exercise, Forward Challenge 06. During the exercise, several scenarios, including a cyber attack on IRS tax systems and a physical attack on a campus facility were simulated and worked by the team. A number of lessons learned were documented that will provide the direction for further improvement of the COOP Plan and the IRS' overall approach to COOP preparedness. The IRS also continued high levels of emphasis on ensuring Occupant Emergency Plans (OEP) and Shelter in Place (SIP) Plans are current for all IRS Facilities.

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IRS measures reported in the IRS' annual performance budget and included in the Treasury Performance Reporting System are discussed below.

1. BSM Project Cost Variance by Release/Subrelease – (Replaces the Cost portion of the Contracted Program Cost and Schedule Variance Measure)

Description: Percent variance by release/sub-release of a BSM funded project's initial, approved cost estimate versus current, approved cost estimate. Cost variances less than or equal to +/- 10 percent are categorized as being within acceptable tolerance thresholds. Cost variances greater than +/- 10 percent of the variance are categorized as being outside of acceptable thresholds.

FY 2006 BSM Project Cost Variance by Release/Subrelease

Cost Variance for Project Segments Completed in FY 2006							
Project	**Release**	**Milestone**	**Planned Cost** (000)	**Current Cost** (000)	**Variance ($)** (000)	**Variance** (%)	**Within Acceptable Tolerance**
F&PC	R1.2	3	16,550	9,014	(7,536)	-46%	NO
F&PC	R1.2	4a	10,536	10,536	-	0%	YES
MeF (Fed/State Project)	R3.2	4	23,773	31,323	7,550	32%	NO
MeF	R4	3	8,000	3,800	(4,200)	-53%	NO
CADE	R1.3.2	FS06	20,767	20,833	66	0%	YES
CADE	R2.1	4	27,049	31,239	4,190	15%	NO

FY 2006 Performance: In FY 2006, the baseline year, the IRS used an improved methodology for determining project cost variance by release/subrelease. Cost variance is reported separately for each major release/subrelease. Overall, the BSM program delivered nearly half of project segment cost within target, and is meeting target expectations for nearly all project segments currently in-progress. In some cases, BSM cost targets exceeding a -10 percent threshold are attributed to reducing project scope. Note: For a detailed variance explanation by project segment, refer to the FY 2006/FY 2007 BSM Expenditure Plan. Aggressively managing and monitoring contractor performance and leveraging resources were key factors contributing to this year's success in meeting the targets for cost variance.

Future Plans: The IRS will continue reporting on cost schedule measures in accordance with the agreed upon performance methodology. Variance exceeding the +/- 10 percent threshold is subject to IRS change notification process review, Executive Steering Committee approval and, if applicable, Modernization and Information Technology Services Enterprise Governance Committee approval. Cost variances exceeding +/- 10 percent or $1 million require Congressional notification. At each review juncture, management ensures that proposed project changes as reported in the BSM expenditure plan are valid and that mitigation plans are in place when applicable.

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2. BSM Project Schedule Variance by Release/Subrelease – (Replaces the Schedule portion of Contracted Program Cost and Schedule Variance Measure)

Description: Percent variance by release/sub-release of a BSM funded project's initial, approved schedule estimate versus current, approved schedule estimate. Schedule variances less than or equal to +/- 10 percent will be categorized as being within acceptable tolerance thresholds. If schedule variances are greater than +/- 10 percent, the variance will be categorized as being outside of acceptable thresholds.

FY 2006 BSM Project Schedule Variance by Release/Subrelease

Schedule Variance for Project Segments Completed in FY 2006							
Project	**Release**	**Milestone**	**Planned Finish Date**	**Current Finish Date**	**Variance (days)**	**Variance (%)**	**Within Acceptable Tolerance**
F&PC	R1.2	3	02/28/06	02/28/06	0	0%	YES
F&PC	R1.2	4a	06/30/06	07/10/06	5	6%	YES
MeF (Fed/State Project)	R3.2	4	03/31/06	03/22/06	-7	-2%	YES
MeF	R4	3	06/30/05	12/09/05	111	59%	NO
CADE	R1.3.2	FS06	12/31/05	12/31/05	0	0%	YES
CADE	R2.1	4	08/10/06	08/25/06	11	7%	YES

FY 2006 Performance: In FY 2006, the baseline year, the IRS used an improved methodology for determining project schedule variance by release/subrelease. Schedule variance is reported separately for each major release/subrelease. The BSM program delivered most (5 out of 6) project segments within schedule variance. (Note: For a detailed variance explanation by project segment, refer to the FY 2006/FY 2007 BSM Expenditure Plan.)

Future Plans: The IRS will continue reporting on schedule measures in accordance with the agreed upon performance methodology. Variance exceeding the +/- 10 percent threshold is subject to IRS change notification process review, Executive Steering Committee approval and, if applicable, Modernization and Information Technology Services Enterprise Governance Committee approval. Cost variances exceeding +/- 10 percent or $1 million require Congressional notification. At each review juncture, management ensures that proposed project changes as reported in the BSM expenditure plan are valid and mitigation plans are in place when applicable. Aggressively managing and monitoring contractor performance and leveraging resources were key factors contributing to this year's success in meeting the targets for schedule variance.

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New Measures

The following measures are reported for the first time in the IRS' FY 2006 MD&A:

- Taxpayer Self Assistance Rate
- Refund Timeliness – Individual (paper)
- Automated Underreporter Efficiency
- Automated Underreporter Coverage

Revised Measures

The following measures were developed based on a revised methodology and were renamed to reflect the new approach. The table below shows the renamed measure along with its replacement.

FY 2006 Measure Name	FY 2005 Measure Name
Field Examination Embedded Quality	Examination Quality – Field
Office Examination Embedded Quality	Examination Quality - Office
Field Collection Embedded Quality	Field Collection Quality of Cases Handled in Person
BSM Project Cost Variance by Release and Subrelease	Contracted Program Cost and Schedule Variance (The project cost component)
BSM Project Schedule Variance by Release and Subrelease	Contracted Program Cost and Schedule Variance (The project schedule component)

The components for calculating the following measures have changed, but the names of the measures remain the same. The year-end actual and projected targets reflected in Section II, Performance Goals and Results have been adjusted accordingly.

- Examination Coverage – Individual
- Examination Efficiency – Individual
- Collection Coverage – Units
- Collection Efficiency – Units

Deleted Measure

Contracted Requirements Stability and Contracted Requirements Delivered

III. Systems Controls and Legal Compliance

Federal Managers' Financial Integrity Act (FMFIA)

During FY 2006, the IRS complied with the internal control requirements of the FMFIA, the Federal Financial Management Improvement Act (FFMIA), the Office of Management and Budget (OMB) Circular A-123, and the Reports Consolidation Act of 2000. The IRS organizations are operating in accordance with the procedures and standards prescribed by the Comptroller General and OMB guidelines.

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

- programs achieve their intended results;
- resources are used consistent with the overall mission;
- programs and resources are free from waste, fraud, and mismanagement;
- laws and regulations are followed;
- controls are sufficient to minimize improper and erroneous payments;
- performance information is reliable;
- system security is in substantial compliance with all relevant requirements;
- continuity of operations planning in critical areas is sufficient to reduce risk to reasonable levels; and
- financial management systems are in compliance with Federal financial systems standards, i.e., FMFIA Section 4 and FFMIA.

The IRS has four open material weaknesses. Because the IRS has remaining material weaknesses and its financial management systems do not substantially comply with FFMIA, the IRS provides qualified assurance that the above listed systems of management control objectives were achieved by the IRS during FY 2006. This assurance is provided relative to Sections 2 and 4 of FMFIA.

The material weaknesses are:

- Improve Modernization Management Controls and Processes
- Financial Accounting of Revenue-Custodial
- Earned Income Tax Credit Non-Compliance
- Computer Security

Federal Financial Management Improvement Act (FFMIA)

As of September 30, 2006, the IRS' financial management systems did not substantially comply with the FFMIA. Remediation Plans for Custodial and Administrative Financial Systems are in place to resolve this condition. The IRS has improved its financial management systems' compliance with FFMIA.

During FY 2006, the IRS continued to improve and enhance its Integrated Financial System (IFS), receiving a clean financial statement audit opinion in the first year of operations. Also, additional functionality was implemented including budget and cost accounting user reports, production of an automated Statement of Net Cost and incorporation of mandated changes by oversight entities and agency management.

Also, during FY 2006, the IRS implemented Release 1 of the Custodial Detail Data Base (CDDB) to improve custodial accounting. Release 1 is the first step toward creating a subsidiary ledger for unpaid assessments to the Interim Revenue Accounting Control System General Ledger and captures cross-reference information on certain Trust Fund Recovery Penalty (TFRP) cases, thus reducing reclassifications. Additional milestones for Releases 2 and 3 were incorporated into the material weakness and FFMIA remediation action plans.

Lien Release Non-Compliance Issue

As of September 30, 2006, the IRS did not consistently comply with section 6325 of the Internal Revenue Code regarding the timely release of federal tax liens. The IRS developed a new action plan to address issues identified in the April 2006 review of the filing and release of tax liens and all issues identified by the Government Accountability Office (GAO) and the Treasury Inspector General for Tax Administration (TIGTA). The Financial and Management Controls Executive Steering Committee is monitoring this plan.

Reports Consolidation Act of 2000

In accordance with the Reports Consolidation Act of 2000, the IRS provides assurance that its Critical Performance Measures are reliable. Internal Revenue Manual 1.5, “Managing Statistics in a Balanced Measurement System Handbook,” provides a detailed template that documents each measure’s definition, formula, reliability, and reporting frequency. These controls ensure the data are consistently and accurately collected over time.

Continuity of Operations

The IRS continues to improve its enterprise-wide information technology security program to bring the IRS in full compliance with the requirements of the Federal Information Security Management Act (FISMA). IRS efforts in FY 2004 and FY 2005 focused on the accomplishment of security certification and accreditation of the network infrastructure systems, which was achieved at the end of FY 2005. In FY 2006, the IRS updated its security plans and completed the certification and accreditation for one-third of its systems to comply with new process guidance issued by OMB and the National Institute of Standards and Technology. The remaining systems will be updated in FY 2007 and FY 2008.

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

The IRS conducted the required evaluation of the effectiveness of the internal control over financial reporting in accordance with OMB Circular A-123 through the following activities:

- Tested internal control sets for the 45 transaction processes identified by Treasury that are material to its Consolidated Financial Statements. These tests included 35 administrative processes covering material portions of the IRS' $10 billion in annual administrative transactions, and 10 custodial tax-related processes, covering material portions of IRS' over $2 trillion in tax revenues processed annually. Based on IRS’ testing, the internal controls were operating effectively and no material weaknesses, other than the ones identified above in the FFMIA part of this document, were found in the design or operation of the internal controls.

- Reviewed controls over IRS' financial reporting, specifically Treasury Information Executive Repository reporting, and determined controls are in place and effective.
- Conducted a self-assessment of the internal control environment using GAO's Abbreviated Internal Control Evaluation Checklist.
- Reviewed IRS compliance with laws and regulatory requirements regarding financial reporting and internal control, specifically compliance with FFMIA, FMFIA, FISMA, Improper Payments Information Act, and the CFO Act, determining that the IRS is in compliance except for the issues cited in this document.
- Reviewed GAO and TIGTA audit reports and findings during the test plan development stage and at the end of the A-123 reporting period, and determined that the IRS is making progress toward completing corrective actions to the auditors' findings.

Based on the results of this evaluation, the IRS provided qualified assurance that its internal control over financial reporting was operating effectively as of June 30, 2006. The qualified assurance is based on the condition that the IRS has four material weaknesses, as reported by GAO in the IRS' FYs 2004 and 2005 audited financial statements. GAO, however, acknowledged in its report that the IRS has developed compensating procedures to produce financial statements that are fairly stated and issued an unqualified opinion.

Limitations of the Financial Statements

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

IV. Future Challenges

The great majority of Americans pay their fair share of taxes, but there is still a significant tax gap created by those taxpayers who don't pay the hundreds of billions in taxes they owe. The tax gap is the difference between what taxpayers should pay and what they actually pay due to:

- taxpayers not filing tax returns;
- not paying their reported tax liability on time; or
- failing to report their correct tax liability.

The IRS' current estimate of the overall gross tax gap is about $345 billion. It is the need to address the tax gap to ensure voluntary compliance that drives much of what the IRS does. The IRS enforcement activities, such as examination and collection, directly target tax gap elements, while IRS taxpayer services enhances compliance by providing the information taxpayers need to calculate their taxes, file tax forms, pay balances or receive refunds.

The IRS enforcement programs yield direct and indirect return on investment. Each dollar invested yields at least four dollars for the Federal Treasury. The link between taxpayer services and increased federal receipts, however, isn't as measurable, but is positive. It is important to understand that the complexity of the nation's current tax system is a significant reason for the tax gap. It is easy for even sophisticated taxpayers to make honest mistakes. Accordingly, helping taxpayers understand their obligations under the tax law is a critical part of addressing the tax gap. The IRS remains committed to assisting taxpayers in both understanding the tax law and paying the proper amount of tax.

Providing taxpayer service over multiple channels to align service content, delivery, and resources with taxpayer and partner expectations will be achieved by the implementation of the Taxpayer Assistance Blueprint (TAB). Elements of the TAB are designed to reduce taxpayer burden, increase voluntary compliance, and improve workforce performance by establishing a credible taxpayer/partner baseline of needs, preferences, and behaviors. Institutionalizing key research, operational, and assessment activities will help the IRS manage and improve service delivery.

The IRS has a robust, balanced, and comprehensive plan to help reduce improper payments. The plan includes base compliance activities and redesign efforts to identify, test, and implement new and enhanced business processes; an outreach component to educate taxpayers and preparers on Earned Income Tax Credit eligibility requirements; and a research strategy that supports the IRS Strategic Plan.

The manner and means by which individuals deploy fraudulent refund schemes is constantly evolving and is becoming more complex and sophisticated. The Questionable Refund Program (QRP) and the Return Preparer Program (RPP) will continue to serve an important tax administration purpose by enabling the IRS to identify and stop the payment of fraudulent refund claims, as well as identify and investigate unscrupulous return preparers.

The Electronic Fraud Detection System (EFDS) is one of several tools used by the IRS. All refund returns are scrutinized by EFDS, which results in the identification of a substantial proportion of false returns. The EFDS automates the review process including screening, income verification, scheme development, and scheme inventory management. As new schemes are identified, the computer system is programmed to identify them to maximize the efficiencies of the automated systems. The IRS must overcome the system failures that prevented the use of the EFDS during the 2006 filing season to make the legacy client/server system operational for the 2007 filing season.

Moving forward, the IRS must continue to focus on technology to ensure it uses technological advances to optimize both taxpayer service and enforcement programs. The IRS plans to continue the implementation of its revised Business Systems Modernization strategy, emphasizing the incremental release of projects to deliver business value sooner and at a lower risk. Modernization efforts will continue to focus on three key tax administration systems that provide additional benefits to taxpayers and the IRS employees: Customer Account Data Engine project; Modernized e-file; and Filing and Payment Compliance.

Recognizing the responsibility for safeguarding Americans' most sensitive financial information, the IRS is taking aggressive steps to improve taxpayer and employee information protection. The IRS will continue to focus on technological solutions (encryption), employee education and awareness, and critical analysis of IRS policies and procedures.

Targeted training, activities to promote retention, and engagement of employees are key elements of the IRS Strategic Plan, and necessary to sustaining an engaged and productive workforce. To meet changing business and technological demands, the IRS will focus efforts on implementing retention and training programs that identify targeted occupations, skill sets, and hard to fill positions. Features of the program include integrating all training, recruitment, hiring, and compensation efforts along with developing new and improved methods of predicting future attrition through retirements. Developing activities specifically targeted toward mitigating the impact of retirements through training, and those necessary to attract and retain new hires with advanced skills will be key to achieving the IRS' business goals.

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Major Management Challenges and High–Risk Areas

Over the last several years the Government Accountability Office (GAO), the Treasury Inspector General for Tax Administration (TIGTA), and the Office of the Inspector General (OIG) for Treasury have identified several Management Challenges and High-Risk Areas facing the IRS. The IRS has identified specific steps and actions to address these issues through its existing program activities. Measures of these program activities serve to show progress in addressing the management challenges and high-risk areas. A crosswalk showing the relationship between management challenges and the IRS Business Operating Divisions is shown below.

Management Challenge or High Risk Area	Business Operating Divisions																
	Agency-Wide Shared Services	Appeals	Chief Counsel	Chief Financial Officer	Communications & Liaison	Criminal Investigation	Human Capital Office	Equal Employment Opportunity & Diversity	Large & Mid-Size Business	Mission Assurance and Security Services	Modernization & Information Technology Services	Office of Professional Responsibility	Research, Analysis & Statistics	Small Business/Self-Employed	Tax Exempt & Government Entities	Taxpayer Advocate Service	Wage & Investment
Modernization of the IRS (Computerized IRS Systems and Business Structure) and IRS Business Systems				X							X			X	X		X
Tax Compliance Initiatives and Enforcement of Tax Laws		X	X		X	X			X		X	X	X	X	X		X
Security of the Internal Revenue Service										X	X						
Using Performance and Financial Information for Program and Budget Decisions	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Complexity of the Tax Law		X	X						X			X	X	X	X	X	X
Providing Quality Taxpayer Service Operations		X			X				X		X	X		X	X	X	X
Processing Returns & Implementing Tax Law Changes During Filing Season		X	X		X				X		X			X	X	X	X
Taxpayer Protection and Rights		X	X			X	X	X	X			X	X	X	X	X	X
Human Capital							X	X									

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The following pages summarize each Management Challenge and High-Risk issue, FY 2006 accomplishments, and actions identified for completion in FY 2007 and beyond

Modernization of the Internal Revenue Service (Computerized Systems and Business Structure) and IRS Business Systems

Issue: Bring the IRS' business systems and financial systems to a level that provides management current and reliable information to support informed decision making. GAO in its FY 2005 High Risk series has consolidated IRS Business Systems Modernization and IRS Financial Management into one Business Systems Modernization high-risk area.

Actions Taken (FY 2006)

- Continued to move the IRS towards realizing its technology modernization strategy through the Customer Account Data Engine (CADE), which provides key taxpayer benefits such as processing of refunds faster, daily posting of transactions and account updates. (Ongoing)
    - Delivered Release 1.3.2, which added Form 1040 and Form 1040A returns (without schedules) to the established baseline of Form 1040EZs. (01/2006)
    - Posted 7.3 million returns for filing season 2006 resulting in the issuance of 7 million refunds to eligible taxpayers totaling $3.4 billion. (01/2006)
    - Deployed CADE Release 2.1, which added Form 1040 Schedules A, B, and R and Form 1040A Schedules 1 and 3. (09/2006)
- Delivered full functionality for Filing & Payment Compliance (Release 1). Functionality provides for the identification of cases to be issued to Private Collection Agencies (PCAs). The system identified and delivered 12,500 cases with the three PCAs awarded contracts in March 2006. (09/2006)
- Implemented mandatory electronic filing for large corporations (those with assets greater than $50 million that file at least 250 returns a year) and certain exempt organizations. The IRS received more than 12,500 returns from required corporations. Also, for the first time, over 10,000 exempt organizations electronically filed 990-series returns (annual forms). (09/2006)
- Automated the Statement of Net Cost in the Integrated Financial System. (09/2006)

Actions Planned or Underway (FY 2007 and beyond)

- Complete the Logistical Data Model and Logical Design for CADE Release 3.0. Complete Customer Technical Review and Life Cycle State reviews for CADE Release 3.0. (11/2006)
- Establish Modernized e-File (MeF) as primary interface for all business filings. MeF will remedy the electronic filing limitations (e-File) within the current legacy systems including those that prevent partnerships with complying. (01/2007)
- Process TY 2006 U.S. Return of Partnership Income (1065 returns) through MeF. (01/2007)

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- Deploy CADE Release 2.2 to add 1040 Schedules C, E, F, (without EINs) and/or SE, D, and update for 2006 tax law changes, including guidance IRS established for implementing the Telephone Excise Tax Refund that eligible taxpayers can request on their 2006 Federal income tax return. (01/2007)
- Expand mandatory electronic filing for large corporations (those with assets greater than $10 million that file at least 250 returns a year) and certain other exempt organization returns. (01/2007)
- Deploy the Correspondence Examination Automation Support (CEASrev1) application to increase efficiency and effectiveness of operations through improved inventory, workload and resources management. (02/2007)
- Continue operation of the computer data security web site that provides information and guidance to assist employees in complying with all IRS data security requirements. (Ongoing)
- Deploy the Filing and Payment Compliance Release 1.2 which will provide automated inventory management tools with additional volumes provided to the selected PCAs, increase caseload to 350,000 cases, improve review queue process and information flow, and become EA compliant. (09/2007)

The current version of IFS software will no longer be supported by the COTS vendor effective December 2009. The IRS has provided Treasury and OMB an initial alternatives analysis that examines several options for a “go forward” strategy for the financial system. Further alternative analysis is ongoing that includes evaluating cost, benefits, and risks associated with federal Center of Excellence (COE) and private Shared Service Provider (SSP) options. IRS has requested FY 2008 funding to upgrade the financial system in FY 2010. The upgrade will include increased federal functionality and vendor-supported system software.

Tax Compliance Initiatives and Enforcement of Tax Laws

Issue: Administer programs to deal with tax gap issues, especially those resulting from corporate and high-income individual taxpayers, as well as domestic and off-shore tax and financial criminal activity. Address the evolving challenge of unpaid taxes and continuing Earned Income Tax Credit (EITC) noncompliance.

Actions Taken (FY 2006)

- Implemented the first phase of the Private Debt Collection (PDC) initiative that allows the IRS to use Private Collection Agencies (PCAs) to collect delinquent tax debts. (01/2006)
- Implemented major programming changes to EITC examination inventory management and expanded abilities of the EITC Dependent Database selection process. Expanded test of Soft Notice treatment to reach taxpayers who are likely to self-correct behavior identified by the new scoring models. (Ongoing)
- Developed and administered two EITC survey instruments in conjunction with the Taxpayer Advocate and Low Income Taxpayer Clinics. The first survey instrument identified correspondence audit barriers experienced by EITC Taxpayers with results available at the end of the calendar year. The second will identify EITC taxpayers' information needs and how effectively these needs are currently being met. (09/2006)
- Updated EITC multi-year return preparer study that addresses paid preparer non-compliance and gathers data on the effects of these efforts on paid preparers as well as taxpayers. (Ongoing)
- Developed the withholding compliance program, an alternative treatment to influence non-compliant taxpayers to establish an adequate withholding behavior to promote future compliance. Developed outreach and educational initiatives to increase withholding compliance in the retired military population. (10/2005)
- Elevated the priority of the Federal Employee/Retiree Delinquency Initiative by centralizing inventory in a specific site so cases can be worked by employees with specialized training. (Ongoing)
- Began using the Return Preparer Analysis Tool to more effectively identify egregious preparer returns for examination potential. (05/2006)
- Upgraded the Bank Secrecy Act (BSA) workload database. Upgrades will provide a more complete record of the affected banks tagged as potentially non-compliant and integrate results from research projects on the attributes that may predict non-compliance. (Ongoing)
- Continued data exchange with state taxing organizations to leverage limited government resources: (09/2006)
  - Initiated the State Revenue Agent Report project to identify non-filers and under-reporters based on state audit reports.

  - Enhanced the multifunctional non-filer strategy to provide a more rigorous and specific data matching processing for IRS and state audit reports and uniform record layout for more efficient data exchange.
  - Piloted the State Reverse File Match Initiative which emphasizes the identification of federal non-filers by matching against state filing databases.

- Initiated the Attributed Tip Income Program, a tip reporting and education program offered to small to medium size employers in the food and beverage industry to help improve the tip income reporting of employees with minimal burden on the employer. Benefits include reduction in industry recordkeeping burden, simple enrollment requirements, and improved reporting of tips on Federal income tax returns. (07/2006)

- Secured and improved tip income reporting agreements for 90 percent of major casinos, providing more consistent tip reporting among the expanding number of Gaming Industry tipped employees. Planned enhancements will increase the accuracy of casino reported year-end-data on tips, reducing potential reporting errors, and reducing burden for participating employee-taxpayers. (08/2006)

- Conducted simultaneous civil and criminal actions to stop abusive tax promotions and prevent their proliferation by high income taxpayers who frequently employ complex, multi-layered transactions. (Ongoing)

- Doubled the number of taxpayers (17 in FY 2005 to 34 in FY 2006) in the Compliance Assurance Program (CAP), a process in which corporate taxpayers and IRS agents work together to examine transactions in “real time” during the taxable year to reach agreement on the taxpayer’s tax liability before the tax return is filed. (Ongoing)

- Continued the Pre-Filing Agreement program that provides corporate taxpayers and Revenue agents with an opportunity to examine and resolve potential issues before tax returns are filed. (Ongoing)

- Substantially completed a major effort to curb abuse by non-profit credit counseling organizations resulting in revocation of exempt status or termination of organizations found to be non-compliant. (05/2006)

- Increased vigilance concerning political campaign intervention by Section 501(c) (3) charitable organizations by issuing new procedures for the 2006 election season to ensure that all referrals are reviewed expeditiously and consistently. The IRS has also expanded educational effort to ensure that charities understand what constitutes prohibited political intervention and how to stay compliant with the tax laws. (02/2006)

- Implemented an inventory management system to assign high-risk examination cases using capacity and a risk-based scoring system. (01/2006)

- Established Issue Management teams to address tax shelter and other high risk issues and improve the IRS’ ability to report on issue trends, enhance risk analysis, and improve return selection. (09/2006)

- Implemented improvements to improve EITC participation and reduce errors:
  - Completed analysis of EITC overclaim rate ranges to identify changes in the rate due to improved taxpayer compliance. (09/2005)
  - Tested the use of a National Directory of New Hires database match in the IRS Criminal Investigation EITC Fraud Detection Centers. (01/2006)
  - Developed new strategies to prevent duplicate claims of qualifying children. (12/2005)
  - Launched second phase of EITC return preparer study to track EITC filing volume and return math error accuracy through outreach campaigns and volunteer tax return preparation. (12/2005)
  - Developed pilot projects with New York and Massachusetts to leverage partnership opportunities with states that offer tax credits comparable to EITC. (06/2006)
  - Designed Dependent's Database check to systemically classify and select EITC amended returns for examination to reduce the amount of erroneous payments by providing the same scrutiny to original returns processing. (07/2006)
  - Initiated survey of taxpayers who participated in the Qualifying Child Certification Proof of Concept to identify specific strategies and improvements for the EITC Program. (09/2006)
  - Completed launch of over 500,000 new start examinations of EITC returns based on enhanced scoring and selection methodology. (09/2006)
  - Initiated research to assess changes in taxpayer EITC filing volume and track EITC return math error accuracy as a result of outreach campaigns and volunteer tax return preparation. (Ongoing)
  - Developed annual enterprise research strategy in partnership with internal and external organizations to better focus EITC compliance and outreach activities. (Ongoing)
  - Identified non-compliant EITC return preparers for due diligence visits and case treatment using the Return Preparer Analysis Tool. (Ongoing)
  - Built a multi-dimensional database that tracks EITC claimants and qualifying children over a period of years for use in future research projects. (Ongoing)
  - Developed and distributed materials to educate taxpayers and practitioners on EITC eligibility rules and compliance issues. (Ongoing)
  - Completed implementation of new EITC examination business processes and technology changes including: (12/2005)
    - Enhanced examination selection criteria and scoring of amended returns to filter cases for EITC qualifications and information about taxpayer/child relationship
    - Identified select returns for pre-refund v. post-refund audit and soft notice treatment
    - Integrated expanded decision support tool for examiners to assist with determinations and to document work papers
    - Improved self-service web and phone applications to assist taxpayers and tax preparers
  - Continued EITC outreach activities that included managing the delivery of marketing and advertising campaigns, and creating EITC specific tools for use by tax preparers using multiple communication/media channels. (Filing Season)

Actions Planned or Underway (FY 2007 and beyond)

- Continue to expand the implementation of Issue Management teams to address high risk tax shelter issues and improve the IRS' ability to report on issue trends, enhance risk analysis, and enhance return selection. (09/2007)

- Develop enhancements to the multifunctional non-filer strategy to improve outreach and compliance efforts and develop alternative treatments to influence non-filing taxpayers to file and remain compliant. (Ongoing)

- Continue the Federal Employee/Retiree Delinquency Initiative to reduce non-compliance of federal employees and retirees. (Ongoing)

- Develop recommendations for a multi-year return preparer strategy that includes managing the delivery of marketing and advertising campaigns, and creating specific tools for use by tax preparers, using multiple communication/media channels. (09/2007)

- Complete the 1120-S phase of the National Research Project (NRP). Results of the project will provide data to revise workload selection criteria. Most NRP 1120-S audits will be complete by October 2007. Analysis of the data will be completed during 2008. (10/2008)

- Develop initiatives to improve participation and reduce overclaims in existing EITC Programs. (Ongoing)
  - Continue to analyze changes in taxpayer EITC filing volume and track EITC return math error accuracy through outreach campaigns and volunteer tax return preparation. (Ongoing)
  - Produce survey instruments that will identify correspondence audit barriers experienced by EITC taxpayers, identify EITC taxpayers' information needs, and assess how effectively these needs are currently being met. (Ongoing)
  - Complete second phase of EITC return preparer's compliance study designed to identify and deter preparers of large numbers of erroneous EITC claims. (02/2007)
  - Continue three-year Qualifying Child test to reduce EITC overclaims. (10/2007)
  - Assess the 2007 EITC marketing/awareness campaigns that target the EITC eligible population and refine/focus as necessary to increase overall participation and improve compliance. (03/2007)
  - Conduct Longitudinal Study that looks at specific EITC claimants over a period of years, studying behavior patterns. (Ongoing)
  - Actively research cost-effective approaches to improve EITC participation and minimize errors. (Ongoing)
  - Educate EITC taxpayers through partnerships with key stakeholders and a public service campaign. (Ongoing)
  - Evaluate the effect of an EITC certification requirement both on the level of erroneous payments and participation by eligible taxpayers. (Ongoing)
  - Explore additional partnering options with state agencies to improve EITC compliance and prevent erroneous payments. (Ongoing)
  - Test use of requests for voluntary adjustments to returns identified as likely to contain errors (soft notices) as an alternative to the traditional examination process. (04/2007)

- o Study characteristics of returns where more than one taxpayer claims the same qualifying child for EITC purposes and recommend new solutions to reduce duplicate claims. (11/2008)

- Expand Schedule M-3 corporate filing requirements to enhance ability to identify compliance risks in book-to-tax differences. (09/2007)
- Continue the State Income Tax Levy Program process of solicitation to participate in the program. (Ongoing)
- Continue to identify other federal payor agencies to participate in the Federal Payment Levy Program and negotiate agreement. (09/2007)
- Validate the Taxpayer Assistance Blueprint service recommendations through extensive research with taxpayers. (10/2006)
- Continue to conduct Fraud/Bank Secrecy Act Program Examinations (Ongoing)
  - o Complete full development of workload database that provides a more complete record of banking institutions. (09/2008)
  - o Integrate results from the identification of attributes to better predict which entities have a greater probability of non-compliance. (09/2008)
  - o Develop and implement BSA requirements for the insurance industry and dealers in precious metals, gems, and jewels. (06/2007)
- Continue to emphasize collection of large dollar assessments, one of the highest priorities in case assignment. (Ongoing)
- Continue efforts to strengthen the Fraud Referral Program to foster voluntary compliance through the recommendation of a criminal investigation and/or civil penalties. (Ongoing)
- Enhance methods of identifying promoters operating in tax havens. (Ongoing)
- Continue to identify and investigate high-impact, corporate fraud. (Ongoing)
- Continue to aggressively develop high-income, high-impact, non-filer cases covering a broad spectrum of occupations and professions. (Ongoing)
- Develop improved criteria for identifying unscrupulous return preparers, especially those with high income clients and those promoting abusive tax avoidance schemes. (Ongoing)
- Continue making improvements to the Return Preparer Analysis Tool (analyzes characteristics of return preparers) to identify more effective compliance treatments for return preparers including the development of return preparer and questionable refund policies. (10/2007)
- Assess the withholding compliance process to determine the usefulness of letters sent to employers and employees who under withhold federal income tax from their wages (lock-in letters). (09/2007)

- Implement toll-free phone system for Innocent Spouse operations. (01/2007)
- Support development of the Correspondence Examination Automated System (CEAS) system to expand electronic case assignment and reassignment among the Campuses. (Ongoing)
- Implement the Electronic Filing of Federal Tax Liens (e-Lien), automating the filing of Notices of Federal Tax Liens and Certification of Release electronically, along with the electronic transmission of recording data. (10/2009)
- Pursue access to the International Trade Data System warehouse to enhance identification of federal excise tax on imports. Under development by US Customs and implementation date is predicated on the completion of the Customs project. (Ongoing)
- Continue to develop methods to detect and deter non-compliance and overstated claims. For example, statistical information from an outside vendor for will be used in calculating estimates of telephone expenses for businesses and individuals. (Ongoing)
- Re-establish the Electronic Fraud Detection System legacy (client/server) system for use during the 2007 filing season. (Ongoing)
- Implement corporate strategies to ensure optimum, balanced audit coverage as well as improve enterprise-wide resource allocations and the use of alternative resolution strategies. (Ongoing)
- Continue focus on registration activity under the American Jobs Creations Act of 2004, identifying potential non-filers and inaccurate filers through reconciliation and comparison of ExSTARS data. (Ongoing)

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Security of the Internal Revenue Service

Issue: Strengthening the security infrastructure and the applications that guard sensitive data.

Actions Taken (FY 2006)

- Completed mitigation of General Support Services' weaknesses identified during certification to upgrade systems from Interim Authority to Operate status to Full Authority to Operate. (09/2006)
- Updated the security certification and accreditation of IRS business applications to comply with the process guidance issued by OMB and the National Institute of Standards and Technology. Security plans and certification and accreditation for one third of IRS systems were updated to the standards. (09/2006)
- Completed design and first phase of development of a back-up for the IRS incident response capability to reduce geographic vulnerability. (09/2006)
- Continued to improve Federal Information Security Management Act of 2002 (FISMA) compliance by further increasing business owner participation in all areas including monitoring, review, mitigation and reporting activities. (Ongoing)
- Assumed Departmental leadership for Presidential Directive 12 (HSPD-12), which mandates a uniform approach to employee authentication and access government-wide. (Multi-year)
- Continued to refine both the IRS' Continuity of Operations Plan (COOP) activities and the IRS' contribution to Department/government-wide COOP activities. Fully participated in the planning and execution of the government-wide COOP exercise, Forward Challenge 06. (09/2006)
- Conducted certification and accreditation update activities to meet government-wide guidelines for information systems certified. The IRS is 96 percent compliant, 33 percent are already certified under the new, more stringent National Institutes of Standards and Technology guidelines. (09/2006)
- Began an enterprise-wide strategy for IT systems disaster recovery, including implementation of strategic testing of disaster recovery plans. (09/2006)
- Developed a physical security technology "roadmap" for the IRS to improve uniformity and cost effectiveness of security technologies at IRS sites. (05/2006)
- Began an agency-wide Risk Assessment for vulnerabilities to identity theft. Interviewed over 100 executives and performed 20 data gathering workshops that resulted in the development of 69 remediation strategies. (Ongoing)
- Partnered with the Treasury Inspector General for Tax Administration to develop and implement the IRS Phishing Web Site to provide guidance to internal and external stakeholders. Established e-mail box so internal and external stakeholders could send

phishing e-mail to IRS for evidence gathering and developing countermeasures. (03/2006)

Actions Planned or Underway (FY 2007 and beyond)

- Complete migration of information technology security compliance reviews to the more structured self-assessments detailed in NIST Special Publication 800-53. (09/2007)
- Complete the implementation of the agency-wide strategy for IT systems disaster recovery, including conducting annual exercises in major computing environments. (09/2007)
- Complete development phases and begin implementation of a back-up for the IRS incident response capability. (09/2007)
- Continue to improve FISMA compliance by solidifying gains in business owner participation in all areas including monitoring, review, mitigation and reporting activities. (Ongoing)
- Establish Disaster Recovery processes for the IRS' 25 Critical Business Processes. Continue to implement a nationwide Disaster Recovery Plan including all major computing facilities. (09/2007)
- Continue to advance HSPD-12 program development, including development of IT infrastructure and deployment of Department-wide policies and practices. (09/2007)

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Using Performance and Financial Information for Program and Budget Decisions

Issue: The absence of accurate and complete management information hinders the IRS' ability to produce timely, accurate and useful information needed for day-to-day decisions.

Actions Taken (FY 2006)

- Introduced a suite of enterprise-wide long-term measures which link directly to the IRS Strategic Plan goals. (01/2006)

- Used results from the OMB Program Assessment Rating Tool (PART) to make the following improvements: (02/2006)
  - New long-term and annual performance measures were developed for the Criminal Investigation Program.
  - Used annual performance plan to improve transparency in budget and PART narratives and show data correlation between budget and performance.

- Finalized an implementation plan for Budget-Performance Integration (BPI) that identified the actions necessary to formulate and execute fully-costed performance. (1st and 2nd quarter 2006)

- Developed automated Statement of Net Cost from Integrated Financial System. (08/2006)

- Implemented FMIS enhancement, Custodial Detail Database (CDDB):
  - Implemented Release 1 of CDDB, the enhancement to FMIS, and is the first step toward creating a subsidiary ledger for Unpaid Assessments and improved reporting for Trust Fund Recovery Penalty cases. (03/2006)
  - Submitted the programming requirements to complete the CDDB design phase, programming, and unit and integration testing to feed custodial accounting information to the Interim Revenue Accounting Control System (IRACS). (06/2006)
  - Performed analysis and decided to use new CDDB unpaid assessment files for the FY 2006 audit. (05/2006)
  - Finalized programming requirements for CDDB Release 2B, which creates the sub-ledger for revenue receipts and refunds. (06/2006)

- Continued to meet Treasury's Information Executive Repository (TIER) 3-day close financial reporting requirements. (Quarterly)

- Maintained clean audit opinion on FY 2005 financial statements, the first year of the Integrated Financial System operations. (11/2005)

Actions Planned or Underway (FY 2007 and beyond)

- CDDB Planned Actions:
  - Create CDDB to Interim Revenue Accounting System (IRACS) interface. (03/2007)
  - Begin test of CDDB Release 2 revenue data base. (06/2007)
  - Further enhance FMIS by developing the CDDB to be compliant with Federal Financial Management Improvement Act of 1996 requirements. The CDDB will add revenues and

refund transactions to begin the creation of subsidiary ledgers (Releases 2 and 3). (FY 2008)

- Fully implement the use of cost accounting data for resource allocation decisions. (FY 2008)

Complexity of the Tax Law

Issue: Simplifying the tax process within current laws while at the same time modernize IRS systems and processes to reduce tax complexity for individual and business taxpayers.

Actions Taken (FY 2006)

- EITC Actions:
  - Updated EITC Assistant to accommodate the Gulf Opportunity Zone Act of 2005 to have nontaxable combat pay included in earned income (Hurricanes Katrina, Rita and Wilma), the extension of the election for EITC, and the Uniform Definition of Child provisions enacted in the Working Families Relief Act of 2004 impact to EITC and filing Status. (01/2006)
  - Unified Family Credit that combines the provisions of the EITC, Child Tax Credit, and Dependency Exemption, to reduce taxpayer compliance burdens associated with claiming these provisions. (Ongoing)

- Continued to work with the Treasury Department on revisions to the regulations relating to the use and disclosure of tax return information by tax returns preparers (Internal Revenue Code §7216). (Ongoing)

- Updated all tax law forms, processes, IRMs, and employee guidance related to late legislation in 2005. (December 2005 through January 2006)

Actions Planned or Underway (FY 2007 and beyond)

- Release Tax Year 2006 version of EITC Assistant incorporating user recommendations and tax law updates. (01/2007)

- Develop a compliance strategy to identify and prevent erroneous Telecommunications Excise Tax Refunds. The goal is to design the least burdensome procedures to enable all eligible taxpayers to claim the right refund. (01/2007)

- Expand Modernized E-file to other forms, including flow-through returns for partnerships and Subchapter S-Corps. (09/2008)

- Implement an option for taxpayers to be able to split refunds into as many as three separate accounts, by updating forms, programming, IRMs, and employee guidance. (Ongoing, implement in 01/2007)

- Begin final stages of returns processing in Philadelphia by rerouting new work to other campuses by July 2007, and complete processing of inventories by the end of FY 2007, thereby ceasing processing operations in September 2007. (09/2007)

- Redesign Form 1040 and create a new Schedule O for processing year 2008; thereby, simplifying taxpayers' reporting of certain adjustments to income, credits, taxes, and payments. (Ongoing)

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- Continue to look for new ways in Accounts Management to resolve quality and productivity issues through use of the Lean Six Sigma process and the “Extreme Breakthrough Performance” process. (Ongoing through 09/2007)

Providing Quality Customer Service Operations

Issue: Providing top quality service to every taxpayer in every transaction is an integral part of the IRS' strategic and modernization plans.

Actions Taken (FY 2006)

- Used pilot models developed in FY 2005 to implement a national rural strategy that provides outreach, free tax return preparation, and/or financial literacy education to rural America. (Ongoing)
  - Partnered with the U.S. Department of Health and Human Services to sponsor workshops statewide, which connect organizations with common goals of helping low-income families.
  - Formed a partnership with the largest funder of rural activities in the United States, and secured commitment to fund the rural strategy in seven states in FY 2007: Louisiana, Michigan, West Virginia, Mississippi, Arkansas, New Mexico, and Montana.
- Continued expansion of Internet Refund Fact of Filing (IRFOF) application to reduce Toll-free telephone demand and offer customers alternative methods of service. (09/2006)
- Incorporated multi-year Quality Improvement Process Plan (VRPP-QIP) including web-based learning to improve quality for the VITA program. (09/2006)
- Refined and tested "Life Cycle Products" line of publications designed to educate taxpayers about the tax impact of significant life events. (09/2006)
- Developed new and revised Spanish-language tax products. (09/2006)
- Conducted focus groups at the Nationwide Tax Forums to obtain feedback from taxpayers and tax practitioners on ways to improve tax forms, instructions and publications. (2006 forums)
- Tested all significant tax form and notice changes with taxpayers and external stakeholders prior to implementing the changes. (Ongoing)
- Delivered the Taxpayer Assistance Blueprint (TAB) (Phase I) report to Congress. Phase I includes options to provide taxpayer service over multiple channels to align content, delivery, and resources with taxpayer and partner expectations to reduce burden, improve workforce performance, and increase voluntary compliance. TAB establishes a credible taxpayer/partner baseline of needs, preferences, and behaviors. (04/2006)
- Actions taken to improve service to those taxpayers filing for the Earned Income Tax Credit included:
  - Developed a service-wide integrated marketing strategy aimed at reducing EITC error that reached 141 million contacts including taxpayers, tax practitioners, members of the media, and partner organizations. (06/2006)
  - Assessed the overall EITC marketing/awareness campaigns that target eligible claimants to increase overall participation and improve compliance. (Ongoing)

- Partnered with the Ogden Usability Lab to expand the testing of EITC notices and forms. (09/2006)

- Installed Contact Recording in 47 Taxpayer Assistance Centers (TACs). Contact recording provides immediate performance feedback to employees to improve the quality and completeness of responses. (07/2006)
- Completed the Phase II rollout of Queuing Management (Q-Matic), a web-based system that captures the number and types of customer contacts in the TACs and automates the process of tracking employee activity. (09/2006)
- Developed TeleFile and Internet electronic funds withdrawal (Direct Debit) applications for notice payments and installment agreements. (09/2006)
- Doubled the number of taxpayers (17 in FY 2005 to 33 in FY 2006) in the Compliance Assurance Program (CAP), a process in which large corporations and IRS agents work together to examine transactions in "real time" during the taxable year to reach agreement on the taxpayer's tax liability before the tax return is filed. (01/2006)
- Continued to work with stakeholders to improve the sixteen Collection notices with a combined annual volume of 46 million. (Ongoing)

Actions Planned or Underway (FY 2007 and beyond)

- Continue expansion of IRFOF ("Where's my refund?) to add more math error explanations, accommodate split refund inquiries, and provide inquiry capability for those taxpayers filing for telecommunications excise tax refunds. (2006 filing season and beyond)
- Continue the process of conducting surveys and focus groups to obtain feedback from taxpayers and tax practitioners about ways to improve tax forms, instructions and publications. (Ongoing)
- Expand the web-based learning program (Link and Learn Taxes) that provides online training in tax return preparation for Stakeholder Partnerships, Education and Communication Partners and Volunteers. (09/2007)
- Expand the "Life Cycle Products" line of publications designed to educate taxpayers about the tax impact of significant life events. (Ongoing through 09/2007)
- Install Contact Recording in 83 TACs locations in FY 2007 and in the remaining 270 TACs in FY 2008 and FY 2009. (Ongoing)
- Expand the use of Q-Matic, the web-based system that captures the number and types of customer contacts in the TACs and automates the process of tracking employee activity, to the remaining TAC sites. (09/2007)

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- Complete planned actions to improve service to those taxpayers filing for the Earned Income Tax Credit:
  - Continue to educate EITC taxpayers through partnerships with key stakeholders and a public service campaign. (Ongoing)
  - Develop targeted EITC partner and compliance-oriented outreach and assistance activities for 2007 filing season. (01/2007)

- Incorporate multi-year Volunteer Return Preparation Program-Quality Improvement Process (VRPP-QIP) plan to promote quality assurance for the Volunteer Income Tax Assistance program.
  - Test the new quality forms by conducting volunteer return preparation session. (09/2007)

- Continue development of Issue Management System (a streamlined and structured process that facilitates corporate issue identification, resolution and feedback) designed to gather data on emerging issues, detect trends, monitor issues, and provide resolutions and communications with greater effectiveness. (Ongoing)

- Continue to expand participation in the Compliance Assurance Process. (09/2007)

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Processing Returns and Implementing Tax Law Changes During the Filing Season

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

Actions Taken (FY 2006)

- Updated all tax law forms, processes, Internal Revenue Manuals (IRMs), and employee guidance related to the emergency supplemental appropriations act to address hurricanes in the Gulf of Mexico, which was enacted late in 2005. (01/2006)
- Piloted an automated adjustment document to make a change or correction to a taxpayer account, reducing adjustment time and increasing the quality of required adjustments. (09/2006)
- Developed strategies to transition and consolidate the Philadelphia Submission Processing Center. (Multi-year initiative)
- Completed deployment of Transcript Delivery System. (12/2005)
- Developed processes and procedures for administering telecommunications excise tax refunds (TETR) to more than 150 million taxpayers by:
    - Modifying all individual and business tax return forms to include TETR information;
    - Creating a new form (1040EZ-T) to be used by individuals who want to request a refund, but who have no other tax filing requirement;
    - Drafting a second new form (8913) to be used by taxpayers who choose to request refunds based on their actual payments rather than use a standard amount set by the IRS;
    - Developing a methodology that can be used by businesses and non-profits to estimate their TETR claims;
    - Launching an outreach campaign to external stakeholder groups;
    - Programming IRS systems to accept form changes;
    - Developing TETR-related procedures (IRMs); and
    - Conducting training for employees who will interact with taxpayers on the phone and at Taxpayer Assistance Centers. (05/2006 and Ongoing leading up to the filing season)

Actions Planned or Underway (FY 2007 and beyond)

- Administer the Telecommunications Excise Tax Refund program by providing additional services to taxpayers claiming the credit including answering taxpayer questions received via telephone, correspondence and through the TACs. (01/2007)
- Assist taxpayers who use IRS Field Assistance and VITA sites to claim the credit. (01/2007)
- Conduct a targeted compliance effort to minimize excise tax refund over-claims. (01/2007)

- Work with community-based organizations to educate low-income taxpayers without a filing requirement and to encourage them to request their telecommunications excise tax refunds. (01/2007)
- Redesign Form 1040 (Individual Income Tax) and create a new Schedule O for processing year 2008 to simplify the reporting of certain adjustments to income, credits, taxes, and payments. (Ongoing)
- Implement an option for taxpayers to be able to split refunds. (01/2007)
- Begin final stages of returns processing in Philadelphia, rerouting new work to other campuses and complete processing of inventories. (09/2007)
- Continue expansion of Modernized E-file requirements and the increase of business electronic return processing. (Ongoing)
- Scan and image paper returns for large corporate returns that do not meet e-file dollar or volume requirements to expedite assessments. (09/2007)

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Taxpayer Protection and Rights

Issue: The IRS has made significant progress in complying with the Internal Revenue Service Restructuring and Reform Act of 1998 and most provisions pertaining to taxpayer protection and rights have been implemented. Significant management attention is still required to ensure that remaining issues have been addressed.

Actions Taken (FY 2006)

- Developed and implemented the Taxpayer Rights Impact Statement to incorporate awareness and consideration of taxpayer rights into all program planning and implementation. (Ongoing)
- Refined procedures to certify compliance with requirements of Title VI of the Civil Rights Act of 1964 to provide equal access and non-discriminatory services to all eligible taxpayers. (Ongoing)
- Designed an education and awareness program with tax preparer partners to: (1) educate taxpayers about the need to ensure preparers they choose to prepare their tax returns are competent, and (2) stress enforcement actions the IRS will take on those preparers found to be negligent or reckless. (Ongoing)
- Continued emphasis on the Return Preparer Program and increasing Program Action Cases (PACs) against preparers who file incorrect or fraudulent returns by focusing on assertion and collection of penalties and employing other enforcement options such as injunctions. Continued discussions with Treasury, OMB, and Congress to increase maximum penalty amounts. (Ongoing)
- Established process and procedures to minimize the effects of questionable refunds on the taxpayer when a refund is held to resolve issues. Included appropriate taxpayer notification procedures including creation of notice explaining the circumstances of the refund hold or denial. (Ongoing)

Actions Planned or Underway (FY 2007 and beyond)

- Continue systems modernization efforts to enhance the IRS' security program to safeguard taxpayer data. (Ongoing)
- Complete the implementation of the agency-wide strategy for IT systems disaster recovery, including conducting annual exercises in major computing environments. (09/2007)
- Continue to study the Questionable Refund Program workflow processes to identify areas where additional improvements can be made, particularly in the area of refund freezes. (Ongoing)

Human Capital

Issue: The IRS' ability to meet expectations outlined by the President's Management Agenda in personnel management area such as recruiting, training, and retaining employees.

Actions Taken (FY 2006)

- Completed development of the IRS Human Capital Strategic Implementation Plan, which outlines the strategies the IRS will follow in addressing the challenges to achieving the desired state of human capital in the IRS. (01/2006)
- Deploy the Learning Content Management System (LCMS) to permit more efficient development of training materials and consistency in training across the Service to improve the skills of current employees and to prepare them for the workforce of tomorrow. (09/2006)
- New training courses offered include enhanced computer skills, desktop integration, purchase card and approver, and electronic installment agreements. (FY 2006)
- Complete conversion of all Mission Critical Occupation (MCO) application processes to the CareerConnector system (provides resume builder functionality for applicants, and a recruitment system that identifies well-qualified candidates for vacancies) and begin the conversion of the non-MCO occupations. (09/2006)
- Improved CareerConnector system recruiting for front-line occupations through expansion of category (qualified, best qualified, etc.) ratings and use of simulations in assessing job applicants. (Ongoing)
- Resolved protest issues/ concerns and issued an award decision for Campus Files Activity to IAP World Services, Inc.
  - Implemented a well-orchestrated communications strategy that included notification of the award decision to employees, NTEU, Congress, Treasury, OMB, and the media. (05/2006)
- Developed an approach to identify business processes that leverage the tools, templates, best practices, and successes of Competitive Sourcing to create a structure that can be used as an alternative to conducting a public-private competition and for certification of high performing organization status. (Ongoing)
- Conducted leadership interviews to determine talent needs, and incorporated results into the Succession Plan, which was rolled out in FY 2006. Talent assessments and creation of a review toolkit are being tested in the W&I and MITS organization. (09/2006)
- Conducted a study of all leadership courses (Executive Readiness Program, Senior Manager Course/Senior Manager Readiness Program, and Frontline Manager Course) to focus on: (09/2006)
  - Delivering content in an effective and efficient manner
  - Identifying and attracting and retaining "high talent" and "high potential" employees for leadership development.

- Designed new management training using tailored case studies, simulations in training and work-out sessions to provide hands-on experience, critical to enhancing employee skills. (Ongoing)
- Continued the selective use of Voluntary Employee Retirement Authority (early-outs) and Voluntary Separation Incentive Payments (buyouts) to support organizational restructuring and workforce reshaping initiatives. (Ongoing)
- Extended recruiting partnerships with key colleges and universities. (Ongoing)
- Modified the employee engagement program to focus on balanced measures at the workgroup level and to the identification of barriers to delivery of the IRS' goals and objectives such as tools, technology and improved processes. (01/2006)

Actions Planned or Underway (FY 2007 and beyond)

- Continue the design of management training using tailored case studies, simulations in training and work-out sessions to provide hands-on experience in order to develop and retain qualified managers. (Ongoing)
- Continue the selective use of Voluntary Employee Retirement Authority (early-outs) and Voluntary Separation Incentive Payments (buyouts) to support organizational restructuring and workforce reshaping initiatives. (Ongoing)
- Utilize the approach developed in FY 2006 to identify business processes that leverage the tools, templates, best practices, and successes of Competitive Sourcing. (Ongoing)
- Continue a multi-year recruitment and marketing plan to target a diverse applicant pool in recruitment and hiring of mission-critical talent. Expand the number and type of colleges and universities included in recruiting partnerships established. (Ongoing)
- Use competency models to identify the general and technical knowledge, skills and abilities essential to current and new employee performance in a position. (Ongoing)
- Analyze results of Succession Planning tests and continue rolling out process to additional sites. Determine if test should be expanded to include Management Officials. (Ongoing)

V. Financial Highlights

Stewardship Information Analysis

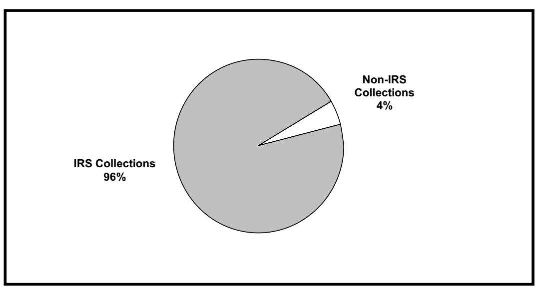
a. Overview of Revenue and Administrative Accounts

The IRS' Fiscal Year (FY) 2006 financial statements received an unqualified audit opinion for the seventh consecutive year.

The Balance Sheet reflects total assets of $26 billion. Of these assets, 79.8 percent are Federal Taxes Receivable. These receivables are the amounts expected to be collected from past due accounts. The decrease in assets of $.7 billion is primarily attributable to decreases in the amounts due from Treasury for tax refunds due taxpayers and taxpayer deposits for unpaid assessments. The majority of the liabilities, 86 percent, consist of amounts due to Treasury related to Federal Taxes Receivable.

The Statement of Custodial Activity shows that IRS programs collected $2.514 trillion in federal receipts. The IRS' collections constitute 96 percent of the Federal Government receipts, as shown in the chart below.

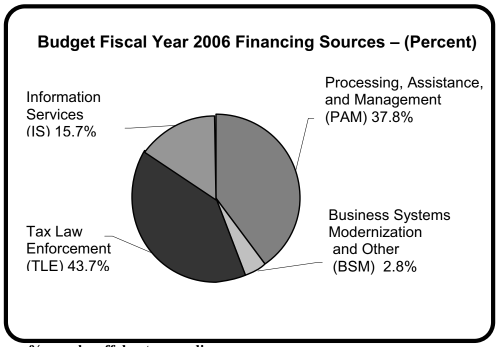
Total Federal Receipts – (Percent)



% may be off due to rounding

b. Financing Sources

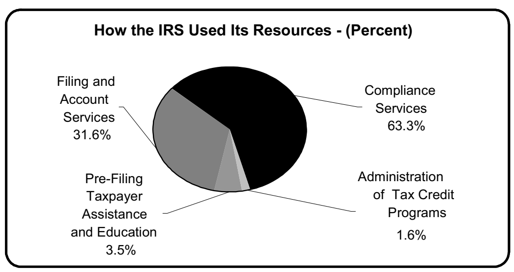
The IRS receives the majority of its funding through annual and multi-year appropriations, which are available for use within certain specified statutory limits. There are three major and two minor operating appropriations. The Processing, Assistance and Management appropriation funds processing tax returns and related documents, assistance for taxpayers in filing returns and paying taxes due, matching information with returns, and managing financial resources. The Tax Law Enforcement appropriation provides funds for examination of tax returns, collection of balances, the administrative and judicial settlement of taxpayer appeals of examination findings, as well as providing resources for strengthened enforcement to reduce valid claims and erroneous filings associated with the Earned Income Tax Credit (EITC) program. The Information Services appropriation funds costs for data processing and telecommunications support for the IRS' activities. The Business Systems Modernization Account is the most significant of the minor operating appropriations and funds capital asset acquisitions of information technology systems. The Health Coverage Tax Credit appropriation (HCTC) funds necessary expenses to implement the program.



% may be off due to rounding

Besides appropriations, the IRS used other financing sources. These included net transfers from other federal agencies, and revenue from user fees for direct services provided to customers (for example, installment fees, photocopy fees, and letter rulings and determinations fees).

c. Use of Resources



% may be off due to rounding

The Statement of Net Cost reflects the use of resources in conducting the IRS' major programs.

The major programs are Pre-filing Taxpayer Assistance and Education, Filing and Account Services, Compliance Services, and Administration of Tax Credit Programs (EITC and HCTC). Pre-filing Taxpayer Assistance and Education activities include taxpayer education and outreach, pre-filing agreements, and tax publication issuance and distribution. Filing and Account Services activities include filing tax returns, maintaining customer accounts, and processing taxpayer information. Compliance Services activities include document matching, examination, collection, and criminal investigation activities. Administration of the Tax Credit programs includes costs for EITC and HCTC health insurance tax credit program activities.

Revenue and Refund Trend Information

Federal tax revenues are collected through six major classifications: individual income, corporate income, excise taxes, estate and gift taxes, railroad retirement, and federal unemployment taxes. FY 2006 revenue receipts ($2.514 trillion) increased by approximately 11 percent from FY 2005 to FY 2006. Individual income taxes increased by 9 percent and include both Federal Insurance Contributions Act (FICA) and Self-Employment Contributions ACT (SECA) taxes. Corporate income taxes increased by 24 percent. Collections from all other tax sources increased 4 percent from FY 2005 to FY 2006.

Gross combined individual income tax and employment tax withholding increased as wages and salaries grew. Gross combined individual non-withheld and SECA receipts increased due to the increase in final payments on calendar year 2005 liabilities. Contributing factors include the higher 2005 incomes, lower 2005 deductions and a higher effective tax rate on 2005 taxable income reported in FY 2006. Net corporate receipts increased due to the growth in gross corporate tax receipts and the decrease in refunds.

Federal tax refund activity, which includes tax, interest, payments for EITC and Child Care Tax Credit in excess of the tax liability, was $277 billion. In FY 2006, the IRS issued $59 million in advance payments of the EITC. Overall refund disbursements increased by 4 percent from FY 2005 to FY 2006.

Excise Tax Trust Fund

The Quarterly Federal Excise Tax Return, Form 720, reports liability for excise taxes. Taxpayers make periodic deposits in advance of filing the return. These deposits are classified as Federal Excise Tax. After the IRS receives and processes the returns, the IRS certifies amounts for several Trust Funds. Amounts reported on the Statement of Custodial Activity are for fiscal year collections, i.e., October 1 through September 30. Because Form 720 reporting requirements are completed after receipt of most of the deposits, the certification amounts will not match the amounts collected in the fiscal year. The table below shows receipts certified to the Airport and Airway Trust Fund, Black Lung Disability Trust Fund and the Highway Trust Fund for the eight liability quarters from December 2003 through September 2005. The Treasury Department's Financial Management Service and the Bureau of Public Debt prepare the warrants and allocations to the various Trust Funds.

	Liability Quarter Ended	
	December, 2003 – September, 2004	**December, 2004 – September, 2005**
Airport & Airway Trust Fund	$9,626,715,000	$10,379,502,000
Black Lung Disability Trust Fund	568,010,000	612,445,000
Highway Trust Fund	36,121,735,000	39,537,447,000
Total	**$46,316,460,000**	**$50,529,394,000**

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

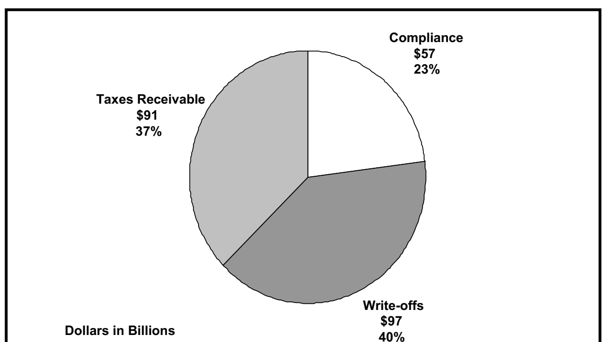
The unpaid assessment balance includes amounts owed by taxpayers who file returns without sufficient payment as well as amounts assessed through the IRS enforcement programs. As

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2006

reflected in the supplemental information to the IRS' FY 2006 Financial Statements, the unpaid assessment balance was about $245 billion as of September 30, 2006.

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

Components of the IRS' $245 Billion of Unpaid Assessments



% may be off due to rounding

Taxes receivable represent $91 billion of unpaid assessments. About $70 billion (77 percent) of this balance is estimated to be uncollectible due primarily to the taxpayer's economic situation, including individual taxpayers who are unemployed, are currently in bankruptcy or have other financial problems. Except for bankruptcy situations, the IRS may continue collection actions for 10 years after the assessment. Thus, these accounts may still ultimately have some collection potential if the taxpayer's economic condition improves.

About $21 billion (23 percent) of taxes receivable ($91 billion) is estimated to be collectible. The collectible balance includes installment agreements with estates and individuals, confirmed payment plans through bankruptcy and some newer amounts due from individuals and businesses with a history of compliance. The taxes receivable amount from September 30, 2005 ($88 billion) to September 30, 2006 ($91 billion) increased by $3 billion. The percent estimated to be collectible at September 30, 2006 (23 percent), decreased from September 30, 2005 (24 percent).

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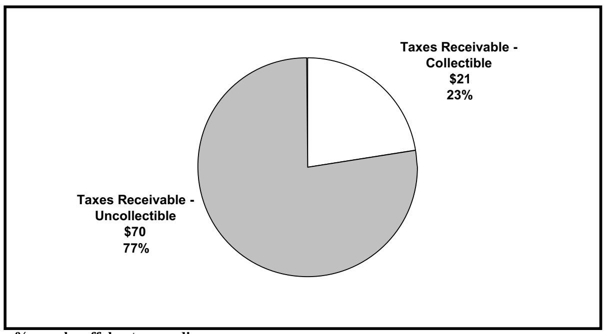
INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2006

Components of the IRS' $91 Billion of Taxes Receivable

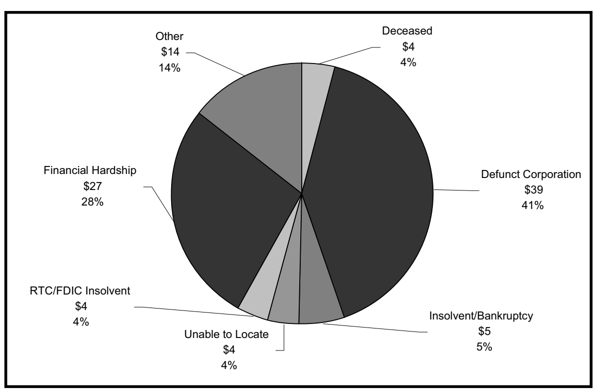


% may be off due to rounding

Compliance assessments of $57 billion represent amounts that have not been agreed to by either the taxpayer or a court. These assessments result primarily from various IRS enforcement programs promoting voluntary compliance. Due to the lack of agreement, they have less potential for future collection than the unpaid assessments considered federal taxes receivable.

Write-off amounts of $97 billion include amounts owed by defunct corporations with no assets and failed financial institutions assisted by the Resolution Trust Corporation (RTC) and the Federal Deposit Insurance Corporation (FDIC). The remaining amounts are owed by taxpayers with extreme economic and/or financial hardships, deceased taxpayers, and taxpayers who are insolvent due to bankruptcy.

Components of the IRS' $97 Billion of Write-offs



% may be off due to rounding

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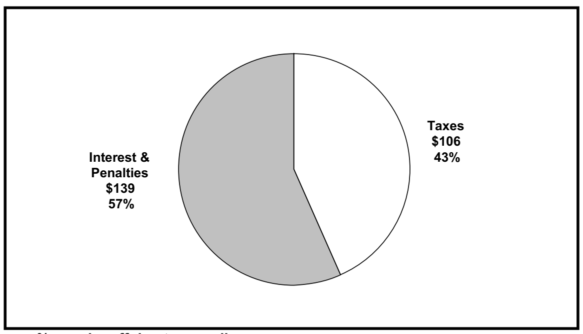
INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2006

It is important to note that the unpaid assessment balance contains unpaid assessed tax, penalty, and interest and accrued penalty and interest computed through September 30, 2006.

About $139 billion (57 percent) of the unpaid assessment balance as of September 30, 2006, consists of interest and penalties and is largely uncollectible.

Unpaid Taxes and Interest and Penalty Components of $245 Billion in Unpaid Assessments



% may be off due to rounding

Interest and penalties are a high percentage of the balance of unpaid assessments because the IRS must continue to accrue them through the ten-year statutory collection date, regardless of whether an account meets the criteria for financial statement recognition or has any collection potential. For example, interest and penalties continue to accrue on write-offs, such as Federal Deposit Insurance Corporation and Resolution Trust Corporation cases, and on examination assessments where taxpayers have not agreed to the amount assessed.

Financial Statements

Balance Sheets

Internal Revenue Service
Balance Sheet
As of September 30, 2006 and 2005

(In Millions)

Assets	**2006**	**2005**
Intragovernmental:		
Fund balance with Treasury (Note 2)	$ 2,066	$ 1,990
Due from Treasury (Note 13)	1,695	1,946
Other assets (Note 4)	205	150
Total Intragovernmental	**3,966**	**4,086**
With the Public:		
Cash and other monetary assets (Note 3)	52	466
Federal taxes receivable, net of allowance for doubtful accounts (Notes 5, 13)	21,000	21,000
Other assets (Note 4)	15	12
Total with the Public	**21,067**	**21,478**
Property and equipment, net (Note 6)	1,280	1,422
Total Assets	**$ 26,313**	**$ 26,986**
Liabilities		
Intragovernmental:		
Due to Treasury (Notes 5, 13)	$ 21,000	$ 21,000
Other liabilities (Note 7)	178	174
Total Intragovernmental	**21,178**	**21,174**
Federal tax refunds payable (Note 13)	1,695	1,946
Other liabilities (Notes 7 to 10)	1,541	1,973
Total Liabilities	**24,414**	**25,093**
Net Position		
Unexpended Appropriations	1,575	1,538
Cumulative Results of Operations	324	355
Total Net Position	**1,899**	**1,893**
Total Liabilities and Net Position	**$ 26,313**	**$ 26,986**

The accompanying notes are an integral part of these statements.

1

Statements of Net Cost

Internal Revenue Service
Statement of Net Cost
For the Years Ended September 30, 2006 and 2005

(In Millions)

Program	2006	2005
Pre-Filing Taxpayer Assistance and Education		
Full cost	$ 407	$ 627
Exchange revenue	(55)	(46)
Net cost of program	**352**	**581**
Filing and Account Services		
Full cost	3,690	3,970
Exchange revenue	(33)	(43)
Net cost of program	**3,657**	**3,927**
Compliance		
Full cost	7,409	6,859
Exchange revenue	(125)	(183)
Net cost of program	**7,284**	**6,676**
Administration of Tax Credit Programs		
Full cost	192	279
Exchange revenue	-	-
Net cost of program	**192**	**279**
Net Cost of Operations (Note 17)	**$ 11,485**	**$ 11,463**

The accompanying notes are an integral part of these statements.

2

Statements of Changes in Net Position

Internal Revenue Service
Statement of Changes in Net Position
For the Years Ended September 30, 2006 and 2005

(In Millions)

	2006 Cumulative Results of Operations	2006 Unexpended Appropriations	2005 Cumulative Results of Operations	2005 Unexpended Appropriations
Beginning Balances	**$ 355**	**$ 1,538**	**$ 812**	**$ 1,255**
Budgetary Financing Sources:				
Appropriations received		10,681		10,318
Canceled appropriations, rescissions and other		(227)	(129)	3
Appropriations used	10,417	(10,417)	10,038	(10,038)
Other Financing Sources:				
Imputed financing from costs absorbed by others	1,060		1,121	
Transfers in/out without reimbursement	18		15	
Transfers to General Fund	(41)		(39)	
Total Financing Sources	**11,454**	**37**	**11,006**	**283**
Net Cost of Operations	**(11,485)**		**(11,463)**	
Net Change	**(31)**	**37**	**(457)**	**283**
Ending Balances	**$ 324**	**$ 1,575**	**$ 355**	**$ 1,538**

The accompanying notes are an integral part of these statements.

3

Statements of Budgetary Resources

Internal Revenue Service
Statement of Budgetary Resources
For the Years Ended September 30, 2006 and 2005

(In Millions)

	2006	2005
Budgetary Resources:		
Unobligated balance, beginning of period	$ 488	$ 570
Recoveries of prior year obligations	127	59
Budgetary appropriations received (Note 11)	10,782	10,408
Spending authority from offsetting collections (Note 19)	104	161
Permanently not available	(227)	(126)
Total Budgetary Resources	**$ 11,274**	**$ 11,072**
Status of Budgetary Resources:		
Obligations incurred (Note 18)	$ 10,722	$ 10,584
Unobligated balance – available (Note 2)	192	252
Unobligated balance – not available (Note 2)	360	236
Total Status of Budgetary Resources	**$ 11,274**	**$ 11,072**
Change in Obligated Balances:		
Obligated balance, net, beginning of period	$ 1,511	$ 1,161
Obligations incurred, net	10,722	10,584
Gross outlays	(10,586)	(10,179)
Recoveries of prior year obligations	(127)	(59)
Change in uncollected customer payments from Federal Sources	2	4
Obligated balance, net, end of period (Note 12)	**$ 1,522**	**$ 1,511**
Net Outlays:		
Gross outlays	$ 10,586	$ 10,179
Less: offsetting collections	(106)	(164)
Less: offsetting receipts	(106)	(91)
Net Outlays	**$ 10,374**	**$ 9,924**

The accompanying notes are an integral part of these statements.

4

Statements of Financing

Internal Revenue Service
Statement of Financing
For the Years Ended September 30, 2006 and 2005

(In Millions)

	2006	2005
Resources Used to Finance Activities:		
Budgetary Resources Obligated:		
Obligations incurred (Note 18)	$ 10,722	$ 10,584
Less: spending authority from offsetting collections and recoveries	(231)	(220)
Less: offsetting receipts	(106)	(91)
Net obligations	**10,385**	**10,273**
Imputed financing from costs absorbed by others	1,060	1,121
Transfers in/out without reimbursement	18	15
Other resources used to finance activities, net	(37)	91
Total Resources Used to Finance Activities	**11,426**	**11,500**
Resources Used to Finance Items Not Part of the Net Cost of Operations:		
Change in budgetary resources obligated for goods, services, and benefits ordered but not yet provided	(50)	(340)
Resources that finance the acquisition of assets	(268)	(286)
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	**(318)**	**(626)**
Total Resources Used to Finance the Net Cost of Operations	**11,108**	**10,874**
Components of the Net Cost of Operations That Will Not Require or Generate Resources in the Current Period:		
Components Requiring or Generating Resources in Future Periods:		
Increase in annual leave liability	16	6
Other	(27)	(28)
Components Not Requiring or Generating Resources in Future Periods:		
Depreciation and amortization	377	464
Revaluation of assets or liabilities	11	147
Total Components of Net Cost of Operations That Will Not Require or Generate Resources in the Current Period	**377**	**589**
Net Cost of Operations	**$ 11,485**	**$ 11,463**

The accompanying notes are an integral part of these statements.

5

Statements of Custodial Activity

Internal Revenue Service
Statement of Custodial Activity
For the Years Ended September 30, 2006 and 2005

(In Billions)

	2006	2005
Revenue Activity		
Collections of Federal Tax Revenue (Note 15)		
Individual income, FICA/SECA, and other	$ 2,035	$ 1,865
Corporate income	380	307
Excise	58	58
Estate and gift	29	26
Railroad retirement	5	4
Federal unemployment	7	7
Total Collections of Federal Tax Revenue	2,514	2,267
Increase/(Decrease) in federal taxes receivable, net	-	1
Total Federal Tax Revenue	**$ 2,514**	**$ 2,268**
Distribution of Federal Tax Revenue to Treasury	**$ 2,514**	**$ 2,267**
Increase/(Decrease) in amount due to Treasury	-	1
Total Disposition of Federal Tax Revenue	**2,514**	**2,268**
Net Federal Revenue Activity	**$ -**	**$ -**
Federal Tax Refund Activity (Note 16)		
Total Refunds of Federal Taxes	$ 277	$ 267
Appropriations Used for Refund of Federal Taxes	(277)	(267)
Net Federal Tax Refund Activity	**$ -**	**$ -**

The accompanying notes are an integral part of these statements.

6

Notes to the Financial Statements

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2006 and 2005

Note 1. Summary of Significant Accounting Policies

A. Reporting Entity

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

Currently, the organization consists of:

- Four operating divisions – Wage and Investment (WAGE) addresses the needs of taxpayers with wage and investment income only. Small Business and Self-Employed (SBSE) serves self-employed individuals and small businesses. Tax-Exempt and Government Entities (TEGE) supports employee plans, tax exempt organizations, and government entities. Large and Mid-Size Business (LMSB) serves corporations, sub-chapter S corporations, and partnerships with assets greater than $5 million.
- Functional support – Appeals, Criminal Investigation, Taxpayer Advocate and Chief Counsel are independent of the operating divisions and other units of the Service. Taxpayer Advocate reports directly to Congress and Chief Counsel reports to the Secretary of the Treasury.
- National Headquarters fills the role of setting broad policy, providing executive oversight, reviewing plans and goals of the operating units, and developing major improvement initiatives.
- Two cross-servicing organizations – Modernization and Information Technology Services (MITS) and Agency Wide Shared Services (AWSS) provide central support to all areas of the Service.

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

B. Basis of Accounting and Presentation

The financial statements have been prepared from the accounting records of the Service in conformity with generally accepted accounting principles (GAAP) in the United States and the Office of Management and Budget (OMB) Circular A-136, *Financial Reporting Requirements*. Accounting principles generally accepted for federal entities are the standards prescribed by the Federal Accounting Standards Advisory Board (FASAB). FASAB is recognized by the American Institute of Certified Public Accountants as the official accounting standards-setting body of the Federal Government.

These financial statements are provided to meet the requirements of the Government Management Reform Act of 1994. They consist of the Balance Sheet, the Statement of Net Cost, the Statement of Changes in Net Position, the Statement of Budgetary Resources, the Statement of Financing, and the Statement of Custodial Activity. The statements and the related notes are prepared in a comparative form to present both FY 2006 and FY 2005 information.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2006 and 2005

Balance Sheet, Statement of Changes in Net Position

These statements are presented on the accrual basis of accounting. Under the accrual method, revenues are recognized when earned, and expenses are recognized when costs are incurred or goods or services are received, without regard to receipt or payment of cash.

Statement of Net Cost

This statement is presented on the accrual basis of accounting. The Statement of Net Cost presents the costs incurred by the Service in performing its mission, net of related exchange revenues. These costs include direct costs, indirect costs assigned in a manner that reflects direct consumption of resources, and a proportionate share of other indirect costs. Effective October 1, 2005, the Service modified its method of allocating functional support and indirect costs in the Statement of Net Cost. The Service transitioned from its manual processes and utilized the cost module of the Integrated Financial System (IFS) to systemically allocate support costs to its operational organizations either by directly attributing costs to the organizations or cost centers (e.g., labor) or by allocating them based on a predetermined factor such as headcount, hours worked, units produced or causal relationships (e.g., rent). The allocation methodology, which goes through a formal approval process each year, enables the Service to more accurately identify and view the operational organizations' direct and indirect costs and to improve the overall quality and availability of essential cost information to support the management of Service operations and day-to-day decision making.

Program costs are aggregated across divisional lines into broad-based cost centers: pre-filing, filing, compliance and administration of tax credit programs described below.

Pre-Filing Taxpayer Assistance and Education

Provides services to taxpayers before returns are filed to assist taxpayers in preparing correct returns. Primary activities include interpretations, preparing and disseminating tax publications and information, taxpayer education programs, researching customer needs, pre-filing agreements and determinations, and initiatives to promote electronic tax filing. Exchange revenues include user fees from the pre-filing agreements and determinations, letter rulings, and enrolled agent fees.

Filing and Account Services

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

Compliance

Administers compliance activities after a return is filed in order to identify and correct possible errors or underpayments. This program includes field collection activities, document matching, examination of returns, criminal investigation, and tax litigation. Exchange revenues include installment agreement fees

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2006 and 2005

and offers in compromise. Exchange revenues also include reimbursable revenues from services provided to other federal agencies.

Administration of Tax Credit Programs

Administers the Earned Income Tax Credit (EITC) and Health Coverage Tax Credit (HCTC) programs. EITC includes expanded customer service, public outreach, enforcement, and research efforts to reduce claims and erroneous filings associated with the program. EITC comprises pre-filing, filing and account services, and compliance activities. EITC payments actually refunded to individuals or credited against other tax liabilities are not included in program costs. HCTC includes activities focused on implementing the health insurance tax credit program set out in the Trade Act of 2002.

Statement of Budgetary Resources

The Statement of Budgetary Resources is presented using the budgetary basis of accounting. Budgetary accounting facilitates compliance with legal constraints and controls over the use of federal funds. This financial statement is in addition to the reports prepared by the Service throughout the year pursuant to OMB directives for purposes of monitoring and controlling the Service's obligation and expenditure of budgetary resources. The FY 2005 Statement of Budgetary Resources has been modified to conform with the FY 2006 presentation of the statement.

Statement of Financing

The Statement of Financing is presented using both an accrual and a budgetary basis of accounting as a means to facilitate understanding of the differences between the two accounting bases.

Statement of Custodial Activity

The Statement of Custodial Activity is presented on the modified cash basis of accounting. This method initially reports revenue in the financial statements on the cash basis, which is then adjusted by the change in net federal taxes receivable, net of the change in refunds payable, during the current fiscal year. This adjustment effectively converts the cash basis revenue and refunds to a full accrual amount. The related distribution of all such collections to the Treasury is similarly reported on the cash basis. It is then adjusted to the accrual basis by the net change during the fiscal year in uncollected amounts due to Treasury.

Refunds of taxes and interest are reported on the cash basis. Refunds include payments of earned income tax credits (EITC), and child care credits, as well as overpayments of taxes.

C. Financing Sources and Imputed Costs

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

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Notes to the Financial Statements

For the Years Ended September 30, 2006 and 2005

Processing, Assistance, and Management

This appropriation provides funds for processing tax returns and related documents, assisting taxpayers in the filing of their returns and in paying taxes that are due, strategic planning and oversight, finance, human resources, and agency-wide shared services.

Tax Law Enforcement

The purpose of this appropriation is to provide funds for the enforcement of Internal Revenue Laws, examination of tax returns, administration of taxpayer appeals, collection of unpaid accounts, and securing unfiled tax returns and payments. It also provides for issuing technical rulings, monitoring employee pension plans, qualifying exempt organizations, examining exempt tax returns, and compiling statistics of income and compliance research.

Information Systems

This appropriation funds costs for data processing and information and telecommunication support for the Service's activities, including developmental information systems and operational information systems. The operational systems are located in a variety of sites including the Martinsburg Computing Center, the Detroit Computing Center, the Tennessee Computing Center, and in field offices and service centers.

Other Appropriations and Allocation Account

Other appropriations consist of an aggregate of smaller multi-functional funds that support the Service's mission to collect the proper amount of tax and provide improved customer service to the taxpayer. The Business Systems Modernization (BSM) appropriation is the largest of these funds and may be obligated as Congress approves expenditure plans. The Health Insurance Tax Credit Administration appropriation funds necessary expenses to implement the health insurance tax credit included in the Trade Act of 2002.

In FY 2006, the Service provided services to the Department of Transportation's Federal Highway Administration for the development, operation, and maintenance of electronic systems for the collection of motor fuel and other highway use taxes. The costs for these services are reported through the use of an allocation account. The Department of Transportation reports all activity for the Service in their financial statements.

Imputed Costs

The Service incurs certain costs that are paid in total or in part by other federal entities. These are pension costs administered by the Office of Personnel Management, legal judgments paid by the Treasury Judgment Fund, and costs of processing payments and collections by the Financial Management Service. These costs are recognized by the Service on its Statement of Changes in Net Position and Statement of Financing as imputed financing sources.

D. Fund Balance with Treasury

The fund balance with Treasury is the aggregate amount of funds in the Service's accounts, including appropriated funds, from which the Service is authorized to make expenditures and pay liabilities, as well as funds in deposit, suspense, and clearing accounts.

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Notes to the Financial Statements

For the Years Ended September 30, 2006 and 2005

E. Other Assets – Accounts Receivable and Advances

Accounts Receivable

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

Advances

Advances to government agencies primarily represent funds paid to the Treasury Working Capital Fund (WCF) and the Department of Interior GovWorks. Centralized services funded through the WCF consist primarily of telecommunications services, payroll processing, and depreciation of property and equipment owned by the WCF. Activities funded through GovWorks consist of the acquisition of furniture.

The majority of advances to the public are for investigations and employee travel advances, which are expensed upon receipt of employees' expense reports.

F. Property and Equipment

Property and equipment is recorded at historical cost. It consists of tangible assets and software. Other than limited exceptions noted below, property and equipment is capitalized regardless of acquisition cost. The Service depreciates property and equipment on a straight line basis over its estimated useful life. A half year depreciation is taken in the first and final years. Disposals are recorded when deemed material.

The Service classifies property and equipment into the following classes: ADP equipment, non-ADP equipment, furniture, investigative equipment, vehicles, major systems, internal use software, and leasehold improvements.

ADP Equipment

ADP Equipment consists of five types of assets along with related equipment: 1) mainframe computers, 2) minicomputers, 3) local area network (LAN) servers, 4) desktop and laptop computers, and 5) telecommunications equipment. ADP equipment includes all related software, including commercial off-the-shelf software, except as separately stated under Internal Use Software.

Office Equipment and Furniture, Investigative Equipment, and Vehicles

The Service capitalizes office equipment and furniture, investigative equipment, and vehicles, with an individual-asset acquisition cost of $5,000 or more.

Major Systems

Prior to FY 2001, the Service capitalized certain costs of large-scale computer software systems as major systems. Subsequently, such costs are included in internal use software. Only projects exceeding $20 million were considered major systems.

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For the Years Ended September 30, 2006 and 2005

Internal Use Software

Beginning in FY 2001, the Service capitalizes direct and indirect costs of internal use software in accordance with Statement of Federal Financial Accounting Standards No.10, *Accounting for Internal Use Software.* Direct costs include direct salaries and benefits of IRS employees assigned to the projects, consultant fees, and contracting costs. Related infrastructure and project management costs are allocated to the projects. Maintenance is excluded.

The Service applies indirect overhead to internal use software projects using a three-year average rate of overhead costs. The overhead rate is applied only to salaries and benefits of IRS employees directly assigned to the internal use software projects.

Internal use software's capitalized costs are accumulated in work in process until final acceptance and testing are successfully completed. Once completed, the costs are transferred to depreciable property. Disposals are recognized when software is determined to be obsolete or nonfunctional. The IRS treats terminated projects and/or subprojects as 100% obsolete.

Leasehold Improvements

All leasehold improvement projects are capitalized regardless of cost.

G. Permanent and Indefinite Funds

The Service uses a special class of funds, designated as "permanent and indefinite", to disburse tax refund principal and related interest. These permanent and indefinite funds are not subject to budgetary ceilings set by Congress during the annual appropriation process. Because Congress permanently funds tax refunds from a budgetary standpoint, tax refunds payable at year-end are fully funded. The asset "Due from Treasury" designates this approved funding to pay year-end tax refund liabilities, which are reflected in the funds used for refund of federal taxes on the Statement of Custodial Activity along with tax refund payments for the year.

Although funded through the appropriation process, refund activity is reported as a custodial activity of the Service. This presentation is appropriate because refunds are, in substance, a custodial revenue-related activity. Federal tax revenue received from taxpayers is not available for use in the operation of the Service and is not reported on the Statement of Net Cost. Likewise, the resultant refunds of overpayments are not available for use by the Service in operations. Consequently, to present refunds as an expense of the Service on the Statement of Net Cost with related appropriations used would be inconsistent with the reporting of the related federal tax revenue and would materially distort the costs incurred by the Service in meeting its strategic objectives.

H. Tax Assessments and Abatements

Under the Internal Revenue Code (26 USC) Section 6201, the Secretary of the Treasury is authorized and required to make inquiries, determinations, and assessments of all taxes that have been imposed and accruing under any internal revenue law but have not been duly paid (including interest, additions to the tax, and assessable penalties). The Secretary has delegated this authority to the Commissioner of the IRS. Unpaid assessments result from taxpayers filing returns without sufficient payments, as well as from the

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2006 and 2005

Service's enforcement programs, such as examination, under-reporter, substitute for return, and combined annual wage reporting.

Under the Internal Revenue Code (26 USC) Section 6404, the Commissioner of the IRS also has authority to abate the paid or unpaid portion of an assessed tax, interest, and penalty. Abatements occur for a number of reasons and are a normal part of the tax administration process (abatements may be allowed for a qualifying corporation that claimed a net operating loss which created a credit that can be carried back to reduce a prior year's tax liability, amend tax returns, and to correct an assessment from an enforcement program, taxes discharged in bankruptcy, accepted offers in compromise, penalty abatements for reasonable cause, contested assessments made due to mathematical or clerical errors, and assessments contested after the liability has been satisfied). Abatements may result in claims for refunds or a reduction of the unpaid assessed amount.

I. Federal Taxes Receivable

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

Taxes receivable consist of unpaid assessments (taxes and associated penalties and interest) due from taxpayers for which the Service can support the existence of a receivable through taxpayer agreement, such as filing of a tax return without sufficient payment, or a court ruling in favor of the Service. Taxes receivable are shown on the balance sheet net of an allowance for doubtful accounts. The allowance for doubtful accounts reflects an estimate of the portion of total taxes receivable deemed to be uncollectible.

Compliance assessments are unpaid assessments for which neither the taxpayer nor a court has affirmed that the taxpayer owes amounts to the Federal Government. Examples include assessments resulting from an IRS audit or examination in which the taxpayer does not agree with the results. These amounts are not reported on the balance sheet; however, statutory provisions require that these accounts be maintained until the statute for collection expires.

Write-offs consist of unpaid assessments for which the Service does not expect further collections due to factors such as taxpayers' bankruptcy, insolvency, or death. These amounts are also not reported on the balance sheet; however, statutory provisions require that these accounts be maintained until the statute for collection expires.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2006 and 2005

Note 2. Fund Balance with Treasury (In Millions)

Fund balance with Treasury as of September 30, 2006 and 2005, consist of the following:

Fund Balance	**2006**	**2005**
Appropriated funds and other	$ 2,066	$ 1,990
Fund Balance with Treasury	**$ 2,066**	**$ 1,990**
Status of Fund Balance with Treasury		
Unobligated balances:		
Available	$ 192	$ 252
Unavailable	360	236
Obligated balances not yet disbursed	1,520	1,508
Other funds	(6)	(6)
Fund Balance with Treasury	**$ 2,066**	**$ 1,990**

The Business Systems Modernization (BSM) fund represents $268 million and $297 million of the appropriated fund balance as of September 30, 2006 and 2005, respectively. BSM funds can only be obligated pursuant to an expenditure plan approved by Congress. Other funds primarily consist of suspense, deposit, and clearing funds.

Note 3. Cash and Other Monetary Assets (In Millions)

Cash and other monetary assets with the public as of September 30, 2006 and 2005, consist of the following:

	2006	**2005**
Imprest fund	$ 4	$ 4
Other custodial assets	48	462
Total Cash and Other Monetary Assets	**$ 52**	**$ 466**

Imprest funds are maintained by Headquarters and field offices in commercial bank accounts.

Other custodial assets primarily represent voluntary deposits received from taxpayers, pending application of the funds to unpaid tax assessments. This category also includes seized monies of less than $1 million as of September 30, 2006 and 2005, respectively, which are held pending the results of criminal investigations. As described in Note 13, other custodial assets are classified as “Non-entity Assets” and are offset by an equal liability in other custodial liabilities.

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Notes to the Financial Statements

For the Years Ended September 30, 2006 and 2005

Note 4. Other Assets (In Millions)

Other assets as of September 30, 2006 and 2005, consist of the following:

	2006		2005	
	Intra-Governmental	With the Public	Intra-Governmental	With the Public
Advances	$ 187	$ 9	$ 130	$ 8
Accounts receivable, net	14	7	16	7
Federal tax lien revolving fund		4	-	2
Suspense	4	(5)	4	(5)
Total Other Assets	**$ 205**	**$ 15**	**$ 150**	**$ 12**

Note 5. Federal Taxes Receivable, Net

Federal taxes receivable (gross) were $91 billion and $88 billion as of September 30, 2006 and 2005, respectively, and consisted of tax assessments, penalties, and interest that were not paid or abated, and which were agreed to by the taxpayer and the Service, or upheld by the courts.

Federal taxes receivable (net) equaled $21 billion as of September 30, 2006 and 2005, respectively, and are the portion of federal taxes receivable (gross) estimated to be collectible. It is based on projections of collectibility from a statistical sample of taxes receivable. An allowance for doubtful accounts of $70 billion and $67 billion was established in FY 2006 and FY 2005, respectively, for the difference between the gross federal taxes receivable and the portion estimated to be collectible. Due to Treasury is the offsetting liability to federal taxes receivable, representing amounts to be transferred to Treasury when collected.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2006 and 2005

Note 6. Property and Equipment (In Millions)

Property and Equipment as of September 30, 2006 and 2005, is shown in the schedule below. The Cost column represents the historical cost of property and equipment, net of disposals. The cost basis for FY 2006 and FY 2005 is $3,529 million and $3,502 million, respectively. Accumulated depreciation for FY 2006 and FY 2005 is $2,249 million and $2,080 million, respectively.

Category	Useful Life (Years)	Cost	Accumulated Depreciation	2006 Net Book Value	2005 Net Book Value
ADP assets	3 to 7	$ 1,733	$ (1,234)	$ 499	$ 502
Furniture and non-ADP equipment	8 to 10	61	(46)	15	20
Investigative equipment	10	10	(8)	2	3
Vehicles	5	76	(58)	18	26
Major systems	7	423	(391)	32	89
Internal use software	7	721	(242)	479	508
Internal use software – work in process		41	-	41	35
Leasehold improvements	10	443	(264)	179	202
Assets under capital lease	4 to 10	21	(6)	15	37
Total Property and Equipment		**$ 3,529**	**$ (2,249)**	**$ 1,280**	**$ 1,422**

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INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2006 and 2005

As of September 30, 2006 and 2005, the Service has 12 internal use software projects, including deployed and work in process. Customer Account Data Engine (CADE) is a project to replace the Service's master file for taxpayer accounts. E-Services is a project to develop web-based products and services for tax practitioners and the public. Modernized E-File is an electronic filing system for tax returns. Security and Technology Infrastructure Release (STIR) is a project to modernize and standardize the information technology security infrastructure throughout the Service. Integrated Financial System (IFS) is an administrative financial system. Internet Refund Fact of Filing is a project to allow taxpayers to review the status of their refund. Enterprise Systems Management (ESM) is a project that created a new information technology infrastructure. Customer Communications is a customer service telephone system. Filing & Payment Compliance is a project to resolve payment and filing compliance issues, including enabling private debt collection.

Deployed internal use software projects consist of the following:

Category	Cost	Accumulated Depreciation	2006 Net Book Value	2005 Net Book Value
Integrated Financial System	$ 147	$ (32)	$ 115	$ 138
Modernized E-File	142	(40)	102	91
E-Services	141	(50)	91	112
CADE	145	(40)	105	84
STIR	76	(38)	38	49
Customer Communications	25	(18)	7	10
Enterprise Systems Management	16	(8)	8	10
Internet Refund Fact of Filing	15	(7)	8	10
Filing & Payment Compliance	3	-	3	-
Other	11	(9)	2	4
Totals	**$ 721**	**$ (242)**	**$ 479**	**$ 508**

Until deployed, internal use software projects are carried as work in process. Major projects in process include future releases of CADE, Modernized E-File, and Filing & Payment Compliance.

The costs of internal use software – work in process consist of the following:

Category	2006	2005
CADE	$ 10	$ 18
Modernized E-File	16	15
Filing & Payment Compliance	15	2
Totals	**$ 41**	**$ 35**

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INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2006 and 2005

Note 7. Other Liabilities (In Millions)

Other liabilities as of September 30, 2006 and 2005, consist of the following:

	Non-Current	Current	2006 Total
Intragovernmental:			
Accrued expenses	$ -	$ 30	$ 30
Accrued payroll and benefits	-	51	51
Workers' compensation	55	41	96
Capital leases	-	1	1
Total Other Liabilities	**$ 55**	**$ 123**	**$ 178**
With the Public:			
Accounts payable	$ -	$ 99	$ 99
Accrued expenses	-	193	193
Accrued payroll and benefits	-	230	230
Workers' compensation	487	-	487
Accrued annual leave	-	478	478
Other custodial liabilities	-	48	48
Capital leases	3	1	4
Commitments & contingencies	-	2	2
Total Other Liabilities	**$ 490**	**$ 1,051**	**$ 1,541**

	Non-Current	Current	2005 Total
Intragovernmental:			
Accrued expenses	$ -	$ 30	$ 30
Accrued payroll and benefits	-	51	51
Workers' compensation	51	41	92
Capital leases	-	1	1
Total Other Liabilities	**$ 51**	**$ 123**	**$ 174**
With the Public:			
Accounts payable	$ -	$ 81	$ 81
Accrued expenses	-	201	201
Accrued payroll and benefits	-	222	222
Workers' compensation	520	-	520
Accrued annual leave	-	462	462
Other custodial liabilities	-	462	462
Capital leases	11	14	25
Total Other Liabilities	**$ 531**	**$ 1,442**	**$ 1,973**

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2006 and 2005

Note 8. Leases (In Millions)

The capital lease liability as of September 30, 2006 and 2005, is $5 million and $26 million, respectively, for photocopiers, ADP Equipment and software licenses. Future payments due on capital leases are as follows:

	Total	2007	2008	2009
Photocopiers	$ 1	$ 1	$ -	$ -
ADP Equipment	5	1	1	3
Total Lease Obligations	6	2	1	3
Less: imputed interest	(1)	(1)	-	-
Present Value of Lease Payments	$ 5	$ 1	$ 1	$ 3

The Service leases office space, vehicles and equipment under annual operating leases. These leases are cancelable or renewable on an annual basis at the option of the Service. They do not impose binding commitments on the Service for future rental payments on leases with terms longer than one year.

Note 9. Commitments and Contingencies

The Service is subject to contingent liabilities involving litigation of cases whose ultimate disposition is unknown. Management has determined that it is probable that some of these proceedings and actions will result in losses. As of September 30, 2006 and 2005, the estimated liability for these cases was $2 million and $0, respectively.

There are also legal actions pending for which management is unable to determine the likelihood of losses. Adverse decisions in these cases may, individually or in the aggregate, have a material effect on the financial statements. As of September 30, 2006 and 2005, there were three cases for which management is unable to determine the likelihood or establish a range of potential losses.

As of September 30, 2006 and 2005, the Service does not have contractual commitments for payments on obligations related to canceled appropriations.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2006 and 2005

Note 10. Liabilities Not Covered by Budgetary Resources (In Millions)

Liabilities not covered by budgetary resources as of September 30, 2006 and 2005, consist of the following:

	2006		2005	
	Intra-Governmental	**With the Public**	**Intra-Governmental**	**With the Public**
Workers' compensation	$ 96	$ 487	$ 92	$ 520
Accrued annual leave	-	478	-	462
Capital lease liability	-	-	-	23
Contingent liability	-	2	-	-

Workers' compensation, accrued annual leave, and contingent liabilities are also reported in Components Requiring or Generating Resources in Future Periods in the Statement of Financing.

Note 11 Appropriations Received

Appropriations received reported in the Statement of Budgetary Resources in FY 2006 and FY 2005 include $101 million and $90 million, respectively, in user fees received from the public for services provided and retained by the agency to reduce its net cost of operations.

Note 12. Obligated Balances (In Millions)

Obligated balances as of September 30, 2006 and 2005, in the Statement of Budgetary Resources, are as follows:

	2006	2005
Undelivered orders – unpaid	$ (932)	$ (941)
Budgetary accounts payable	(605)	(587)
Budgetary accounts receivable	15	17
Total Obligated Balances	**$ (1,522)**	**$ (1,511)**

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2006 and 2005

Note 13. Non-entity Assets (In Millions)

Non-entity assets arise from the Service's custodial duty to collect taxes, disburse tax refunds and maintain proper accounting for these activities in the books and records of the Service. Non-entity assets as of September 30, 2006 and 2005, consist of the following:

	2006		2005	
	Intra-Governmental	With the Public	Intra-Governmental	With the Public
Due from Treasury	$ 1,695	$ -	$ 1,946	$ -
Federal taxes receivable, net of allowance for doubtful accounts	-	21,000	-	21,000
Other custodial assets	-	48	-	462

Due from Treasury represents tax refunds due to taxpayers but not disbursed as of September 30, 2006 and 2005.

Federal taxes receivable are transferred to Treasury upon receipt. An amount equal to federal taxes receivable has been recognized as an offsetting intragovernmental liability – Due to Treasury. Federal taxes receivable is described in more detail in Note 5.

Other custodial assets, also discussed in Note 3, primarily relate to seized monies and the deposits received from taxpayers, pending application of the funds to unpaid tax assessments.

Note 14. Comparison of Statement of Budgetary Resources and the President's Budget (In Millions)

The *Budget of the United States Government* that will include FY 2006 actual budgetary execution information will not be published until January 2007. Accordingly, the disclosure information required by Statement of Federal Financial Accounting Standard No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting,* is not available at the time of publication of these financial statements.

Balances reported in the FY 2005 Statement of Budgetary Resources and the related President's Budget are shown in the following table for each of the major appropriations and the Business Systems Modernization fund. The table does not include other minor appropriations.

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Notes to the Financial Statements

For the Years Ended September 30, 2006 and 2005

	FY 2005	
	Statement of Budgetary Resources	President's Budget
Processing, Assistance, and Management:		
Total budgetary resources	$ 4,228	$ 4,122
Status of budgetary resources:		
Obligations incurred	$ 4,071	$ 4,065
Unobligated balances – available	58	57
Unobligated balances – unavailable	99	-
Total status of budgetary resources	$ 4,228	$ 4,122
Outlays	$ 3,951	$ 3,949
Tax Law Enforcement:		
Total budgetary resources	$ 4,548	$ 4,489
Status of budgetary resources:		
Obligations incurred	$ 4,489	$ 4,481
Unobligated balances – available	8	8
Unobligated balances – unavailable	51	-
Total status of budgetary resources	$ 4,548	$ 4,489
Outlays	$ 4,307	$ 4,314
Information Systems:		
Total budgetary resources	$ 1,785	$ 1,717
Status of budgetary resources:		
Obligations incurred	$ 1,679	$ 1,674
Unobligated balances – available	42	43
Unobligated balances – unavailable	64	-
Total status of budgetary resources	$ 1,785	$ 1,717
Outlays	$ 1,487	$ 1,486

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2006 and 2005

	FY 2005	
	Statement of Budgetary Resources	President's Budget
Business Systems Modernization Fund:		
Total budgetary resources	$ 442	$ 435
Status of budgetary resources:		
Obligations incurred	$ 317	$ 317
Unobligated balances – available	119	118
Unobligated balances – unavailable	6	-
Total status of budgetary resources	$ 442	$ 435
Outlays	$ 246	$ 246

There are significant differences between the SBR and the President's Budget which are attributable to differing Treasury and OMB requirements. The differences are primarily due to expired and unexpired appropriations. The SBR includes both unexpired and expired appropriations, while the President's Budget discloses only unexpired budgetary resources that are available for new obligations.

Note 15. Collections of Federal Tax Revenue (In Billions)

The Service transfers total tax collections to the U.S. Treasury. Collection activity, by financial statement line item for the fiscal years ended September 30, 2006 and 2005, and by tax year for fiscal year ended September 30, 2006, is as follows:

	Tax Year				Collections Received	Collections Received
	2006	2005	2004	Prior Years	FY 2006	FY 2005
Individual income, FICA/SECA, and other	$1,310 *	$ 691	$ 17	$ 17	$ 2,035	$ 1,865
Corporate income	259 **	104	1	16	380	307
Excise	43	15	-	-	58	58
Estate and gift	-	19	1	9	29	26
Railroad retirement	4	1	-	-	5	4
Federal unemployment	5	2	-	-	7	7
Total	**$1,621**	**$ 832**	**$ 19**	**$ 42**	**$ 2,514**	**$ 2,267**
	64%	33%	1%	2%	100%	

* Includes other collections of $492 million.

** Includes tax year 2007 corporate income tax receipts of $10 billion.

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INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2006 and 2005

In FY 2006, Individual income, FICA/SECA, and other taxes include $71 billion in payroll taxes collected from other federal agencies. Of this amount, $12 billion represents the portion paid by the employers.

Note 16. Federal Tax Refund Activity (In Billions)

Refund activity, broken out similarly to collection activity by financial statement line item for the fiscal years ended September 30, 2006 and 2005, and by tax year for fiscal year ended September 30, 2006, is as follows:

	Tax Year				Refunds Disbursed	Refunds Disbursed
	2006	2005	2004	Prior Years	FY 2006	FY 2005
Individual income, FICA/SECA, and other	$ 1	$ 226	$ 13	$ 6	$ 246	$ 231
Corporate income	1	9	4	17	31	36
Excise	-	-	-	-	-	-
Estate and gift	-	-	-	-	-	-
Railroad retirement	-	-	-	-	-	-
Federal unemployment	-	-	-	-	-	-
Total	**$ 2**	**$ 235**	**$ 17**	**$ 23**	**$ 277**	**$ 267**
	1%	85%	6%	8%	100%	

Individual income, FICA/SECA, and other refund amounts include EITC and child tax credit refunds.

Note 17. Intragovernmental Costs and Exchange Revenue (In Millions)

Gross cost and earned revenue for the Service are categorized as follows:

	2006			2005		
	Intra-Governmental	With the Public	Total	Intra-Governmental	With the Public	Total
Gross cost	$ 3,829	$ 7,869	$11,698	$ 3,856	$ 7,879	$11,735
Earned revenue	(47)	(166)	(213)	(118)	(154)	(272)
Net cost	**$ 3,782**	**$ 7,703**	**$11,485**	**$ 3,738**	**$ 7,725**	**$11,463**

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INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2006 and 2005

Note 18. Obligations Incurred

In FY 2006, the Service incurred $10,634 million in obligations funded by direct appropriations and $88 million funded by reimbursable revenue and transfers from the Treasury Asset Forfeiture Fund. In FY 2005, the Service incurred $10,429 million in obligations funded by direct appropriations and $155 million funded by reimbursable revenue and transfers from the Treasury Asset Forfeiture Fund. Obligations incurred are reported by the Service under Apportionment Category B which distributes budgetary resources for the entire fiscal year. Resources for Business Systems Modernization are distributed by projects.

Note 19. Spending Authority from Offsetting Collections (In Millions)

Spending authority from offsetting collections as of September 30, 2006 and 2005, in the Statements of Budgetary Resources and Financing, is as follows:

	2006	2005
Reimbursable Revenue	$ 71	$ 142
Receipts for Tax Lien Revolving Fund	8	5
Refunds from Vendors	8	-
Treasury Asset Forfeiture Fund Transfers	17	14
Total Spending Authority From Offsetting Collections	**$ 104**	**$ 161**

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Supplemental Information

INTERNAL REVENUE SERVICE

Supplemental Information - Unaudited

For the Years Ended September 30, 2006 and 2005

Statement of Net Cost by Responsibility Segment (In Millions)

	2006	2005
Operating divisions:		
WAGE	$ 2,911	$ 2,422
SBSE	2,491	2,734
LMSB	800	771
TEGE	268	251
Total	6,470	6,178
Functional support:		
Appeals	209	210
Chief Counsel	322	308
Criminal Investigation	619	539
Taxpayer Advocate	186	186
Communications	24	24
Total	1,360	1,267
Operating Net Cost	**7,830**	**7,445**
General and Administration	1,721	1,841
Information Technology	1,546	1,566
Depreciation/Loss on Disposal	388	611
Total Net Cost	**$ 11,485**	**$ 11,463**

Other Claims for Refunds

Management has estimated amounts that may be paid out as other claims for tax refunds. This estimate represents an amount (principal and interest) that may be paid for claims pending judicial review by the Federal courts or, internally, by Appeals. In FY 2006, the total estimated payout (including principal and interest) for claims pending judicial review by the Federal courts is $14.8 billion and by Appeals is $7.1 billion. In FY 2005, the total estimated payout (including principal and interest) for claims pending judicial review by the Federal courts was $11.9 billion and by Appeals was $11.1 billion. To the extent judgments against the government in these cases prompt other similarly situated taxpayers to file similar refund claims, these amounts could become significantly greater.

INTERNAL REVENUE SERVICE

Supplemental Information - Unaudited

For the Years Ended September 30, 2006 and 2005

Federal Taxes Receivable, Net (In Billions)

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

The components of the total unpaid assessments and derivation of net federal taxes receivable as of September 30, 2006 and 2005, were as follows:

	2006	2005
Total unpaid assessments	$ 245	$ 230
Less: Compliance assessments	(57)	(44)
Write-offs	(97)	(98)
Gross federal taxes receivable	91	88
Less: Allowance for doubtful accounts	(70)	(67)
Federal taxes receivable, net	**$ 21**	**$ 21**

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

To eliminate double-counting, the compliance assessments reported above exclude trust fund recovery penalties, totaling $9 billion as of September 30, 2006 and $13 billion as of September 30, 2005, that were assessed against officers and directors of businesses who were involved in the non-remittance of federal taxes withheld from their employees. The related unpaid assessments of those businesses are reported as taxes receivable or write-offs, but the Service may also recover portions of those businesses' unpaid assessments from any and all individual officers and directors against whom a trust fund recovery penalty is assessed.

Earned Income Tax Credit

The EITC is a special credit for employed taxpayers whose earnings fall below the established allowance ceiling. In FY 2006, the Service issued $36 billion in EITC refunds. In FY 2005, the Service issued $35 billion in EITC refunds. An additional $5.4 billion and $5.3 billion of the EITC was applied to reduce taxpayer liability for FY 2006 and FY 2005, respectively.

INTERNAL REVENUE SERVICE

Supplemental Information - Unaudited

For the Years Ended September 30, 2006 and 2005

Social Security and Medicare Taxes

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

A portion of FICA benefits involve old-age, survivors, and disability payments. These benefits are funded by the "social security tax" which is currently 6.2% of wages and tips up to $94,200 and an employer matching amount of 6.2% bringing the total rate to 12.4%. These benefits are also funded by a self-employment tax of 12.4% on self employment income up to $94,200. For FY 2005, the income ceiling for both wages and tips and self-employment income was $90,000. Remaining benefits under FICA pertain to hospital benefits (referred to as "Medicare") and are funded by a separate 1.45% tax on all wages and tips (there is no wage limit) and the employer matching contribution of 1.45% bringing the total rate to 2.9%. Self-employed individuals pay a Medicare tax of 2.9% on all self employment income. Social Security taxes collected by the IRS were estimated to be approximately $614 billion and $583 billion in FY 2006 and FY 2005, respectively. Medicare taxes collected by the IRS were estimated to be approximately $178 billion and $167 billion in FY 2006 and FY 2005, respectively.

INTERNAL REVENUE SERVICE

Supplemental Information - Unaudited

For the Years Ended September 30, 2006 and 2005

Schedule of Budgetary Resources by Major Budget Accounts (In Millions)

	Fiscal Year 2006				
	Processing Assistance and Management	Tax Law Enforcement	Information Systems	Business Systems Modernization and Other	Total
Budgetary Resources:					
Unobligated balance – beginning of period	$ 158	$ 59	$ 106	$ 165	$ 488
Recoveries of prior year obligations	73	28	21	5	127
Budgetary appropriations received	4,136	4,726	1,599	321	10,782
Spending authority from offsetting collections	44	43	8	9	104
Non-expenditure transfers, net	(62)	(11)	93	(20)	-
Permanently not available	(114)	(60)	(41)	(12)	(227)
Total Budgetary Resources	**$ 4,235**	**$ 4,785**	**$ 1,786**	**$ 468**	**$ 11,274**
Status of Budgetary Resources:					
Obligations incurred	$ 4,081	$ 4,699	$ 1,695	$ 247	$ 10,722
Unobligated balance – available	25	29	34	104	192
Unobligated balance – not available	129	57	57	117	360
Total Status of Budgetary Resources	**$ 4,235**	**$ 4,785**	**$ 1,786**	**$ 468**	**$ 11,274**
Change in Obligated Balances:					
Obligated balance, net, beginning of period	$ 475	$ 311	$ 534	$ 191	$ 1,511
Obligations incurred, net	4,081	4,699	1,695	247	10,722
Gross outlays	(4,035)	(4,660)	(1,636)	(255)	(10,586)
Recoveries of prior year obligations	(73)	(28)	(21)	(5)	(127)
Change in uncollected customer payments from Federal sources	-	2	-	-	2
Obligated balance, net, end of period	**$ 448**	**$ 324**	**$ 572**	**$ 178**	**$ 1,522**
Net Outlays:					
Gross outlays	$ 4,035	$ 4,660	$ 1,636	$ 255	$ 10,586
Less: offsetting collections	(43)	(45)	(9)	(9)	(106)
Less: offsetting receipts	-	-	-	(106)	(106)
Net Outlays	**$ 3,992**	**$ 4,615**	**$ 1,627**	**$ 140**	**$ 10,374**

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INTERNAL REVENUE SERVICE

Supplemental Information - Unaudited

For the Years Ended September 30, 2006 and 2005

	Fiscal Year 2005				
	Processing Assistance and Management	Tax Law Enforcement	Information Systems	Business Systems Modernization and Other	Total
Budgetary Resources:					
Unobligated balance – beginning of period	$ 117	$ 79	$ 79	$ 295	$ 570
Recoveries of prior year obligations	30	14	12	3	59
Budgetary appropriations received	4,089	4,399	1,591	329	10,408
Spending authority from offsetting collections	46	104	6	5	161
Non-expenditure transfers, net	(7)	6	120	(119)	-
Permanently not available	(47)	(54)	(23)	(2)	(126)
Total Budgetary Resources	**$ 4,228**	**$ 4,548**	**$ 1,785**	**$ 511**	**$ 11,072**
Status of Budgetary Resources:					
Obligations incurred	$ 4,071	$ 4,489	$ 1,679	$ 345	$ 10,584
Unobligated balance – available	58	8	42	144	252
Unobligated balance – not available	99	51	64	22	236
Total Status of Budgetary Resources	**$ 4,228**	**$ 4,548**	**$ 1,785**	**$ 511**	**$ 11,072**
Change in Obligated Balances:					
Obligated balance, net, beginning of period	$ 432	$ 247	$ 358	$ 124	$ 1,161
Obligations incurred, net	4,071	4,489	1,679	345	10,584
Gross outlays	(3,997)	(4,415)	(1,492)	(275)	(10,179)
Recoveries of prior year obligations	(30)	(14)	(12)	(3)	(59)
Change in uncollected customer payments from Federal sources	-	4	-	-	4
Obligated balance, net, end of period	**$ 476**	**$ 311**	**$ 533**	**$ 191**	**$ 1,511**
Net Outlays:					
Gross outlays	$ 3,997	$ 4,415	$ 1,492	$ 275	$ 10,179
Less: offsetting collections	(46)	(108)	(5)	(5)	(164)
Less: offsetting receipts	-	-	-	(91)	(91)
Net Outlays	**$ 3,951**	**$ 4,307**	**$ 1,487**	**$ 179**	**$ 9,924**

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Other Accompanying Information

INTERNAL REVENUE SERVICE

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2006 and 2005

Child Tax Credit

The child tax credit provided under Internal Revenue Code (26 USC) Section 24 was originally authorized by the Taxpayer Relief Act of 1997 (Public Law 105-34). The child tax credit is a special credit for taxpayers who work, whose earnings fall below the established allowance ceiling, and who have a qualifying child. In FY 2006, the Service issued $15 billion in child tax credit refunds. An additional $32 billion of child tax credits were applied to reduce taxpayer liability. In FY 2005, the Service issued $15 billion in child tax credit refunds. An additional $32 billion of child tax credits were applied to reduce taxpayer liability.

Tax Gap

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 FY 2006 estimates, represents the amount of noncompliance with the tax laws. Underreporting tax liability accounts for 83 percent of the gap, with the remainder almost evenly divided between non-filing (eight percent) and underpaying (nine percent). The estimate is based on a study of individual returns filed for tax year 2001. It does not include underpayments by corporate taxpayers or taxes that should have been paid on income from the illegal section of the economy.

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 nonfiling gap), underreporting the correct amount of tax on timely filed returns (the underreporting gap), and not paying on time the full amount reported on timely filed returns (the underpayment gap). Of these three components, only the underpayment gap is observed; the nonfiling gap and the underreporting gap must be estimated. 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 Service 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 Service's balance sheet. The tax gap and the collection gap are related and overlapping concepts, but they have significant differences. The collection gap is a cumulative balance sheet concept for a particular point in time, while the tax gap is like an income statement item for a single year. Moreover, the tax gap estimates include all noncompliance, while the collection gap includes only amounts that have been assessed (a small portion of all noncompliance).

INTERNAL REVENUE SERVICE

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2006 and 2005

Tax Burden and Tax Expenditures

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

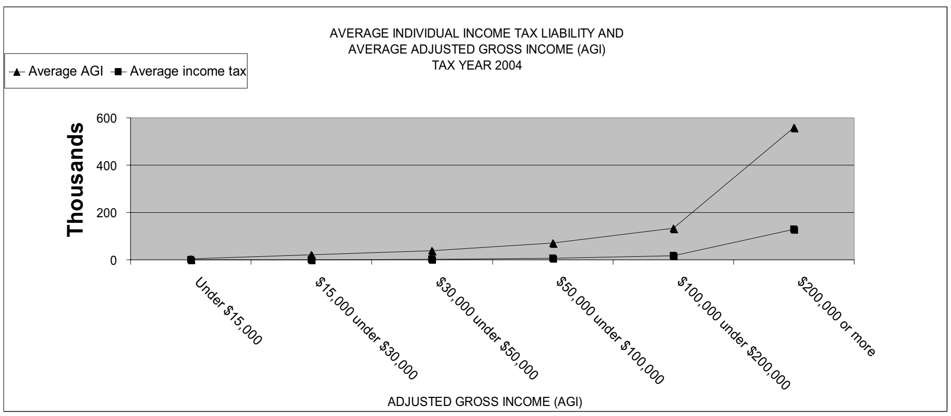
Total tax expenditures are the foregone federal revenue resulting from deductions and credits provided in the Internal Revenue Code. Since tax expenditures directly affect funds available from government operations, decisions to forego federal revenue are as important as decisions to spend federal revenue.

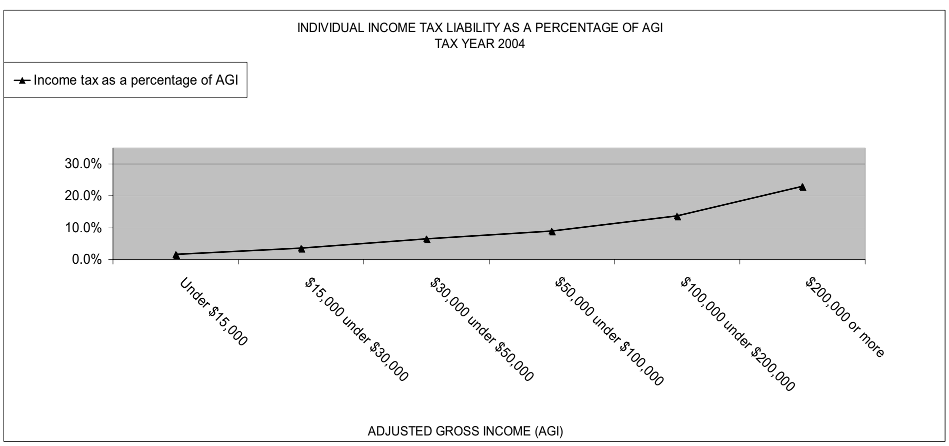
INTERNAL REVENUE SERVICE

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2006 and 2005

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





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	37,315	200,248	3,306	5,366	89	1.7%
$15,000 under $30,000	29,581	650,044	23,749	21,975	803	3.7%
$30,000 under $50,000	24,536	957,783	62,190	39,036	2,535	6.5%
$50,000 under $100,000	28,196	1,984,569	178,486	70,385	6,330	9.0%
$100,000 under $200,000	9,750	1,291,062	176,173	132,417	18,069	13.6%
$200,000 or more	3,007	1,681,201	386,515	559,096	128,538	23.0%
Total	132,385	6,764,907	830,419			

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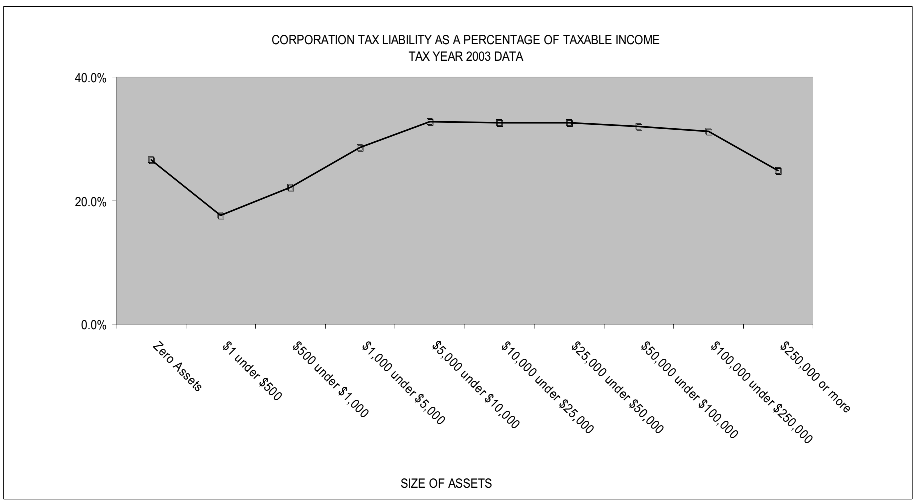
INTERNAL REVENUE SERVICE

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2006 and 2005

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



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..................................	7,476	1,987	26.6%
$1 under $500...............................	8,159	1,435	17.6%
$500 under $1,000.........................	3,541	785	22.2%
$1,000 under $5,000......................	10,482	2,994	28.6%
$5,000 under $10,000....................	6,240	2,045	32.8%
$10,000 under $25,000..................	9,033	2,941	32.6%
$25,000 under $50,000..................	8,208	2,677	32.6%
$50,000 under $100,000................	10,321	3,297	31.9%
$100,000 under $250,000..............	20,870	6,516	31.2%
$250,000 or more..........................	615,006	152,840	24.9%
Total..	699,336	177,517	25.4%

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Material Weaknesses, Reportable Condition, and Compliance Issues

Material Weaknesses

During our audits of the Internal Revenue Service's (IRS) fiscal years 2006 and 2005 financial statements, we continued to identify four material weaknesses in internal controls. These material weaknesses have given rise to significant management challenges that have (1) impaired management's ability to prepare financial statements and other financial information without extensive compensating procedures, (2) limited the availability of reliable information to assist management in effectively managing operations on an ongoing basis, (3) reduced IRS's effectiveness in enforcing the Internal Revenue Code, (4) resulted in errors in taxpayer accounts, (5) increased taxpayer burden, and (6) reduced assurance that data processed by IRS's information systems are reliable and appropriately protected. The issues that we have identified and discuss in this report relate to IRS's controls over (1) financial reporting, (2) unpaid assessments, (3) federal tax revenue and refunds, and (4) information security. We reported on each of these issues last year[1] and in prior audits. We highlight these issues in the following sections. Less significant matters involving IRS's system of internal controls and its operations will be reported to IRS separately.

Financial Reporting

In fiscal year 2006, as in prior years, IRS did not have financial management systems adequate to enable it to accurately and timely generate and report the information needed to both prepare financial statements and manage operations on an ongoing basis. To overcome these systemic deficiencies with respect to preparation of its annual financial statements, IRS was compelled to employ extensive compensating procedures that were costly and labor intensive. During fiscal year 2006, IRS (1) did not have an adequate general ledger system for financial reporting purposes, (2) could not reliably report the specific amount of revenue collected for each of several of the federal government's largest revenue sources, and (3) was unable to readily determine the costs of its activities and programs and did not have cost-based performance information to assist in making or justifying resource allocation decisions. Although labor-intensive compensating procedures yielded financial statements that were fairly stated as of September 30, 2006 and 2005, they do not afford real-time data needed to assist in managing operations on a day-to-day basis and to assist in making or justifying resource allocation decisions.

[1]GAO, *Financial Audit: IRS's Fiscal Years 2005 and 2004 Financial Statements*, GAO-06-137 (Washington, D.C.: Nov. 10, 2005).

As we noted in last year's report,[2] during fiscal year 2006, IRS's general ledger system was not supported by adequate audit trails or integrated with its supporting records for material balances, including federal tax revenue, federal tax refunds, taxes receivable, and property and equipment (P&E). Because of these deficiencies, IRS's general ledger system does not conform to the *U.S. Government Standard General Ledger* (SGL) at the transaction level as required by the *Core Financial System Requirements* of the Joint Financial Management Improvement Program (JFMIP)[3] or the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA). Further, IRS's use of two separate, nonintegrated general ledgers, one to account for its tax administration activities and another to capture the costs of conducting those activities, greatly complicates efforts to measure the cost of IRS's tax administration efforts.

In November 2004, IRS implemented the first release of the Integrated Financial System (IFS), which now serves as IRS's core administrative financial management system. The major components of this first release of IFS are accounts payable, accounts receivable, budget formulation, budget execution, general ledger, financial reporting, and cost accounting. Additional key components were originally planned to be implemented with future releases of IFS, such as property management, procurement, and a workload management system. However, technological improvements and budgetary constraints have led IRS to reconsider its commitment to future releases of IFS while it reviews other available options, such as acquiring alternate software or utilizing the services of a shared service provider. IRS has not yet decided which course of action to take or obtained necessary funding. It is therefore unclear how or when IRS will attain the functionality originally planned for future releases of IFS. In addition, to account for and report on over $2 trillion in annual tax-related transactions, IRS continues to rely on legacy financial management systems that do not interface with IFS.

[2]GAO-06-137.

[3]Joint Financial Management Improvement Program, *Core Financial System Requirements*, JFMIP-SR-02-01 (Washington, D.C.: November 2001). JFMIP was originally formed under the authority of the Budget and Accounting Procedures Act of 1950 as a cooperative undertaking of the Office of Management and Budget, the Department of the Treasury, the Office of Personnel Management, and GAO, working in cooperation with each other and with operating agencies to improve financial management practices in the federal government. On December 1, 2004, JFMIP ceased to exist as a separate organization, with OMB's Office of Federal Financial Management assuming many JFMIP functions.

In previous years, IRS had difficulty determining the specific amount of revenue it actually collected for three of the federal government's four largest revenue sources—Social Security, hospital insurance, and individual income taxes. During fiscal year 2006, IRS performed an analysis to estimate the amounts collected for Social Security and hospital insurance. However, IRS is not yet confident of the reliability of these amounts, and consequently reported them in its unaudited supplemental information rather than the audited financial statements. In addition, IRS continued to be unable to determine, at the time payments are received, collections for other trust funds that receive excise tax receipts, such as the Highway Trust Fund. This is primarily because the accounting information needed to validate the taxpayer's liability and record the payment to the proper trust fund is provided on the tax return, which is received months after the payment is submitted. Further, the information on the tax return pertains only to the amount of the tax liability, not how to distribute the amount previously collected among the appropriate trust funds. IRS does not require taxpayers to submit information identifying the type of tax at the time of payment because it has taken the position that imposing such a requirement would create an additional burden to those particular taxpayers. In addition, IRS's systems cannot at present routinely capture and report the information it does receive. IRS is working on systems improvements to accommodate this type of information. However, IRS will continue to be unable to timely report the specific amount of revenue it actually collects for these large revenue sources until it has the systems capability to record, and requires taxpayers to provide, this information. This condition also results in the federal government depending on a complex, multistep process to distribute excise taxes to the recipient trust funds that continues to be susceptible to error.

IRS's inability to timely report specific amounts of excise tax revenue to recipient trust funds is significant for these funds and their administrators. Since fiscal year 2004, when all federal agencies were required to begin meeting the Office of Management and Budget's (OMB) stipulated reporting date of November 15, the annual excise tax receipts reported by recipient trust funds include 6 months of estimated receipts. The trust funds must report 6 months of estimated receipts because, under its existing processes, IRS takes 5-½ months to complete its certification of excise tax receipts and, therefore, does not complete the certifications for the third and fourth quarters of the fiscal year until after November 15. To the extent that these estimates differ from the certified amounts, inaccurate distributions to the trust funds could result and, in the case of the Highway Trust Fund, allocations of revenues to states could be done incorrectly.[4] In July 2003, we made recommendations to IRS for accelerating its certification process. In response to our recommendations, IRS has performed precertifications for the past 3 years to determine the extent to which an acceleration of the process would affect the amounts distributed to the trust funds. Based on IRS's analysis of the precertifications, which has indicated no significant variances between precertified and actual certified amounts for each quarter for the past 3 years, the Department of the Treasury (Treasury) Excise Tax Working Group[5] has decided to accelerate the actual certification to the precertification timeline, which will accelerate the certification by approximately 2 months. The accelerated certification will begin with the second quarter (September 30, 2006, liability quarter) that is certified in fiscal year 2007. As a result of the acceleration, beginning with the fiscal year 2007 reporting year, the annual excise tax receipts reported by recipient trust funds will include only 3 months of estimated receipts.

During fiscal year 2005, we reported that IRS implemented a cost accounting module as part of the first release of IFS but that it required improvements or additional components, such as a workload management system, before its full potential would be realized. During fiscal year 2006, IRS further improved its cost accounting capabilities by developing and implementing a methodology for allocating its costs of operations to its business units. This methodology utilizes the new cost accounting module of IFS and allows IRS to accumulate the full costs of operating each business unit and facilitates financial reporting. For example, in fiscal year 2006 IRS was able, for the first time, to generate its statement of net cost directly from IFS. While these are positive steps, IRS has not yet determined what the full range of its cost information needs are or how best to utilize the cost module's existing capabilities to satisfy those needs. IRS has also not yet implemented a related workload management system intended to improve IRS's ability to effectively manage its large workforce and to provide the cost module with detailed labor cost information at the activity or program level. Without this detail, IRS is unable to either readily

[4]The Transportation Equity Act for the 21st Century, Pub. L. No. 105-178, 112 Stat. 107 (June 9, 1998), enhanced the link between the amount of funds received by states and the amount of tax receipts credited to the Highway Trust Fund by requiring that highway program funds be distributed to states on the basis of annual highway account receipts.

[5]The Treasury Excise Tax Working Group consists of Treasury agencies with trust fund responsibilities (IRS, Office of the Fiscal Assistant Secretary, Bureau of the Public Debt, Financial Management Service, and Office of Tax Analysis). The working group meets to discuss and coordinate issues related to excise tax trust fund distributions.

determine the costs of activities and programs that involve activities in multiple business units, such as the Automated Underreporter Program, or segregate the costs for each activity in cases where multiple activities, such as the processing of different types of tax returns, are performed by a single business unit. Consequently, at this time, IRS cannot rely on the system as a significant planning and decision-making tool. It will likely require several years and implementation of additional components, such as a workload management system, as well as integration with its tax administration activities, before the full potential of IRS's cost accounting module will be realized. In the interim, IRS decision making for attaining efficiencies and enhancing effectiveness will continue to be hampered by a lack of meaningful underlying cost information.

Despite progress made during fiscal year 2006, the continued existence of these financial reporting weaknesses once again compelled IRS to expend more time and effort to maintain its accounting records and generate financial management information than would otherwise have been necessary. Further, despite these monumental efforts, IRS continued to lack reliable and timely financial information to assist in managing operations throughout fiscal year 2006. Addressing the financial reporting deficiencies discussed above would enhance this process by providing management the reliable and timely information that it needs to support informed decision making without having to resort to costly and time-consuming procedures to compensate for information system deficiencies.

Unpaid Tax Assessments

During fiscal year 2006, we continued to find serious internal control issues that affected IRS's management of unpaid assessments. Specifically, we continued to find that (1) IRS lacked a subsidiary ledger for unpaid assessments that would allow it to produce accurate, useful, and timely information with which to manage and report externally and (2) errors and delays in recording taxpayer information, payments, and other activities.

These conditions continued to hinder IRS's ability to effectively manage its unpaid assessments.[6]

IRS's management of unpaid assessments is hindered by a lack of effective supporting systems. IRS continues to lack a detailed listing, or subsidiary ledger, that tracks and accumulates unpaid assessments and their status on an ongoing basis. In fiscal year 2006, IRS began a phased-in implementation of its Custodial Detailed Database (CDDB). One of the key objectives of CDDB is to ultimately serve as a subsidiary ledger for IRS's tax administration activities, including tax revenue receipts, refund disbursements, and unpaid tax debt, by linking account information in IRS's master files[7] with its general ledger for tax administration activities. The first phase of CDDB primarily consisted of implementing computer programs that analyze and classify related taxpayer accounts from IRS's master file that are associated with unpaid payroll taxes. Although IRS successfully implemented the first phase of CDDB during fiscal year 2006, full operational capability of CDDB is still several years away and depends on the successful implementation of future system releases planned through 2009. As a result, IRS continues to rely on a costly, labor-intensive manual compensating process for external reporting.

Specifically, to report balances for taxes receivable and other unpaid assessments in its financial statements and supplemental information, IRS must continue to apply statistical sampling and estimation techniques to data in its master files to estimate the balances at year-end. While the first release of CDDB refined this process by analyzing and classifying taxpayer accounts from IRS's master files that are associated with unpaid payroll taxes, the process continued to take several months to complete; required adjustments totaling billions of dollars; and produced amounts that after adjustments, were only reliable as of the last day of the fiscal year.

[6]Unpaid assessments consist of (1) federal taxes receivable, which are taxes due from taxpayers for which IRS can support the existence of a receivable through taxpayer agreement or a favorable court ruling; (2) compliance assessments where neither the taxpayer nor the court has affirmed that the amounts are owed; and (3) write-offs, which represent unpaid assessments for which IRS does not expect further collections because of factors such as the taxpayer's death, bankruptcy, or insolvency. Of these three classifications of unpaid assessments, only federal taxes receivable are reported on the principal financial statements.

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

Consequently, the lack of a subsidiary ledger inhibits IRS's ability to timely develop reliable financial and management reports useful for ongoing management decisions.

IRS's management of unpaid assessments also continued to be hindered by inaccurate tax records. We continued to find errors and omissions in taxpayer records resulting from IRS's failure to accurately and timely record information. Errors in IRS records can cause frustration to taxpayers who either do not owe the debt or owe significantly lower amounts.

For example, during our audit we found that IRS erroneously recorded a taxpayer's reported tax of $1,694 as $169 million in its systems, and sent the taxpayer two erroneous notifications to pay this amount due plus penalties and interest of nearly $200 million. Upon receipt of these notices, the taxpayer obtained the services of a certified public accountant to resolve the matter with IRS; IRS ultimately corrected the error after several months. In another example, IRS incorrectly recorded a taxpayer's amended payroll tax return for one tax period in a different tax period.[8] This resulted in IRS erroneously assessing the taxpayer over $4 million in taxes that were not owed. IRS ultimately corrected the error several months later, after erroneously notifying the taxpayer and requiring the taxpayer to provide additional information.

We also identified some taxpayers that were assessed excess penalties because of an error in IRS's computer program that calculates and records penalty assessments. IRS increases the penalty rate assessed against taxpayers for failing to pay taxes owed from one-half of 1 percent to 1 percent when the taxpayer fails to pay the tax debt following repeated notification of the taxes due. If the taxpayer then fully pays the amount owed, IRS is required to reset the penalty rate back to one-half of 1 percent if it assesses additional taxes against the taxpayer at a later time. However, IRS's penalty calculation program did not recognize instances where this situation occurred and continued to assess penalties at the higher penalty rate on subsequent tax assessments. IRS determined that this error

[8] A "tax period" varies by tax type. For example, the tax period for payroll and excise taxes is generally one quarter of a year. The taxpayer is required to file quarterly returns with IRS for these types of taxes, but payment of the taxes occurs throughout the quarter. In contrast, for income, corporate, and unemployment taxes, a tax period is 1 year.

affected over 62,000 taxpayers with over 69,000 accounts, but IRS had not corrected these accounts as of September 30, 2006.[9]

On the other hand, some input errors and posting delays can cost the government money. For example, IRS found a corporate officer liable for not remitting federal tax withholdings from employees' salaries to IRS. When recording the assessment on the officer's master file account for one tax period, IRS erroneously recorded a second assessment for the same amount. IRS attempted to correct the mistake by reversing the duplicate transaction several weeks later. However, IRS erroneously reversed both the original and duplicate assessments. Consequently, there was no longer any assessment on the officer's master file account for this tax period. IRS did not identify its error until our current audit, and the statutory period for assessing new taxes on this specific tax period had expired.[10] As of September 30, 2006, IRS had not determined whether it could still legally pursue payment of these taxes from this officer.

As in prior years,[11] we continued to find errors involving IRS's failure to properly record payments to all related taxpayer accounts associated with unpaid payroll taxes.[12] IRS's current systems continued to be unable to automatically link each of the multiple assessments made for the one tax liability. Consequently, if the business or any officer of that business paid some or all of the outstanding taxes, IRS's systems were unable to automatically reflect the payment as a reduction in the amounts owed on

[9]The balance of unpaid assessments from the affected taxpayers' accounts totaled approximately $745 million. We were unable to determine the exact amount by which the error overstated the account balances but know that the amount is significantly less than the total. Additionally, we were unable to determine whether any of the affected taxpayers had already paid the excess penalties assessed.

[10]The statutory period for assessing new taxes is generally 3 years from when a tax return is either filed or due, whichever is later. I.R.C. Section 6501(a).

[11]GAO-06-137.

[12]When a company does not pay the taxes it withholds from employees' wages, such as Social Security or individual income tax withholdings, IRS has the authority to assess all responsible officers individually for the taxes withheld from employees. Although assessed to multiple parties, the liability need only be paid once. Thus, IRS may record assessments against each of several individuals for the employee-withholding component of the payroll tax liability of a given business in an effort to collect the total tax liability of the business. The assessments made against business officers are known as trust fund recovery penalties. See 26 U.S.C. § 6672 and implementing IRS guidance in the *Internal Revenue Manual* at § 4.23.9.13, Trust Fund Recovery Penalty (Mar. 1, 2003).

any related accounts. Over the past several years, IRS has taken several steps to compensate for the lack of an automated link between related accounts. For example, IRS manually inputs a code in each account that cross-references it to other related accounts. In addition, since August 2001, IRS has established procedures to more clearly link each penalty assessment against an officer to a specific tax period of the business account. In July 2003, IRS also began phasing in the use of an automated trust fund recovery penalty system that is intended to properly cross-reference payments received and thus eliminate the opportunity for errors that plague the current manual process.

Although IRS is making improvements in its processes for recording trust fund recovery penalties, our work in fiscal year 2006, as in prior years, continued to find deficiencies in this process, leading to errors in taxpayers' accounts. In our testing of 80 statistically selected payments recorded on trust fund recovery penalty accounts established since August 2001, we found 9 instances in which IRS did not properly record payments received on all related taxpayer accounts. Of these 9 payments, 4 were not properly recorded in all related accounts even though the accounts contained the required cross-referencing at the time that the payments were made. Based on our testing, we estimate that 11.3 percent of trust fund recovery payment transactions posted to accounts established since August 2001 and still outstanding during fiscal year 2006 could contain inaccuracies.[13]

Although IRS has implemented a number of compensating procedures, the ultimate solution to many of the issues related to IRS's management of unpaid assessments, such as the lack of a subsidiary ledger and the lack of an automated link between related accounts, continues to be the successful modernization of IRS's systems.

Tax Revenue and Refunds

During fiscal year 2006, we continued to find that IRS's controls were not fully effective in maximizing the federal government's ability to collect what is owed and in minimizing the risk of payment of improper refunds. IRS recognized this in its fiscal year 2006 Federal Managers' Financial Integrity Act of 1982 (FIA) assurance statement to Treasury, in which it reported material weaknesses in earned income tax credit (EITC)

[13]We are 95 percent confident that the error rate does not exceed 18.9 percent.

noncompliance and financial accounting of revenue. IRS's taxpayer compliance programs identify billions of dollars of potentially underreported taxes and erroneous EITC claims each year. However, largely because of perceived resource constraints, IRS selects only a portion of the questionable cases it identifies for follow-up investigation and action. In addition, IRS often does not initiate follow-up on the cases it selects until months after the related tax returns have been filed and any related refunds disbursed, adversely affecting its chances of collecting amounts due on these cases. Consequently, the federal government is exposed to potentially significant losses from reduced revenue and disbursements of improper refunds.

The options available to IRS in its efforts to identify and pursue the correct amount of taxes owed and to ensure that only valid refunds are disbursed continue to be limited. For example, third-party information, such as the data provided on IRS 1099 forms,[14] that can corroborate the amount of income reported by taxpayers is not required to be filed until after the start of the tax filing season.[15] Consequently, comparison of such information with tax return data is problematic because IRS does not have time to prepare the third-party data for matching prior to the receipt of individual tax returns. Additionally, while it processes hundreds of millions of tax returns each filing season, IRS must issue refunds within statutory time constraints or be subject to interest charges.[16]

As we previously reported, IRS has some preventive controls that help to reduce the magnitude of underreported taxes owed and improper refunds issued. For example, IRS's Examination Branch is responsible for performing examinations on tax returns with potentially erroneous EITC claims to determine the validity of the claims.[17] When performed before refunds are disbursed, these examinations are an important control to

[14]IRS 1099 forms are used by third parties, such as financial institutions, to report taxpayers' interest income, dividend distributions, and other miscellaneous income.

[15]The tax filing season for individuals primarily occurs from January 1 through April 15 of each year.

[16]By statute, IRS must pay interest on refunds not paid within 45 days of receipt or due date, whichever is later (26 U.S.C. § 6611).

[17]Because it is a refundable tax credit, an EITC claim always results in a reduction of the taxpayer's calculated tax liability. However, depending on the taxpayer's amount of taxes withheld, and the amount of tax due on the taxpayer's return before application of any credits, it may or may not result in a refund for a particular tax year.

prevent disbursement of improper refunds. However, in some cases these examinations are performed after any related refunds are disbursed, which negates their effectiveness as a preventive control and instead serves only as a basis for pursuing recovery after the fact. Another preventive control that IRS has relied on in the past is the Electronic Fraud Detection System (EFDS), which is IRS's primary source for identification of leads on fraudulently filed tax returns. With EFDS fully operational, IRS stopped over $412 million in improper refunds during processing year[18] 2005. However, during processing year 2006, IRS took the original EFDS off-line to install a new Web-based version, but encountered problems with the Web version and stopped all related system development activities before it became operational. As a result, IRS did not have the services of EFDS to prevent fraudulent refunds during processing year 2006. The actual amount of improper refunds disbursed during fiscal year 2006 as a result of EFDS being off-line is unknown. However, the Treasury Inspector General for Tax Administration estimated that as much as $318 million in improper refunds may have been disbursed during processing year 2006 while EFDS was off-line.[19]

In its guidance to heads of federal agencies issued in accordance with the Improper Payments Information Act of 2002 (IPIA),[20] OMB identified the EITC as a program subject to IPIA and required that Treasury accordingly report estimates of EITC-related improper payments to the President and Congress. EITC claims totaled approximately $41 billion in fiscal year 2006, of which approximately $36 billion was refunded to taxpayers and approximately $5 billion was used to reduce assessed taxes. IRS used the preliminary results of the National Research Program study of tax year 2001 data to estimate the level of compliance of individual filers for fiscal

[18]A processing year is the calendar year in which tax returns and related data are processed. During processing year 2006, IRS is processing primarily 2005 tax returns.

[19]Treasury Inspector General for Tax Administration, *The Electronic Fraud Detection System Redesign Failure Resulted in Fraudulent Returns and Refunds Not Being Identified*, 2006-20-108 (Washington, D.C.: Aug. 9, 2006).

[20]Pub. L. No. 107-300, 116 Stat. 2350 (Nov. 26, 2002). IPIA requires the head of each federal agency to annually review all programs and activities the federal agency administers to identify those that may be susceptible to significant improper payments and to estimate the amount of improper payments in those susceptible programs in accordance with guidance prescribed by OMB. Agencies are required to submit these estimates to Congress before March 31 of the following applicable year. Office of Management and Budget, *Implementation Guidance for the Improper Payments Implementation Act of 2002, P. L. 107-300*, M-03-13 (Washington, D.C.: May 21, 2003).

year 2006. Based primarily on the results of the study, IRS estimated that from 23 percent to 28 percent of the value of EITC payments disbursed during fiscal year 2006 were improper. This error rate indicates that of the approximately $36 billion of EITC-related refunds disbursed during fiscal year 2006, at least $8 billion, and potentially as much as $10 billion, was likely to have been improper.

Because of time and other constraints noted above, IRS relies extensively on detective controls, such as automated matching of tax returns with third-party data such as W-2s (wage and tax statements), to identify for collection underreported taxes and improper refunds. However, these programs are not run until months after the returns have been filed; consequently, they do not prevent improper refunds from being disbursed. IRS's matching program for individual tax returns identifies billions of dollars of potentially underreported taxes each year. IRS follows up on a portion of these cases identified to determine how much tax is actually due and to pursue collection of those amounts. Because the volume of cases IRS can follow up on depends on resource availability, IRS conducts an analysis that identifies case characteristics that have historically yielded greater assessments as a result of follow-up efforts. In recent years, IRS has increased the number of returns investigated and the dollar amount of the total potential underreported taxes. For example, for tax year 2001, IRS identified discrepancies in 15.7 million tax returns, with potential underreported taxes totaling $17.2 billion, but only investigated 3 million (19 percent) of these tax returns, which accounted for about $7.7 billion (45 percent) of the total potential underreported taxes.[21] By contrast, for tax year 2004, IRS identified discrepancies in 15 million tax returns with potential underreported taxes totaling $16 billion, and investigated 4.6 million (31 percent) of these tax returns, which accounted for about $12.7 billion (78 percent) of the total potential underreported taxes.[22]

However, as these figures also illustrate, IRS continues to pursue only a portion of the potential underrported taxes it identifies. In addition, in deciding which or how many cases to pursue, IRS does not consider historical collection experience or the costs incurred to work the related cases, which could further improve IRS's net return on the cases it does

[21]GAO, *Financial Audit: IRS's Fiscal Year 2003 and 2002 Financial Statements*, GAO-04-126 (Washington, D.C.: Nov. 13, 2003).

[22]Tax year 2004 is the most recent year for which complete matching program results are available.

elect to pursue. There are factors that affect IRS's ability to accelerate the timing of its automated matches, such as the limitations of its current automated systems and the timing of filing requirements for preparers of third-party documents, some of which are beyond IRS's control. Nonetheless, the information from IRS's automated matching program suggests that a substantial amount of additional revenue might be realized if additional resources, coupled with more timely receipt of information and more effective systems to compare such information, were devoted to follow-up efforts. At present, billions of dollars in underreported taxes could remain uncollected and improper refunds could be disbursed.

Information Security

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

IRS has made progress in implementing information security for its financial and tax processing systems and information by addressing many of its previously reported security weaknesses. For example, among other things, IRS implemented stronger password settings regarding expiration and complexity and improved controls over data sharing among mainframe users. IRS also improved employee training on recovering critical systems in the event of a disaster.

Although IRS has made progress toward correcting previously identified information security weaknesses, significant weaknesses in electronic access and other information security controls continued to exist during fiscal year 2006. Corrective actions had not been completed for some of the previously identified weaknesses. For example, the security software configurations on the mainframe system, which supports IRS's general ledger for tax administration activities, continued to contain numerous invalid and obsolete entries, leaving IRS with a system that is overly complicated and difficult to secure, especially in terms of monitoring actual access privileges. We also identified new weaknesses. For example, we found that IRS's procurement system, which processed about $3.9 billion in fiscal year 2006, was vulnerable to a well-known exploit whereby database commands can be inserted into the application through a user input screen that is available to everyone on the agency's network. The significance of this vulnerability is compounded by the fact that IRS had granted administrative privileges to the database account used by the application, allowing anyone who exploits this vulnerability to have powerful database privileges, including the ability to change data. In addition, IRS had not fully employed mitigating controls used to detect malicious activity, such as logging and monitoring user activity. The agency also stored user IDs and passwords in mainframe files that could be read by every mainframe user. This information could provide a malicious user access to IRS's data retrieval system, which contains taxpayer information. Weaknesses also existed in other areas, such as physical security, configuration management, segregation of duties, and personnel security. If IRS does not adequately mitigate these weaknesses, unauthorized individuals could gain access to critical systems, where they may intentionally or inadvertently read, modify, or delete sensitive data or computer programs, possibly without being detected. These individuals could also obtain personal taxpayer information and use it to commit financial crimes, such as identity theft. Previously reported weaknesses that have not been corrected, and the new weaknesses identified during our fiscal year 2006 financial audit, increase the risk that data processed by the agency's financial management and tax administration systems are not reliable.

A key reason for the information security weaknesses in IRS's financial and tax processing systems was that it has not yet fully implemented a security program[23] to ensure that controls are effectively established and maintained. Although IRS continues to make important progress in developing a framework for its information security program, we identified instances in which the program had not been fully or consistently implemented for its information systems. For example, the system that supports IRS's general ledger for tax administration activities did not have a documented security plan. In addition, although IRS was periodically testing security controls on the systems we reviewed, it did not always take remedial action to address deficiencies identified through these tests. For example, in March 2006, IRS identified a vulnerability in the process that

[23]In December 2002, Congress enacted the Federal Information Security Management Act of 2002 (FISMA), which requires agencies to develop, document, and implement an information security program. FISMA was enacted as title III of the E-Government Act of 2002, Pub. L. No. 107-347, 116 Stat. 2946 (Dec. 17, 2002). This requirement was enacted in section 301(b)(1) of FISMA, which is now codified at 44 U.S.C. § 3544(b).

manages network connectivity to its procurement system database server; this condition continued to exist at the time of our review 4 months later. Further, one of the systems we reviewed did not have an alternate backup facility in place in the event of a disaster. Until IRS takes additional steps to fully implement key elements of its information security program, its facilities and computing resources and the information that is processed, stored, and transmitted on its systems will likely remain vulnerable, and management will not have assurance of the integrity and reliability of the information generated.

The new information security deficiencies we identified in fiscal year 2006 and the unresolved deficiencies from prior audits represent a material weakness in IRS's internal controls over its procurement, asset management, and tax administration accounting systems. Collectively, these deficiencies reduce IRS's ability to secure its financial and taxpayer information. We plan to issue a separate report on the newly identified weaknesses and the status of previously identified weaknesses.

Reportable Condition

In addition to the material weaknesses discussed above, we identified a reportable condition concerning weaknesses in IRS's internal controls over hard-copy tax receipts and taxpayer information.

In our previous report on the results of our audit of IRS's fiscal year 2005 financial statements, we discussed the presence of a reportable condition with respect to weaknesses in IRS's internal controls over P&E. Over the past several years, IRS has made substantial progress in strengthening internal controls and procedures that enhanced its ability to account for P&E. In fiscal year 2006, IRS made further improvements over recording P&E transactions in its accounting records. Although IRS continues to lack an integrated property management system, the improvements made in fiscal year 2006, combined with progress made over the past several years, have mitigated this issue. Thus, we no longer consider the lack of an integrated accounting and property system to constitute a reportable condition.

Hard-Copy Tax Receipts and Taxpayer Information

IRS manually processes hundreds of billions of dollars of hard-copy taxpayer receipts and related taxpayer information at its service center campuses, field office taxpayer assistance centers, other field office units, and commercial lockbox banks.[24] In previous audits, we have reported that weaknesses in IRS's controls designed to safeguard taxpayer receipts and information increase the risk that receipts in the form of checks, cash, and the like could be misappropriated or that the information could be compromised.[25] During our fiscal year 2006 audit, we identified actions IRS has taken to address some of these weaknesses. For example, IRS issued guidance to its large- and midsized taxpayer assistance centers that enhanced managerial and supervisory review requirements and provided for segregation of duties between preparation and review activities relating to documents that accompany shipments of taxpayer receipts and information to affiliated IRS service center campuses for processing. Additionally, we observed that at one service center campus, IRS had taken corrective actions to address several physical security vulnerabilities, which, if left uncorrected, could have resulted in unauthorized access to the facility. Also, during fiscal year 2006, IRS and the Financial Management Service continued implementation of a joint lockbox performance measurement system begun in fiscal year 2005, which was designed to address deficiencies in internal controls, such as those identified in our prior audits, by establishing strict standards and accountability for adherence to these standards. Because the lockbox performance measurement system was not fully implemented during fiscal year 2006, we could not assess the overall impact it will have on improving the effectiveness of internal controls at the lockbox banks. However, the system focuses on increased oversight by requiring quarterly reviews relating to physical security and internal controls over receipts and receipt processing, and subsequent reporting of the reviews' results to bank management officials. In addition, a bank receiving a cautionary rating, indicating notable deficiencies in overall performance, may be subject to the following punitive actions if performance does not improve:

[24]IRS's receipt processing facilities include service center campuses, which process tax returns and payments submitted by taxpayers and deposit tax payments in depository institutions; taxpayer assistance centers, which accept payments from and provide assistance directly to taxpayers; commercial lockbox banks that operate under contract with the Financial Management Service to provide tax receipt processing and deposit services on behalf of IRS; and other business operating divisions that provide taxpayer audit and assistance centers. Other business-operating divisions are organized along the following business lines: Large and Mid-Size Businesses, Small Business/Self-Employed, and Tax Exempt/Government Entities.

[25]GAO, *Internal Revenue Service: Status of Recommendations from Financial Audits and Related Financial Management Reports*, GAO-06-560 (Washington, D.C.: June 6, 2006); *Management Report: Improvements Needed in IRS's Internal Controls*, GAO-06-543R (Washington, D.C.: May 12, 2006); and GAO-06-137.

(1) ineligibility to bid on new work or receive additional volume, (2) placement in a probationary status for no less than 90 days, and (3) loss of existing work. This system has the potential to significantly improve internal controls at the lockbox bank facilities.

However, despite the improvements we found at IRS's taxpayer assistance centers, service center campuses, and lockbox banks, IRS's controls over receipts and related hard-copy taxpayer information did not sufficiently limit the risk of theft, loss, or misuse of such funds and information. Specifically, we found the following:

- *Weaknesses in physical security controls designed to prevent unauthorized access to IRS's receipt processing facilities.* For example, during our fiscal year 2006 audit, we observed that (1) the external perimeter was vulnerable to external intrusions (at five service center campuses); (2) guards did not respond timely to alarms (at two service center campuses and one taxpayer assistance center), and (3) security cameras did not provide for 360 degree coverage of the building exterior or the facility's external perimeter (at two service center campuses and three lockbox banks). These weaknesses increase the risk that the integrity of IRS facilities and the taxpayer receipts and information they process may be compromised.

- *Weaknesses in procedural safeguards and controls designed to account for, control, and protect taxpayer receipts and related taxpayer information.* For example, during our fiscal year 2006 audit, we found that (1) sensitive taxpayer information in electronic form sent off-site for storage was not encrypted to prevent potential unauthorized access (at three lockbox banks), (2) there was no documentation that vendors with off-site possession of actual or potential sensitive taxpayer information had received required background investigations (at two service center campuses and one lockbox bank), and (3) mail potentially containing taxpayer receipts was not adequately secured to prevent potential tampering or theft (at two service center campuses). These weaknesses increase the risk that taxpayer receipts and information may be compromised during processing at IRS facilities and lockbox banks.

- *Weaknesses in controls designed to safeguard hard-copy taxpayer receipts and related taxpayer information during transport between IRS business units and to or from third parties, such as depository institutions and post offices.* For example, during our fiscal year 2006 audit, we found that (1) there was no evidence that IRS employees sending packages containing taxpayer receipts and information followed up with responsible parties at the recipient location when document transmittal forms used to specifically identify the contents of the packages shipped remained unacknowledged by the recipient (at one service center campus and five Small Business/Self-Employed units); (2) packaging and shipping procedures used by IRS employees did not adequately secure taxpayer receipts and information to prevent potential tampering or unauthorized access (at one service center campus and two Small Business/Self-Employed unit); and (3) there was no evidence documenting managerial review of transfer-related documents[26] (at three service center campuses, two lockbox banks, two taxpayer assistance centers, and four Small Business/Self-Employed units). These weaknesses increase the risk that taxpayer receipts may be lost, misappropriated, or delayed in transit between offices and that their loss, misappropriation, or delayed arrival may not be timely detected.

These internal control weaknesses increase IRS's vulnerability to theft or loss and expose taxpayers to increased risk of losses from financial crimes committed by individuals who inappropriately gain access to taxpayer receipts and confidential information entrusted to IRS. IRS's progress in addressing these issues has been hampered by a tendency, at times, to focus corrective actions on the issues we identify at the specific locations where we find them, versus proactively addressing potential weaknesses at other comparable locations to determine the full scope of the issues across all IRS receipt processing facilities potentially affected. For example, during our fiscal year 2005 financial audit, we identified a physical security weakness in a perimeter fence at one service center campus, which IRS subsequently corrected. However, IRS did not concurrently follow up to assess whether similar issues existed at other service center campuses. During our fiscal year 2006 audit, we found that similar vulnerabilities existed at two additional service center campuses. The recurrence of this issue might have been avoided if IRS had been more proactive in its use of the information we provided in fiscal year 2005. While IRS has made significant progress in this area, the issues identified during our fiscal year 2006 audit indicate that more remains to be done to effectively address

[26]Transfer-related documents include courier, mail, and deposit logs and forms 795 and 3210, which accompany taxpayer receipts and other information shipped to other IRS locations.

these matters, which are critical to IRS's success in meeting its customer service goals.

Compliance Issues

Our work on compliance with selected provisions of laws and regulations disclosed one area of noncompliance that is reportable under U.S. generally accepted government auditing standards and OMB guidance. This area relates to the release of federal tax liens against taxpayers' property. We also found that IRS's financial management systems do not substantially comply with the requirements of FFMIA.

Release of Federal Tax Liens

The Internal Revenue Code grants IRS the power to file a lien against the property of any taxpayer who neglects or refuses to pay all assessed federal taxes. The lien becomes effective when it is filed with a designated office, such as a courthouse in the county where the taxpayer's property is located.[27] The lien serves to protect the interest of the federal government and as a public notice to current and potential creditors of the government's interest in the taxpayer's property. For example, federal tax liens are disclosed in credit reports of individuals. Under section 6325 of the Internal Revenue Code, IRS is required to release federal tax liens within 30 days after the date the tax liability is satisfied or has become legally unenforceable or the Secretary of the Treasury has accepted a bond for the assessed tax.

In each year beginning with our audit of IRS's fiscal year 1999 financial statements, we found that IRS did not always release the applicable federal tax lien within 30 days of the tax liability being either paid off or abated, as required by the Internal Revenue Code.[28] We found that this condition continued to exist in fiscal year 2006.

In prior audits, we tested a statistical sample of tax cases with liens in which the taxpayers' total outstanding tax liabilities were either paid off or abated during the fiscal year under audit. In fiscal year 2006, IRS performed its own test of the effectiveness of its lien release process as

[27] 26 U.S.C. §§ 6321, 6323.

[28] GAO-06-103.

part of implementing the requirements of the revised OMB Circular No. A-123. Consequently, we reviewed and validated IRS's test results.

In its testing of 84 statistically selected tax cases with liens in which the taxpayers' total outstanding tax liabilities were either paid off or abated during fiscal year 2006, IRS found 26 instances in which it did not release the applicable federal tax lien within the statutorily mandated 30 days. The time between satisfaction of the liability and release of the lien ranged from 44 days to 638 days. In 4 cases, the lien still had not been released at the time of IRS's review. Based on these results, IRS estimates that for 31 percent of unpaid tax assessment cases in which it had filed a tax lien that were resolved in fiscal year 2006, IRS did not release the lien within 30 days.[29]

In 13 of the 26 cases in which liens were not released timely, the delay in the lien release was caused by IRS's failure to timely record information on the taxpayer's account to show that the taxpayer had satisfied or was otherwise relieved of the tax liability. In 6 of these cases, IRS did not properly credit all of the taxpayer's outstanding accounts when the taxpayer sent in one payment to satisfy the tax liability of multiple tax accounts. Consequently, one or more of the taxpayer's accounts remained open even though the taxpayer had fully satisfied the total tax liability. This, in turn, prevented the initiation of the lien release process for these cases. In 5 of the other cases, IRS did not timely update the taxpayer's account to reflect that the taxpayer had been discharged of the taxes in bankruptcy court. In the remaining 2 cases, IRS did not timely update the taxpayer's account to indicate the taxpayer had satisfied all the conditions of an offer-in-compromise. IRS's delay in timely recording this information also prevented the initiation of the lien release process. The failure to promptly release tax liens could cause undue hardship and burden to taxpayers who are attempting to sell property or apply for commercial credit. We issued a report in January 2005 that discusses other issues that contribute to IRS's failure to timely release federal tax liens, along with our recommendations to address those issues.[30]

[29]IRS is 97.5 percent confident that the percentage of cases in which the lien was not released within 30 days does not exceed 41 percent.

[30]GAO, *Opportunities to Improve Timeliness of IRS Lien Releases*, GAO-05-26R (Washington, D.C.: Jan. 10, 2005).

Financial Management Systems' Noncompliance With FFMIA

In fiscal year 2006, we continued to find that IRS's financial management systems did not substantially comply with the requirements of FFMIA. Specifically, IRS's systems did not comply with *Federal Financial Management System Requirements* (FFMSR), federal accounting standards (U.S. generally accepted accounting principles), and the SGL at the transaction level. We found that IRS (1) cannot rely solely on information from its general ledger to prepare its financial statements; (2) lacks a subsidiary ledger for its unpaid assessments; and (3) lacks an effective audit trail from its general ledger back to detailed records and transaction source documents for material balances, such as tax revenues and tax refunds. IRS's implementation of the first release of IFS represented a major step forward and has provided significant benefits, such as enhanced audit trails and a cost module. However, as noted earlier in this report, IRS is no longer committed to the future releases of IFS that were to include additional features essential to IRS's ability to realize the system's full potential, such as workload and procurement management. Since IRS does not yet have a viable alternative planned, it is unclear how or when IRS will obtain these capabilities. Additionally, IRS continues to rely on obsolete legacy systems to process tax revenues, tax refunds, and unpaid tax assessments. These systems do not interface with IFS, which accounts for and reports only IRS's nontax administrative activities.

This noncompliance with FFMIA ties in with our earlier discussions of material weaknesses related to the inability of IRS's financial management systems to produce auditable financial statements and related disclosures that conform with U.S. generally accepted accounting principles without substantial compensating processes and significant adjustments. These weaknesses also indicate that IRS's systems cannot routinely accumulate and report the full cost of its activities. Since IRS's systems do not comply with FFMSR, U.S. generally accepted accounting principles, and the SGL, they also do not comply with OMB Circular No. A-127, *Financial Management Systems* (revised July 23, 1993). In its FIA assurance statement to Treasury, IRS reported that its financial management systems did not substantially comply with the requirements of FFMIA in fiscal year 2006.

IRS has established a remediation plan to address the conditions affecting its systems' inability to comply substantially with the requirements of FFMIA. This plan outlines the actions to be taken to resolve these issues, but many future corrective actions are on hold and currently unfunded. Because of the long-term nature of IRS's systems modernization efforts, which IRS expects will resolve many of the most serious issues, many of the planned time frames exceed the 3-year resolution period specified in FFMIA. However, for these instances IRS has received a waiver from this requirement from OMB, as authorized by FFMIA.

Details on Audit Methodology

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

- Examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements. This included selecting statistical samples of unpaid assessment, revenue, refund, accrued expenses, payroll, nonpayroll, P&E, accounts payable, and undelivered order transactions. These statistical samples were selected primarily to substantiate balances and activities reported in IRS's financial statements. Consequently, dollar errors or amounts can and have been statistically projected to the population of transactions from which they were selected. In testing these samples, certain attributes were identified that indicated either significant deficiencies in the design or operation of internal control or compliance with provisions of laws and regulations. These attributes, where applicable, can be and have been statistically projected to the appropriate populations.

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

- Evaluated the overall presentation of the financial statements.

- Obtained an understanding of internal controls related to financial reporting (including safeguarding assets), compliance with laws and regulations (including the execution of transactions in accordance with budget authority), and the existence and completion assertions related to performance measures reported in the Management Discussion and Analysis.

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

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

- Tested compliance with selected provisions of the following laws and regulations: Anti-Deficiency Act, as amended (31 U.S.C. § 1341(a)(1) and 31 U.S.C. § 1517(a)); Purpose Statute (31 U.S.C. § 1301); Release of lien or discharge of property (26 U.S.C. § 6325); Interest on underpayment, nonpayment, or extensions of time for payment of tax (26 U.S.C. § 6601); Interest on overpayments (26 U.S.C. § 6611); Determination of rate of interest (26 U.S.C. § 6621); Failure to file tax return or to pay tax (26 U.S.C. § 6651); Failure by individual to pay estimated income tax (26 U.S.C. § 6654); Failure by corporation to pay estimated income tax (26 U.S.C. § 6655); Prompt Payment Act (31 U.S.C. § 3902(a), (b), and (f) and 31 U.S.C. § 3904); Pay and Allowance System for Civilian Employees (5 U.S.C. §§ 5332 and 5343, and 29 U.S.C. § 206); Federal Employees' Retirement System Act of 1986, as amended (5 U.S.C. §§ 8422, 8423, and 8432); Social Security Act, as amended (26 U.S.C. §§ 3101 and 3121 and 42 U.S.C. § 430); Federal Employees Health Benefits Act of 1959, as amended (5 U.S.C. §§ 8905, 8906, and 8909); Transportation, Treasury, Independent Agencies, and General Government Appropriations Act, 2005, Pub. L. No. 108-447, div. H, tit. II, 118 Stat. 2809, 3199 (Dec. 8, 2004); and Department of the Treasury Appropriations Act, 2006, Pub. L. No. 109-115, div. A, tit. II, 119 Stat. 2396, 2432 (Nov. 30, 2005).

- Tested whether IRS's financial management systems substantially comply with the three requirements of the Federal Financial Management Improvement Act of 1996 (Pub. L. No. 104-208, div. A, § 101(f), title VIII, 110 Stat. 3009, 3009-389 (Sept. 30, 1996).

Comments from the Internal Revenue Service

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

DEPUTY COMMISSIONER

November 6, 2006

Mr. David M. Walker
Comptroller General
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Walker:

Thank you for the opportunity to comment on the draft report titled, *Financial Audit: IRS' Fiscal Years 2006 and 2005 Financial Statements.* We are pleased that the Internal Revenue Service (IRS) received an unqualified opinion on the combined financial statements for a seventh consecutive year. The unqualified opinion demonstrates that the IRS accurately accounts for approximately $2.5 trillion in tax revenue receipts, $277 billion in tax refunds, and $11 billion in IRS appropriated funds.

The report recognizes the significant accomplishments the IRS made this year in addressing outstanding audit issues while also implementing the requirements of Appendix A of the Office of Management and Budget (OMB) Circular A-123, Management's Responsibility for Internal Control. The IRS met the new provisions of OMB A-123 and Treasury mandates, a significant and highly visible challenge due to the complexity and need to create an entirely new process. The IRS tested internal control sets for 45 transaction processes and over 200 internal controls identified by Treasury that are material to its consolidated financial statements.

We are dedicated to continuing to improve financial management at the IRS, as evidenced by the following significant fiscal year (FY) 2006 achievements:

- Eliminated property and equipment reportable condition through implementation of a first level procurement review, revision of material group codes, and implementing a materiality threshold for capital asset review
- Reduced Matters for Further Consideration (MFCs) for the safeguarding of taxpayer receipts by 60 percent from FY 2005
- Reduced MFCs in administrative accounting by 40 percent from FY 2005
- Accelerated the quarterly excise tax certifications to the Department of the Treasury by two months and disclosed more detailed information on Social Security tax and the three largest Excise Tax Trust Funds revenues as supplemental information to the FY 2006 financial statements and in the Management Discussion and Analysis

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- Improved cost allocation methodology and generated FY 2006 Statement of Net Cost from the Integrated Financial System (IFS)
- Automated the obligation adjustment process in IFS
- Implemented Release 1 of the Custodial Detail Data Base, creating a subsidiary ledger for unpaid assessments that was used for audit sampling, one year ahead of schedule

Improving information security continues to be a priority for the IRS. The IRS is improving protection of sensitive information by expanding the use of encryption, increasing employee education and awareness, and improving IRS information security policies and procedures to ensure protection of taxpayer, employee, and IRS sensitive information. The IRS established a Security Services and Privacy Executive Steering Committee to coordinate information security improvements and to leverage subject matter experts from the areas of information technology security, physical security, and privacy and identity theft.

I want to recognize the Government Accountability Office's support throughout the FY 2006 audit and assistance as the IRS implemented the new requirements of OMB Circular A-123. While challenges remain, the IRS has established its ability to consistently produce accurate and reliable financial statements. We have a solid management team in place to continue to improve financial management, and we continue to increase the focus on information security and internal controls while improving financial reporting.

Sincerely,

John M Dalrymple

John M. Dalrymple

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