United States Government Accountability Office

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Report to the Secretary of the Treasury

November 2005

FINANCIAL AUDIT

IRS's Fiscal Years 2005 and 2004 Financial Statements

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GAO-06-137

November 2005

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Highlights

Highlights of GAO-06-137, a report to the Secretary of the Treasury

FINANCIAL AUDIT

IRS's Fiscal Years 2005 and 2004 Financial Statements

Why GAO Did This Study

Because of the significance of Internal Revenue Service (IRS) collections to 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 IRS prepares are reliable and (2) IRS management maintained effective internal controls. We also test IRS's compliance with selected provisions of significant laws and regulations and its financial management systems' compliance with the Federal Financial Management Improvement Act of 1996 (FFMIA).

What GAO Recommends

In prior audits, GAO made recommendations to IRS to address issues that continued to persist during this year's audit. GAO will monitor IRS's progress in implementing the 84 recommendations that remain open as of the date of this report. IRS agreed with the report's findings, noting that it fairly presented IRS's progress and challenges. IRS cited its implementation of the first phase of its new financial systems and its planned initiatives to address its financial management challenges. IRS noted that it had established a strong commitment to improve financial management and to aggressively pursue process and systems improvements.

www.gao.gov/cgi-bin/getrpt?GAO-06-137.

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 2005 and 2004 financial statements were fairly presented in all material respects. Because of serious internal control and financial management systems deficiencies, however, IRS again had to rely extensively on resource-intensive compensating processes to prepare its financial statements. Due to 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. In fiscal year 2005, IRS successfully implemented the first phase, or release, of its new Integrated Financial System (IFS), which is intended to replace the outdated financial management systems IRS used in recent years to process and report administrative (nontax) transactions. This first phase 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. In addition, IRS continued to make progress in its efforts to address its weaknesses in controls over hard-copy taxpayer receipts and data and over property and equipment. However, 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. In addition, IRS was not always in compliance with a law concerning the timely release of tax liens.

IRS's most serious financial management weaknesses are rooted in its continued reliance on outdated automated systems. The lack of a sound financial management system that can produce timely, accurate, and useful information needed for day-to-day decisions continues to present a serious challenge to IRS management. While implementation of the first phase of IFS during fiscal year 2005 was noteworthy, it is still several years away from achieving its full potential, which is contingent on future system releases and development of a means to integrate the new system with the systems IRS uses to support its tax administration activities. IRS's present financial management systems, which do not substantially comply with FFMIA, inhibit IRS's ability to address the financial management and operational issues that affect its ability to fulfill its responsibilities as the nation's tax collector. Further, the continued and serious weaknesses in information security have significant implications for the reliability of information produced by the new financial management system being implemented. Solving IRS's financial management problems depends largely on the ultimate success of IRS's ongoing systems modernization effort.

Contents

Abbreviations

CADE	Customer Account Data Engine
CAP	Custodial Accounting Project
CFO Act	Chief Financial Officers Act of 1990
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
FMS	Financial Management Service
IFS	Integrated Financial System
IRS	Internal Revenue Service
JFMIP	Joint Financial Management Improvement Program
OMB	Office of Management and Budget
P&E	property and equipment

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Comptroller General
of the United States

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

November 10, 2005

The Honorable John W. Snow
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, 2005 and 2004. 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, 2005, 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 2005 and 2004 financial statements were made possible 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, this effort is not scheduled to be completed for several years. Until the modernization is accomplished, 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 sixth consecutive year, IRS has received an unqualified opinion on its financial statements and, for the fourth consecutive year, the audit was completed and the report issued by November 15.

Over the last several years, IRS has made great strides in addressing its financial management challenges and has resolved or substantially mitigated several material weaknesses in its internal controls. However, IRS's most serious financial management weaknesses are rooted in its continued reliance on outdated automated systems, whose numerous limitations render IRS unable to develop cost-based performance or other information to support informed decision making throughout the year.

Solving these problems depends largely on the ultimate success of IRS's ongoing systems modernization effort. In 1995, we designated financial management and systems modernization at IRS as high-risk areas.[1] However, because resolution of IRS's most serious and intractable financial management issues largely depends on the success of IRS's business systems modernization efforts, in 2005 we combined these two previous high-risk areas into one Business Systems Modernization high-risk area.[2]

During fiscal year 2005, IRS successfully implemented the first phase, or release, of its new Integrated Financial System (IFS), which is intended to replace the outdated financial management system that IRS used in recent years to process and report administrative transactions. This first phase 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, full operational capability of IFS is several years away, and is contingent on the successful implementation of future system releases. Additionally, IRS will need to address how IFS will ultimately be integrated with those systems that support financial management of its tax administration functions to fully resolve many of its long-standing financial management challenges.

Among the most serious financial management issues still remaining to be addressed are the continued significant weaknesses in IRS's information security. Consequently, 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

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

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

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. As we previously reported, 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 9 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 have designated as high risk.[3] In recent years, 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 faces 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 recently completed a study of the rate of compliance with the nation's tax laws by individuals and some small business taxpayers, and is exploring approaches to developing compliance estimates for other groups of taxpayers. 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; Senate Committee on the Budget; Subcommittee on Transportation, Treasury, the Judiciary, Housing and Urban Development

[3] GAO-05-207.

and Related Agencies, Senate Committee on Appropriations; Subcommittee on Taxation and IRS Oversight, Senate Committee on Finance; Subcommittee on Oversight of Government Management, the Federal Workforce, and the District of Columbia, Senate Committee on Homeland Security and Governmental Affairs; House Committee on Appropriations; House Committee on Ways and Means; House Committee on Government Reform; House Committee on the Budget; Subcommittee on Transportation, Treasury, and Housing and Urban Development, the Judiciary, and the District of Columbia, House Committee on Appropriations; Subcommittee on Government Management, Finance, and Accountability, House Committee on Government Reform; and Subcommittee on Oversight, House Committee on Ways and Means. 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 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,[4] this report presents the results of our audits of the financial statements of the Internal Revenue Service (IRS) for fiscal years 2005 and 2004. The financial statements report the assets, liabilities, net position, net costs, changes in net position, budgetary resources, reconciliation of net costs to budgetary obligations, 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 reported by taxpayers or identified by IRS, often referred to as the tax gap,[5] nor do they include information on tax expenditures.[6]

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, three computing centers, and numerous other field offices throughout the United States. In each of fiscal years 2005 and 2004, IRS collected about $2.3 trillion and $2.0 trillion, respectively, in tax payments, processed hundreds of millions of tax and information returns, and paid about $267 billion and $278 billion, respectively, in refunds to taxpayers.

[4]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).

[5]IRS includes an estimate of the tax gap in the tax gap disclosures contained in the other accompanying information to the financial statements. This estimate is based on a recently completed study by IRS on the rate of compliance with the tax laws by individuals and some small business taxpayers. IRS is exploring approaches to developing compliance estimates for other groups of taxpayers.

[6]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.

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. While progress is being made to modernize its financial management capabilities, IRS nonetheless continued to confront many of the pervasive internal control weaknesses that we have reported each year since we began auditing its financial statements in fiscal year 1992,[7] though it continued to make strides in addressing its financial management challenges. In fiscal year 2005, for the sixth 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 fourth 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.

IRS's continued success in meeting this reporting date is a major accomplishment and, for fiscal year 2005, was all the more notable because IRS met this date while implementing the first phase of its new financial management system, which is ultimately expected to resolve its most serious financial management challenges. Nevertheless, many of IRS's long-standing systems and internal control weaknesses continued to exist, necessitating continued reliance on costly compensating processes, statistical estimates, external contractors, substantial adjustments, and monumental human efforts to prepare a set of reliable financial statements. These costly efforts would not be necessary if IRS's systems and controls operated effectively.

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

During fiscal year 2005, IRS continued to make progress in its efforts to address its weaknesses in controls over financial reporting, property and equipment (P&E), and hard-copy taxpayer receipts and data. For example, as a result of its implementation of the first phase of its new financial management system, IRS improved the timeliness and accuracy of its recording of P&E acquisitions. Additionally, IRS implemented several initiatives to improve the safeguarding of, and accountability for, hardcopy taxpayer receipts and data at lockbox banks and taxpayer assistance centers. However, control deficiencies in P&E and physical security over taxpayer receipts and data continued to represent reportable conditions,[8] requiring further attention by IRS management. Additionally, we continue to consider issues related to controls over financial reporting, management of unpaid assessments, and collection of revenue and issuance of tax refunds to be material weaknesses.[9] These weaknesses are caused primarily by IRS's continued reliance on outdated automated systems to provide the financial information that management relies on to make decisions. 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.

IRS has made progress in improving its financial management, and the process changes IRS has instituted in the last several years represent good financial management practices. However, IRS's most serious remaining problems are caused by its inadequate automated systems, and these problems will continue to exist until its systems are replaced. In the interim, opportunities for further improvement will be limited. Until its systems are replaced, IRS will continue to be challenged to sustain the level of effort needed to produce reliable financial statements timely. Perhaps more important, IRS will continue to rely on processes that cannot produce the accurate, useful, and timely financial and performance information IRS

[8]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.

[9]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.

needs for decision making on an ongoing basis, which is a primary objective of the CFO Act. These processes also cannot fully address the underlying financial management and operational issues that adversely affect IRS's ability to effectively fulfill its responsibilities as the nation's tax collector.

IRS is currently installing a new financial management system intended to resolve many of the issues discussed in this report. During fiscal year 2005, IRS implemented a major component of this system—the first release of the Integrated Financial System (IFS). IFS is intended to replace the outdated financial management system IRS has used in recent years to process and report administrative transactions such as procurement and utilization of budgetary resources, and to provide IRS with a general ledger system that complies with the U.S. Government Standard General Ledger. During the fiscal year, IRS converted financial data from its previous financial system to IFS, verified that the information was converted properly, and closely monitored the conversion in an effort to ensure a successful transition to this first release of IFS. Replacing a financial system of this magnitude is an inherently difficult and complex effort that entails significant risks. IRS recognized this, and devoted significant resources to mitigate those risks. This, and earlier decisions to delay implementation to address issues that arose during the design of the system, enabled IRS to successfully implement the first phase of IFS with minimal disruptions to its financial activities.

While IRS's progress with respect to the implementation of this first phase of IFS is noteworthy, it is important to recognize that substantial work remains to be done to complete the modernizing of IRS's financial management systems so as to achieve sound financial management. Presently, IFS serves as IRS's core financial management system for its administrative activities, and includes such functionality as accounts payable, accounts receivable, budget formulation and execution, and the general ledger. While IFS contains cost accounting capability, it will be several years before such capabilities can be fully and successfully utilized. Additionally, IRS's effort to bring the system online experienced significant problems and delays in the past, and this, coupled with funding constraints, led to a decision to indefinitely defer future releases of IFS, including those related to property management, procurement, and performance management functions.

IRS also will have to address 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. During fiscal year 2005, IRS expanded processing of the less complex individual tax returns through the first phase, or release, of the Customer Account Data Engine (CADE), which is the system being designed to replace IRS's master files.[10] CADE was to eventually provide tax information to IFS for reporting purposes through the Custodial Accounting Project (CAP), a system which was to support management needs for information related to tax operations for purposes of day-to-day decision making, performance management, and reporting. However, significant delays and problems, as well as budget constraints, resulted in first the deferral, and later the cancellation, of CAP. At this time, IRS is exploring options to implement alternative systems that would perform the functions that CAP had been intended to perform, but it remains unclear when IRS's new financial management systems will be fully implemented. Additionally, continuing and newly identified weaknesses in IRS's information security raise serious concerns about the integrity of information that will be generated from these modernized systems, as well as about future modernization efforts that support the preparation of IRS's financial statements.

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, 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.

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, the taxpayer, or courts agree on the amounts owed. Cumulative unpaid tax assessments for which

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

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 Accountability and Control* (revised June 21, 1995).[11]

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 2005 and 2004. Nonetheless, IRS continues to face the following key issues that represent material weaknesses in internal controls:

[11]A reexamination of internal control requirements for financial reporting by federal agencies was initiated in light of the new internal control requirements for publicly traded companies contained in the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002). On December 21, 2004, OMB issued a revision of Circular No. A-123, *Management's Responsibility for Internal Control*, which will become effective in fiscal year 2006. In the interim, OMB has instructed federal agencies to continue to follow the 1995 revision.

- 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 two reportable conditions, which, although not material weaknesses, represent significant deficiencies 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. These conditions concern deficiencies in (1) 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, and (2) controls over P&E, which preclude IRS from readily reconciling its property records to its financial records.

We have reported on these material weaknesses and reportable conditions in prior audits and have provided IRS recommendations to address these issues. Eighty-four of these recommendations were still open as of the date of this report.[12] 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.

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' property.

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.

[12]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.

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

Consistency of Other Information

IRS's Management Discussion and Analysis and required supplemental 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]

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.

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

- 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, 2005 and 2004. 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 the agency's financial management progress and remaining management and systems challenges. IRS noted that the agency's dedication to financial management improvement enabled it to achieve, for the sixth consecutive year, an unqualified opinion on its financial statements. Additionally, IRS cited a number of financial management improvements it had undertaken during fiscal year 2005, the most notable of which was its successful deployment of the initial release of its Integrated Financial System (IFS). In addition to the implementation of IFS, IRS noted other financial management improvements, such as (1) implementation of a crosswalk to convert the Interim Revenue Accounting Control System trial balance accounts into a format compliant with the United States Standard General Ledger, (2) centralization of all Small Business/Self-Employed Automated Trust Fund Recovery Penalty (TFRP) work to two campuses to improve efficiency and reduce TFRP assessment errors by improving the cross-referencing and posting of the payment process, and (3) development of Security and Internal Control Performance Measures for physical security, courier, personal security, and internal controls over receipts and receipt processing at lockbox banks.

In its response, IRS also agreed with our findings and opinions related to information security, and indicated that it had developed an action plan to address deficiencies in access controls, rules of behavior, contingency planning and disaster recovery, audit trails, training, and certification and accreditation. IRS also recognized the need to continue to address identified problems and remain focused on its modernization efforts. IRS noted that the agency had established a deep and continuing commitment to improving financial management and its intention to aggressively pursue appropriate actions to improve processes and systems.

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

David M. Walker
Comptroller General
of the United States

October 31, 2005

Management Discussion and Analysis

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2005

I. Introduction

The Internal Revenue Service (IRS) administers America's tax laws and collects the revenues that fund most government operations and public services. To do so, the IRS helps taxpayers comply with the tax system and ensures that those who are unwilling to comply pay their fair share. In a constantly evolving economy, this mission requires not only a sharp focus on service and enforcement, but also an increasingly flexible agency, one capable of smooth adjustment to 21st century change.

The IRS' five-year Strategic Plan provides the blueprint to meet this challenge. This plan focuses on three key goals: improving taxpayer service, enhancing enforcement of the tax law and modernizing the IRS through its people, processes and technology. Fiscal Year (FY) 2005 witnessed the IRS making significant progress toward each of these goals.

The way taxpayers pay their taxes and access IRS information is changing. This year, for the first time, more than half of all taxpayers filed electronically and more than five million of these taxpayers filed for free though the Free File Alliance. Additionally, tens of millions of taxpayers visited the IRS website to obtain forms, publications and answers to their many tax questions. In FY 2005, as in prior years, IRS employees made millions of contacts with American taxpayers and businesses, improving service to them by reducing response times to taxpayer inquiries, improving communications with taxpayers, providing taxpayers and their paid prepares with needed resources and reducing the paperwork burden.

The IRS has also increased enforcement with the aim of improving taxpayer compliance. The FY 2005 performance results confirm that the IRS is striking the right balance between service and enforcement. For FY 2005, the IRS met or exceeded the targets in 17 of its 21[1] measures (81% compared to 67% in FY 2004). Of particular note are the IRS' efforts to enhance criminal enforcement, use of civil injunctions to stop abusive tax schemes and investigate promoters and users of tax shelters. Two major settlement initiatives involving the use of abusive tax shelters generated over $4.7 billion in revenue. IRS enforcement actions also contribute to national security and homeland defense; the IRS has a unique role in combating the use of charitable organizations to raise funds for terrorist organizations.

Business systems modernization remains a high priority for the IRS. A robust, secure and up-to-date infrastructure will improve services—both to taxpayers and to other government agencies—and will strengthen enforcement by giving IRS employees better tools. In FY 2005, the IRS implemented its new Integrated Financial System (IFS), designed to provide the IRS with more accurate and timely financial information and improved compliance with legislative and regulatory requirements. The major components of IFS are accounts payable, accounts receivable, budget formulation, budget execution, general ledger, financial statements and cost accounting. Today there are thousands of procurement commitments, obligations and receipt/acceptance documents being processed through the new IFS system. Another success includes the Customer Account Data Engine (CADE),

[1] Data for the Earned Income Tax Credit measure will not be available until the close of Calendar Year 2005 and two information systems measures were discontinued this year.

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the IRS' modernized database; CADE posted over 1.4 million returns for filing season 2005 and generated over $427 million in refunds.

During FY 2006, the IRS will continue to seek efficiencies in delivering taxpayer service, bolster its enforcement efforts to improve compliance with the tax laws and modernize its infrastructure. The IRS will continue to research and evaluate information regarding taxpayer service needs, priorities, and preferences in order to improve delivery services. In the area of enforcement, the IRS will expand enforcement by targeting its case work and enforcement activities to more effectively deliver results and drive down the tax gap. Finally, the IRS will continue its modernization with the further development of CADE; Modernized e-File (MeF); and the Filing and Payment Compliance system, a system that analyzes tax collection cases to determine uncontested cases that no longer require IRS involvement and can be turned over to private collection agencies.

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.

This mission statement reflects the IRS' priorities of supporting taxpayers in fulfilling their tax obligations, providing high quality services and information and applying and enforcing the tax laws with the highest standards of fairness and integrity.

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

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.

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 centered on unique groups of taxpayers: individual taxpayers, small business owners, 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.

Direct Reports to the Commissioner

A number of business units and functions report directly to the IRS Commissioner. They set policies, provide leadership and direction for the Internal Revenue Service and provide

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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 the Government and the taxpayer. Appeals provides an independent channel for taxpayers who wish to dispute a recommended enforcement action.

- **Taxpayer Advocate Service (TAS)** helps taxpayers resolve 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 has 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** provides correct and impartial interpretation of the Internal Revenue laws and the highest quality legal advice and representation for the Internal Revenue Service. The Chief Counsel's principal customers are the IRS Commissioner, the operating divisions, the functional units and 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, and various research organizations, the Department of the Treasury and the general public by producing studies, program evaluations and statistical analyses of taxpayer trends and data and by providing 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

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 nine campuses perform tax processing services. Twenty five sites provide account management services. Employees at five campuses perform compliance services, which tend to focus on dependent exemptions, credits, filing status and personal deductions. W&I's field operations provide information, support and assistance to taxpayers in fulfilling their tax obligations.

  In FY 2005, the IRS consolidated its Customer Account Services (CAS) units, making better use of resources and streamlining and enhancing communications. Consolidating the top level management structure allowed the IRS to continue the successes of high levels of service, decreased inventory and cycle times and deployment of successful web applications for customers while eliminating redundancies and duplication.

- **Small Business and Self Employed Division (SB/SE)** serves partially or fully self-employed 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 Service, allocating 93% of its resources to compliance activities. SB/SE is aligned along functional lines of Examination, Collection, Specialty Tax Programs, Compliance Services/Campus Operations and Fraud/Bank Secrecy Act to provide a more focused approach to program delivery by making the best use of existing knowledge and experience, ensuring end-to-end accountability and leveraging the specialized expertise of the workforce.

- **Large and Mid-Size Business Division (LMSB)** is the branch of the IRS charged with administering taxes for the largest corporations and partnership entities in the United States – multinational businesses with assets of over $10 million. LMSB serves about 54,600 corporate taxpayers and related entities with a combined annual tax liability approaching $200 billion. Its 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 is able to provide taxpayers with specialized, focused support on specific tax issues. LMSB's six thousand person workforce consists largely of field-based employees, including revenue agents, international examiners, field specialists, technical experts and various support personnel. Collectively, they deal with tax issues ranking among the most complex addressed by any division in the Internal Revenue Service.

- **Tax-Exempt and Government Entities Division (TE/GE)** serves a wide range of customers including small local community organizations, municipalities, major universities, pension funds, state governments, Indian tribal governments and tax exempt bond issuers. TE/GE administers and enforces a variety of complex laws governing tax-exempt organizations and entities. TE/GE employees ensure that these tax-exempt entities properly adhere to applicable statutes.

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- **Criminal Investigation (CI)** enforces the criminal provisions of Internal Revenue Code and related statutes. 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 (non-filers). 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. Criminal Investigation is organized in 31 field offices grouped in five areas. Each field office is headed by a Special Agent in Charge (SAC) who reports to a Director of Field Operations (DFO) responsible to the National Headquarters. 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

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

- **Chief Information Officer (CIO)** leads the Modernization and Information Technology Services (MITS) organization, which delivers information technology solutions that anticipate and meet enterprise-wide needs by empowering employees to deliver customer-centered, systems, products, services and support. The CIO advises the Deputy Commissioner for Operations Support on strategic technology planning, data administration, technology standards and privacy assurance and telecommunications issues.

- **Agency-Wide Shared Services (AWSS)** delivers shared services throughout the IRS, including space acquisition and management, acquisition planning and the Employee Resource Center.

- **Human Capital Officer (HCO)** supports all IRS Divisions and Functions in attracting, motivating and retaining quality employees to meet the needs of America's taxpayers and the tax administration system. HCO also oversees labor relations programs and various human resources functions, including the employee pre-complaint processing and prevention, and alternative dispute resolution services.

- **Chief Financial Officer (CFO)** oversees the IRS' 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.

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- **Mission Assurance (MA)** is responsible for the protection of taxpayer data and information systems and the continuing security of IRS personnel and facilities.

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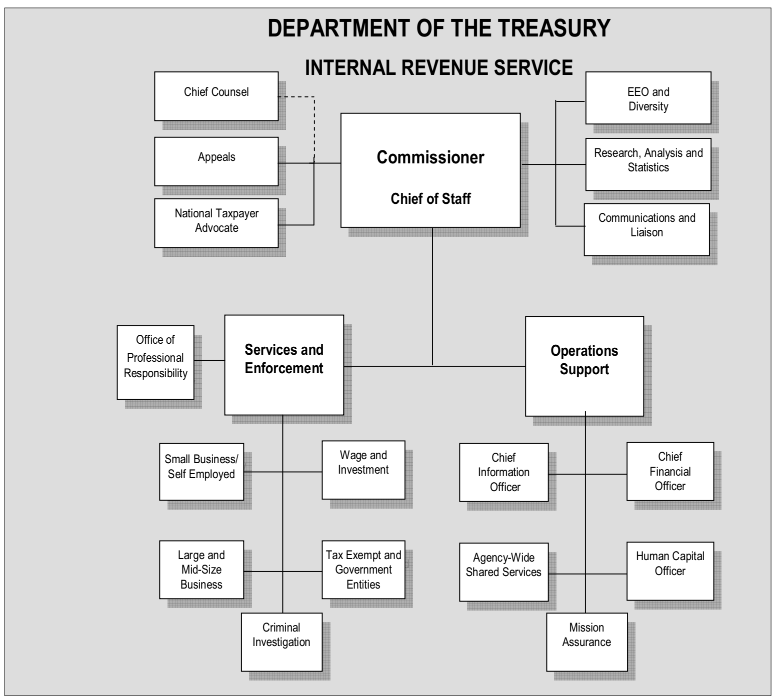
The organizational chart below shows these reporting relationships.



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II. Performance Goals and Results

The IRS uses performance measures to determine its effectiveness in meeting its three strategic goals. The FY 2005 performance information that follows is organized by the IRS' strategic goals, highlighting successes and challenges.

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

Taxpayer Service and Burden Reduction

Assisting the public to understand their tax reporting and payment obligations is the cornerstone of taxpayer compliance. For FY 2005, the IRS met or exceeded performance for all (8 of 8) of its performance targets related to taxpayer service. The following highlights the IRS' performance in FY 2005:

- Processed more than 130 million individual returns and issued more than 99 million refunds totaling over $210 billion during the 2005 filing season (Tax Year 2004).
- Achieved an 82.6% level of service on answering toll-free calls from taxpayers, above the target of 82%.
- Answered 33.4 million assistor telephone calls and completed nearly 25.7 million automated calls.
- Correctly responded to 89% of tax law questions and 91.5% of account questions received via the telephone.

For FY 2005, the IRS set a record for the number of returns filed electronically. For the first time, more than half (68 million) of all individual taxpayers filed electronically, representing an 11% increase over FY 2004. The IRS also received a higher satisfaction rating from e-filers. The 2004 NOP World rating was 52%, an increase from 49% in 2003 and a substantial increase over its lowest point of 32% in 1998. For FY 2005, the IRS exceeded all of its performance targets related to electronic filing including:

- Home computer usage to prepare and e-file tax returns increased 17.3% to more than 17.1 million returns.
- Tax preparation professional use of e-file increased 11%, with 47.6 million filing electronically.
- In its third year, the Free File Alliance, the public private partnership between the IRS and a consortium of tax software companies, saw 5 million taxpayers use the free service, a 43% increase from last year.

The IRS now requires many businesses and tax-exempt organizations to file their returns electronically. The IRS introduced new forms for filing extensions for corporations and information returns for private foundations to the suite of electronic forms offered. The IRS electronically received more than 143,000 business returns from nearly 6,000 participating providers, twice the number participating in FY 2004.

The IRS remains committed to making it easier for all taxpayers to understand their filing requirements. The IRS simplified tax forms and instructions to allow taxpayers to fulfill their reporting obligations more quickly and with less frustration. As an example, Schedule C-EZ was designed to allow taxpayers with a small home business to report business expenses at a higher threshold and in a simplified format. By giving taxpayers an alternative to the more complex Schedule C, more than 500,000 small business owners were able to save time and money in meeting reporting requirements. Similar design and procedural changes were made in partnership returns, unemployment tax deposits and quarterly withholding tax reporting requirements. The simplified forms and procedures also assist taxpayers by decreasing pre-filing preparation errors and reducing the need for post-filing error notices.

Internet access to online forms and publications makes it easier for taxpayers to secure forms and find instructions. More than 4.8 billion "hits" registered in FY 2005 on the award-winning website, IRS.gov, a 20% increase over FY 2004. This increase was largely due to improved website functionality and an expanded selection of electronically-provided services. Internet tools such as the "IRS Withholding Calculator" give the taxpayer self-service access to information previously reported in a lengthy publication. More than 22 million taxpayers used the popular "Where's my Refund?" application to check on the status of their refunds this past filing season, 49% more than last year. A new feature of the refund inquiry application allowed taxpayers to generate replacement checks if the first one was lost or undeliverable due to an out-of-date address. The IRS also expanded electronic tax products for businesses through increased marketing and business e-file programs. In addition, the IRS expanded the suite of products and services geared toward Spanish speaking taxpayers including new marketing flyers, tax forms, and publications; toll free assistance; and accessibility through web links.

The IRS is striving to make the Earned Income Tax Credit (EITC) easier to claim by eligible taxpayers. In FY 2005, the IRS deployed the EITC Assistant on IRS.gov. EITC Assistant is a web-based application to help taxpayers determine eligibility, filing status and estimated EITC amount. The EITC Assistant is available in English and Spanish and reflects the EITC tax law changes, including new income limits for EITC eligibility as well as the option to include nontaxable combat pay in earned income for the earned income credit. The IRS also deployed telephone and web self-service applications on IRS.gov to help taxpayers determine their certification status and explain determinations made during the certification process. IRS enhanced the EITC Online Toolkit for tax professionals and launched EITC messages on Housing and Urban Development (HUD) kiosks in over 100 locations nationwide.

Modernizing the IRS' antiquated business systems and identifying new opportunities to provide taxpayers with e-Government functionality are key components of taxpayer service. A robust and secure infrastructure will improve services – both to taxpayers and other government agencies and will give the IRS the speed, security, and functionality to keep pace with a modern and increasingly electronic economy.

The IRS continues to provide alternative services to assist taxpayers that do not have Internet access or are not in close proximity to established walk-in Taxpayer Assistance Centers. The IRS, through its partners, operates 38 self-help kiosks in 20 states and increases service options during the filing season by offering service in alternate locations such as shopping malls, libraries and other government offices. The Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) partner programs provide Internet access to participants as part of their services. In FY 2005, the VITA/TCE partnerships experienced a 10% (71% to 78%) increase over FY 2004 in e-file usage with almost 86% of VITA returns and nearly 70% of TCE returns filed electronically.

During FY 2006, the IRS will continue to seek alternative, less costly ways to address the challenge of improving taxpayer service. The following discussion addresses two of the most significant challenges for the IRS.

Delivering cost effective and efficient services needed to meet the demands of diverse taxpayer segments remains a challenge for the IRS, particularly in today's constrained budget environment. The IRS will employ highly integrated and targeted service, balancing accessibility and ease of use to reduce taxpayers' burden in complying with the tax laws through continued research and evaluation of taxpayer service needs, priorities, and preferences for obtaining information or services. The IRS will seek opportunities to invest in technology, process improvement and training to achieve consistent quality of service with reduced unit delivery costs.

Achieving the goal of having taxpayers submit 80% of all filings, information, and returns, electronically by FY 2007 remains a significant challenge. While the e-filing rate continues to increase, it is only this past year in FY 2005, that more than half of all individual tax returns were filed electronically. The IRS is considering mandating e-filing for certain groups, by regulation or legislation, to ensure increased e-filing. Also, the Administration's proposal to extend the April filing date for electronically-filed tax returns to April 30, if enacted, may also increase electronic filing. But without a legislative change to mandate electronic filing, the challenge remains one of identifying options to encourage more of the taxpaying public to e-file. For example, many taxpayers use tax preparation software to prepare their returns, but then print out and mail in the return. The IRS must develop additional strategies to induce more of these taxpayers and preparers to take the next step and file electronically.

Hurricane Katrina Support

IRS assisted taxpayers following the wake of Hurricane Katrina by granting tax filing and payment relief to all affected taxpayers. Over 4,100 IRS employees helped FEMA register hurricane victims by opening a dedicated toll-free disaster phone line and providing a special information section on the IRS web site. As of September 30, 2005, IRS employees have answered more than 706,246 registration calls for FEMA, more than 30,000 calls on the special IRS toll-free line and provided over 163,864 disaster relief kits.

Following are key indicators the Service uses to measure success in improving taxpayer service from the IRS Strategic Plan for 2005 through 2009.

Customer Satisfaction Data
The IRS determines its customers' overall level of satisfaction of its programs and services primarily through telephone and mail surveys. Data are also captured for the IRS by the University of Michigan Business School's National Quality Research Center for the American

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Customer Satisfaction Index and by NOP World, formerly Roper Starch Worldwide, a public opinion polling firm.

On the 2004 American Customer Satisfaction Index Survey (ACSI), the IRS received an overall score of 64 out of a possible 100 for All Individual Tax Filers, a 25% increase over the 1999 score of 51. This survey reports satisfaction with IRS variables, such as timeliness, accessibility, courtesy and professionalism. Individual taxpayers are significantly more satisfied with the e-file return process than with paper filing. The 2004 annual rating for IRS in the NOP World favorability survey (the percentage of the public that has a favorable opinion of the IRS as compared with most federal agencies) was 52%, up from 49% in 2003 and a substantial increase over its lowest point of 32% in 1998.

Rate of Accuracy
Customer Accuracy measures how often customers received the correct answer to their inquiry and/or had their case resolved correctly based upon all available information and Internal Revenue Manual (IRM) required actions.

The IRS exceeded its performance targets for both Toll Free Tax Law and Toll Free Account accuracy measures in FY 2005, with Tax Law measuring 89% and Accounts measuring 91.5%. Improvements in the scores are attributed to numerous process changes implemented in FY 2005 such as an improved Probe and Response Guide, the roll-out of Contact Recording (recording of calls for manager/employee feedback) and training assistors on the full scope of accounts-related inquiries.

Level of Service
The IRS measures Level of Service as the relative success rate of taxpayers that call for toll-free services seeking assistance from a Customer Service Representative (CSR). Improved efforts in training and modernizing raised the level of service for those taxpayers who want to speak to an assistor to 82.6%. The IRS will continue to staff toll free call sites to achieve the CSR Level of Service target of 82% based on the number of calls it expects to answer.

Rate of Electronic Interaction
The IRS measures the rate of interaction for both individual and business returns. For the first time, over half of individual returns were filed electronically, an 11% increase from the previous year. FY 2005 performance for business returns achieved a 17.8% participation rate and is expected to grow further as more filing choices are developed for business tax return filers.

Timeliness of Responding to Customer Inquiries
The IRS measures the time taxpayers wait on the telephone when calling the IRS about their accounts, inquiring about tax laws when preparing tax returns, as well as the time from account creation to disposition for taxpayers needing account resolution assistance. Additional measures calculate the response time for those taxpayers who communicate electronically with the IRS.

In FY 2005, the IRS customer assistance call centers received over 59 million calls. Improvement efforts such as replacing paper processes with electronic ones reduced calls and lessened the need for contacting the IRS. This, plus quality control revisions, raised the level of service for the taxpayers who speak to an assistor to an unusually high 87% in FY 2004. For FY 2005, the IRS achieved the target of 82%, a reasonable target that is more in line with

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previous performance while continuing to reflect gradual improvement. Although the average time callers spent waiting for telephone assistance has dropped steadily over the last few years, the IRS experienced an increase in call waiting times based on increased demand and its plan to stabilize resources dedicated to telephone services.

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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 measure is reported as the percentage of taxpayers that are calling IRS toll-free services and speak to an assistor.

CSR Level of Service				
FY 2002 Actual	FY 2003 Actual	FY 2004 Actual	FY 2005	
			Plan	Actual
68.0%	80.0%	87.0%	82.0%	82.6%

FY 2005 Performance: Target Achieved. The IRS met/exceeded the FY 2005 target.

Future Plans: The IRS will continue to properly staff toll free call sites in order to maintain the CSR Level of Service target of 82% based on the number of calls it expects to answer.

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 2002 Actual	FY 2003 Actual	FY 2004 Actual	FY 2005	
			Plan	Actual
--	--	--	7,261	7,585

FY 2005 Performance: Target Achieved. The IRS met/exceeded the FY 2005 target.

Future Plans: The IRS expects performance to continue to increase as more taxpayers choose to use automated and electronic means to contact the IRS instead of traditional, less efficient methods such as paper correspondence and speaking to live assistors.

3. Percent of Eligible Taxpayers Who File for EITC

Description: The number of taxpayers who actually claim 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 2002 Actual	CY 2003 Actual	CY 2004 Actual	CY 2005	
			Plan	Actual
--	--	80.0%*	80.0%	Not Yet Available

*For CY 2004, the IRS participation rate estimate of 80.0% is based on the regression model that is currently being refined.

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FY 2005 Performance: Data to calculate the actual results will be available after the close of Calendar Year (CY) 2005 for TY 2004.

Future Plans: The IRS is refining the methodology for estimating the percent of eligible taxpayers claiming EITC by developing an advanced regression alternative. The IRS is also considering researching an alternative methodology to compare current population survey data and EITC tax data. Once the analysis is complete, the IRS will assess each methodology and make a decision on the best method to use in estimating participation.

4. Customer Accuracy – Toll-Free Tax Law

Description: The percentage of a live assistor giving the correct answer with the correct resolution to taxpayers' tax law inquiries. It measures how often the customer received the correct answer to their tax law inquiry and/or had their case resolved correctly based upon all available information and Internal Revenue Manual (IRM) required actions.

Customer Accuracy – Toll-Free Tax Law				
FY 2002 Actual	FY 2003 Actual	FY 2004 Actual	FY 2005	
			Plan	Actual
--	82.0%	80.0%	82.0%	89.0%

FY 2005 Performance: Target Achieved. The IRS met/exceeded the FY 2005 target.

Future Plans: The type and complexity of tax law questions changes each year as new and often complex tax laws are enacted.

5. Customer Accuracy- Toll-Free Accounts

Description: Percentage of a live assistor giving the correct answer with the correct resolution to the taxpayer. It measures how often the customer received the correct answer to their account inquiry and/or had their case resolved correctly based upon all available information and Internal Revenue Manual (IRM) required actions.

Customer Accuracy – Toll-Free Accounts				
FY 2002 Actual	FY 2003 Actual	FY 2004 Actual	FY 2005	
			Plan	Actual
--	88.0%	89.0%	89.8%	91.5%

FY 2005 Performance: Target Achieved. The IRS met/exceeded the FY 2005 target.

Future Plans: Incremental improvement in performance is expected in FY 2006 and beyond with the implementation of Contact Recording deployment.

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 those 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 19 (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 2005.

Timeliness of Critical Filing Season Tax Products to the Public				
FY 2002 Actual	FY 2003 Actual	FY 2004 Actual	FY 2005	
			Plan	Actual
--	--	76.0%	80.0%	91.4%

FY 2005 Performance: Target Achieved. The IRS met/exceeded the FY 2005 target.

Future Plans: The IRS expects performance to increase slightly for FY 2006 as a result of efficiencies from locating IRS employees on-site at print vendors' facilities to monitor the quality and timeliness of printed tax products and implementing tighter inventory control by holding managers to higher standards for better determining tax products publication status.

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 are business tax products, Tax Exempt and Government Entities and miscellaneous tax products. This measure contains two components: (1) percentage of paper tax products that meet the scheduled start to ship date within five business days of the actual start to ship date and (2) percentage of scheduled electronic tax products that is available on the Internet within five business days of the ok-to-print date. The intent is to have the tax products available to the public 30 days before the form is required to be filed

Timeliness of Critical Other Tax Products to the Public				
FY 2002 Actual	FY 2003 Actual	FY 2004 Actual	FY 2005	
			Plan	Actual
--	--	76.0%	80.0%	80.0%

FY 2005 Performance: Target Achieved. The IRS met/exceeded the FY 2005 target.

Future Plans: The IRS expects performance to increase for FY 2006. Standardized and measurable processes will be used to manage the quality and timeliness of tax product revision resulting from new or late legislation.

8. Percent Individual Returns Processed Electronically

Description: Number of electronically filed individual tax returns divided by the total individual returns filed. Includes all returns where electronic filing is permitted (practitioner e-file, Telefile, VITA [Volunteer Income Tax Assistance], On-Line Filing, Federal/State returns, etc.).

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Percent Individual Returns Processed Electronically				
FY 2002	FY 2003	FY 2004	FY 2005	
Actual	Actual	Actual	Plan	Actual
36.0%	40.0%	47.0%	51.0%	51.1%

FY 2005 Performance: Target Achieved. The IRS met/exceeded the FY 2005 target.

Future Plans: E-file participation rates are expected to increase to over 55% in 2006, based on current experience, historical growth, increased advertising, marketing and expanded e-file programs, including free Internet filing through the Free File Alliance.

9. Percent Business Returns Processed Electronically

Description: The percentage of total number of business returns accepted electronically (posted to Business Master File) divided by the total returns received through all sources at IRS sites.

Percent Business Returns Processed Electronically				
FY 2002	FY 2003	FY 2004	FY 2005	
Actual	Actual	Actual	Plan	Actual
--	--	17.4%	17.0%	17.8%

FY 2005 Performance: Target Achieved. The IRS met/exceeded the FY 2005 target.

Future Plans: The IRS expects the percent of business filers to increase in the future due to increased marketing; expanded business e-file programs, including the acceptance of new forms and schedules attached to employer, estates and trusts, and partnership tax returns; acceptance of amended returns; and acceptance of the new annualized employment tax return.

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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

Tax Revenue Collected

The majority of the revenue the IRS collects is paid voluntarily. In FY 2005, the IRS collected more than two trillion dollars in revenue with a record $47.3 billion collected through enforcement activities, a 9.7% increase from FY 2004. The $47.3 billion in enforcement revenue was collected through concerted efforts by the IRS to detect and deter non-compliance with the tax code.

Reducing the tax gap (the difference between what taxpayers should pay and what they actually pay) is at the heart of the IRS' renewed emphasis on enforcement and serves as a means to reducing our nation's deficit. The tax gap measures the extent to which taxpayers do not pay their correct tax liability on time, either because they do not file a required tax return on time, do not pay on time the amount of tax that they report on their timely return, or most importantly, fail to accurately report their correct tax liability on their timely return.

Underreporting of income taxes, employment taxes and other taxes represents about 80% of the tax gap as noted in the March 2005 release of the IRS' preliminary tax gap estimates for Tax Year 2001. The single largest sub-component of underreporting involves the individual income tax, with individuals understating their incomes, taking improper deductions, overstating business expenses or erroneously claiming credits. The National Research Program (NRP) study further confirmed that the majority of understated income comes from business activities, not wage or investment income. By the end of December 2005, the IRS expects to provide detailed estimates of individual income tax non-compliance based largely on an analysis of the NRP data.

The IRS is primarily focusing its attention on corrosive activities conducted by corporations, high income taxpayers and other major contributors to the tax gap. The IRS will use data collected from the NRP study on individual taxpayers to ensure its audits of individuals are focused on the most noncompliant returns. Targeting high-risk taxpayers should improve IRS efficiency and reduce the burden on compliant taxpayers. It will also increase and focus the IRS' enforcement presence where it is most needed.

Reducing the tax gap is the IRS' most significant challenge. In FY 2006, the IRS will continue to target its case work and enforcement activities to more effectively deliver results and drive down the tax gap. The IRS will focus its analysis of tax information and data from compliance research studies to better define and quantify the tax gap. The IRS will use the results of these efforts to better understand and counter the methods and means of those taxpayers who fail to report or pay what they owe.

Enforcement Activities

The IRS met or achieved 69% (9 of 13) of its enforcement-related performance targets in FY 2005. These results were achieved through streamlining and centralizing work processes, improving workload selection techniques and increasing managerial involvement in casework. The IRS emphasized efficiency and implemented initiatives to reduce cycle time, such as refining case selection criteria. Closely monitoring resources and inventories, a focus on case quality and the use of embedded quality reports and data to drive improvement efforts also contributed to this success. As a result, the IRS completed over 215,000 high-income audits (taxpayers earning $100,000 or more) in FY 2005, 10% more than the previous year and more than twice as many than in FY 2001. Total audits of all taxpayers exceeded 1 million in 2005 for the second consecutive year, a 20% increase from FY 2004.

The IRS audited 81% more small business and 15% more corporations in FY 2005, a significant achievement given the size (more than $10 million) and complexity of these corporate entities. The IRS also expanded examination coverage by increasing its focus on identification of limited non-compliant corporate returns and the development of strategies to address issues at the entity level instead of the return level. A reinforced focus on case quality helped the IRS deliver improved business results for the second consecutive year.

Prominent settlement initiatives (offered to taxpayers before the IRS initiated an audit) generated more than $4.7 billion in additional revenue in FY 2005. One significant tax shelter case worth noting was the *Son of Boss*, in which more than 1,200 qualified taxpayers elected to participate in a settlement offer. The taxes, interest and penalties collected from the *Son of Boss* settlement offer have exceeded $3.7 billion. A second settlement initiative is underway, in cooperation with the Securities and Exchange Commission. This abusive tax transaction involves the transfer of executive stock options or restricted family stock to family-controlled entities for the personal benefit of executives. At least 42 companies and 700 executives participated in this abusive practice, resulting in the collection of $1 billion through September 2005.

The IRS increased audit coverage of those responsible for the promotion and use of abusive tax schemes and avoidance transactions. During the past five years, the IRS identified more than 200,000 questionable returns prepared by practitioners on behalf of their clients. These returns claimed over $700 million in refunds. Since August 2002, the IRS completed more than 98,000 audits and assessed more than $200 million in additional tax as a result of the on-going return preparer investigations.

The IRS Criminal Investigation Division (CID) leveraged its Counterterrorism Program effectively to achieve its core mission, while simultaneously supporting the war on terrorism. The IRS participated in interagency counter-terrorism efforts, providing technical assistance in terrorism-related investigations, examining foreign grants, and matching third party information. The IRS also undertook a study of tax-exempt organizations with foreign grants and operations to determine how well internationally-oriented U.S. charities are protecting their assets from diversion and compliance with tax laws. In FY 2005, CID recommended 86 cases for prosecution, of which 67 resulted in indictments or other forms of action. Approximately 50% of CID's inventory of terrorism related cases has a tax related violation under investigation.

In FY 2005, the IRS also improved its collection performance by improving workload selection techniques, reengineering outdated processes to account for improved case selection tools, deploying centralized processing to reduce overhead in the internal support functions and increased managerial presence in review of case decisions. Improved case selection tools including risk-based modeling are a critical component for ensuring timely processing of appropriate cases of the Collection Program's inventory. For example, employment taxes (also known as trust fund or payroll) are at high risk for non-compliance and one of IRS' collection priorities due to rapid pyramiding of quarterly employment tax liabilities. Risk based modeling reveals the best opportunity for bringing an employer with multiple delinquent quarters (pyramiding) back into full compliance is early intervention. Collection's inventory delivery system factored pyramiding into case assignment rules, ensuring earlier assignment of cases meeting these criteria and to stem growth in the overall collection inventory. The IRS also reduced its inventory growth through timely and appropriate filing of Notices of Federal Tax Lien. Educating taxpayers about lien subordination, discharge, posting bonds or other collateral where appropriate has aided taxpayers in satisfying their outstanding liabilities, increasing compliance. As a result of these efforts, the IRS collected 14% more revenue and closed 12% more cases compared to FY 2004.

Moving forward in FY 2006 and beyond, the IRS will continue to identify effective enforcement strategies necessary to target growing and increasingly complex corrosive tax schemes.

An enforcement priority for the IRS is to deter and prevent abusive tax avoidance transactions or tax motivated transactions that are corrosive to the equity and the fairness of the tax law for all taxpayers. Vigorous enforcement of the criminal provisions of the Internal Revenue Code, coupled with appropriate civil sanctions, materially contributes to maintaining voluntary compliance and public confidence in the fairness of the tax system. Tax shelter promoters continue to modify schemes, making it difficult to detect patterns and identify participants on a timely basis. Because these types of transactions present unacceptable tax avoidance behavior, the IRS needs to continue efforts to identify them timely and to make the public aware of the IRS' concerns.

Recent trends indicate that the tax shelter population will continue to expand to small to mid-size corporations where the issues will be more difficult to identify and examine. Large corporate taxpayers are increasingly engaging in structured transactions designed individually for them, thereby avoiding some of the provisions allowing early identification. These structured transactions involve highly complex fact patterns and large dollar issues. Promoters of tax shelters are migrating from the large accounting firms to firms and businesses that specialize in tax shelters. These promoters are less compliant for registration and less stable in their business operations, making it more difficult to pursue them for information and for penalties.

The number of fraudulent refund claims continues to escalate. For the 2005 processing year, the IRS identified approximately $451 million of fraudulent refund claims for individuals. Return preparer fraud continues to be one of the IRS' key investigative priorities as well. The current inventory of return preparer investigations represents a five-year high. As of August 2005, subject criminal investigation initiations increased approximately 22% over the same time period in 2004. For tax return processing year 2005, IRS fraud detection centers identified more than

33,000 questionable client returns associated with unscrupulous tax return preparers, claiming approximately $103 million in refunds. Key to effective detection and deterrence of these fraudulent claims is the need to invest in new technology.

Following are the key indicators the Service uses to measure success in enhancing enforcement of the tax law from the IRS Strategic Plan for 2005 through 2009.

Percent of Priority Guidance List Items Published
The 2004-2005 Guidance Priority List (GPL) included 283 projects, focusing resources on guidance items most important to taxpayers and tax administration. Sixty-six additional items were added during the course of the plan year (July 1, 2004 – June 30, 2005). The IRS' 2005 goal was to publish 76% of the Guidance Priority List; final performance shows 211 items were published, 75% of the original and 60% of the final GPL.

The IRS did not meet its goal in part due to a shift in priorities necessitated by enactment (October 2004) of the American Jobs Creation Act of 2004 (AJCA) which required immediate implementation. The AJCA made sweeping changes in corporate and international taxation and 97% of the provisions were effective before, on, or within six months of the date of enactment. One hundred seventy eight new provisions required IRS to issue guidance to help taxpayers understand key concepts of the act.

The Office of Chief Counsel will continue to monitor and prepare for legislation resulting from the President's tax reform initiative. Fundamental reform would affect all aspects of the economy and all taxpayers. The IRS and Counsel will support the Treasury Department in its efforts to craft and evaluate different reform options by assessing administrative and technical issues.

Percent of Americans Who Think it is OK to Cheat on Taxes
The IRS Oversight Board conducts an annual NOP World survey to assess the public's perceptions about tax compliance. The survey was initially conducted in 1999 and has been repeated each year since 2001. Results from the 2005 survey are expected in January 2006. In 2004, 86% of taxpayers (up five points from 2003), continued to believe that it is "not at all" acceptable to cheat on income taxes. More taxpayers (73%, up 4 points from 2003 and down 8 points from the 1999 high point) completely agreed that it is everyone's civic duty to pay their fair share of taxes and that everyone who cheats should be held accountable (62%, up 2 points from 2003).

Average Cycle Time
A measure of the length of time from receipt of a case for audit or collection until the audit or collection activity is completed; average cycle time is computed on audits of individuals, small and large business entities and tax-exempt entities.

The IRS' principal strategy is reducing the Months-In-Group cycle time; i.e., the portion of the overall cycle time when the return is actually under examination within a field group. Over the past two years, the IRS has realized an 18% improvement in Industry Months-In-Group cycle time and a 15% improvement in Coordinated Industry Months-In-Group cycle time. Several new initiatives, such as the Appeals/LMSB Joint Cycle Time Measure, increased Fast Track Appeals, more limited scope examinations and electronic filing, are underway or in place to reduce overall cycle time.

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The mix of examination inventory is complex, with growing numbers of tax shelter, partnership and joint committee returns, which have longer cycle times than less risky return categories. The IRS uses several strategies, such as Modernized e-Filing, better return risk assessment and Months-in-Group cycle time to counteract the negative influence of these long cycle time, high-risk return categories on overall cycle times.

The IRS' Field Collection organization has made great strides in reducing cycle time in FY 2005. For non-payment cases, the cycle time was reduced from 42 weeks to 36 weeks, a 16% reduction.

Rate of Reporting Compliance
The Rate of Reporting Compliance or the Voluntary Reporting Rate (VRR) is defined as the amount of individual income tax that is reported on timely-filed returns for a given tax year, expressed as a percentage of the amount of tax liability that should have been reported on those returns. The IRS has made preliminary estimates of the Tax Year 2001 VRR based on the recently completed National Research Program study of individual income tax reporting compliance. Preliminary estimates range from 82% to 85%, roughly consistent with estimates from similar studies for earlier years. Final estimates are due at the end of 2005. Estimates of the amount of Tax Year 2001 individual income tax that was underreported range from $150 billion to $187 billion.

Rate of Filing Compliance
The timely filing rate is the percentage of required returns that are filed timely for a given tax year. This rate for individual taxpayers is computed by dividing the estimated number of required returns filed on time for a given tax year by the estimated number of all individual returns required to be filed for that year. The IRS' latest estimate of the timely filing rate was 88.9% for Tax Year 2001.

Rate of Payment Compliance
The voluntary payment compliance rate is the percentage of the total tax liability reported on timely filed returns that is paid in a timely manner. The voluntary payment compliance rate is 98.9 percent for Tax Year 2003, which is a slight improvement over Tax Year 2002.

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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. Examination Coverage – Individual

Description: The sum of all individual returns closed for Field Examination, Office Examination, Correspondence Examination and Automated Underreporter programs divided by the total individual return filings for the prior calendar year.

Examination Coverage – Individual				
FY 2002 Actual	FY 2003 Actual	FY 2004 Actual	FY 2005	
			Plan	Actual
--	--	--	1.28%	1.42%

FY 2005 Performance: Target Achieved. The IRS met/exceeded the FY 2005 target.

Future Plans: The IRS will use the National Research Program (NRP) results for developing improved analytics and workload identification and selection of the types of cases it selects for review and examination. Additionally, based on the NRP data, the IRS will highlight requisite skill sets and determine if a fundamental change in recruitment and training processes should be explored. Areas of emphasis include Abusive Promotions, High Income Taxpayers, Schedule C filers and Fraud.

2. Examination Quality – Field

Description: The score awarded to a reviewed Field Examination case by a Quality Reviewer using the Examination Quality Measurement System (EQMS) quality standards.

Examination Quality – Field				
FY 2002 Actual	FY 2003 Actual	FY 2004 Actual	FY 2005	
			Plan	Actual
74.0%	75.0%	78.0%	80.0%	84.0%

FY 2005 Performance: Target Achieved. The IRS met/exceeded the FY 2005 target.

Future Plans: The IRS will continue to focus on improving the quality of all facets of the examination process, including timeliness of actions, proper consideration of related and multi-year returns, appropriate use of income probes, fraud indications are properly pursued and developed, and application of report writing procedures to improve future performance. In FY2006, Field Examination is converting to the Embedded Quality (EQ) system of measuring quality. EQ directly links the examiners Critical Job Elements to the quality measurement system, improving the relationship between individual performance and organizational objectives.

3. Examination Quality – Office

Description: The score awarded to a reviewed Office Examination case by a Quality Reviewer using the Examination Quality Measurement System (EQMS) quality standards.

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Examination Quality – Office				
FY 2002	FY 2003	FY 2004	FY 2005	
Actual	Actual	Actual	Plan	Actual
71.0%	76.0%	76.0%	77.0%	81.0%

FY 2005 Performance: Target Achieved. The IRS met/exceeded the FY 2005 target.

Future Plans: The IRS will continue to focus on improving the quality of all facets of the examination process, including timeliness of actions, proper consideration of related and multi-year returns, appropriate use of income probes, appropriate fraud indications are properly pursued and developed. In FY2006, Field Examination is converting to the Embedded Quality (EQ) system of measuring quality. EQ directly links the examiners Critical Job Elements to the quality measurement system, improving the relationship between individual performance and organizational objectives.

4. Examination Coverage – Business

Description: Large and Mid Size Business "customer base" returns (returns filed by large corporations), examined and closed during the current Fiscal Year, divided by filing of the same type returns for the preceding calendar year.

Examination Coverage – Business				
FY 2002	FY 2003	FY 2004	FY 2005	
Actual	Actual	Actual	Plan	Actual
--	--	--	7.0%	7.9%

FY 2005 Performance: Target Achieved. The IRS met/exceeded the FY 2005 target.

Future Plans: The IRS plans to expand examination coverage for corporations through innovative approaches such as pre-filing initiatives (such as the Compliance Assurance Process), Limited Issue Focus Examinations (LIFE) and the Currency Initiative. Through improved modeling and the use of targeted specialized teams, the IRS will focus its resources on the issues that pose the greatest compliance risk and begin to identify enterprises that appear to be non-compliant.

5. Examination Efficiency – Individual

Description: The sum of all individual returns closed (Field Examination, Correspondence Examination and Automated Underreporter) divided by the total FTEs expended in relation to those individual returns.

Examination Efficiency – Individual				
FY 2002	FY 2003	FY 2004	FY 2005	
Actual	Actual	Actual	Plan	Actual
--	--	--	219	222

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FY 2005 Performance: Target Achieved. The IRS met/exceeded the FY 2005 target.

Future Plans: Future strategies to improve performance include improvements to the work stream through better case identification and classification, including leveraging NRP data to improve Exam's ability to select the best workload for examination. Emphasis will continue to be placed on multi-year non-compliance, reduced cycle time, streamlined automation and utilization of risk analysis/assessment in all business processes.

6. Examination Quality – Industry

Description: The average of the percentage of critical elements passed on Industry cases reviewed.

Examination Quality – Industry				
FY 2002 Actual	FY 2003 Actual	FY 2004 Actual	FY 2005	
			Plan	Actual
69.0%	74.0%	74.0%	78.0%	77.0%

FY 2005 Performance: Target Not Achieved. The IRS did not meet its FY 2005 target due to several factors related to the examination planning process, specifically identification of material issues. Contributors to the lower rate include lack of documentation of the initial risk analysis in which material issues are considered and documentation of mandatory referrals to specialists. While improved from last year, the preparation and proper use of the Administrative Procedures Document (documentation regarding exam techniques such as interviews; reconciliation of books to tax returns; inspection of prior, subsequent and related tax returns; and tour of taxpayers' business) continues to be a concern. Revenue Agents and managers are not including the document in the case file or properly sign it as required. Preparation and inclusion of the No-Change report in the file when a case is closed without adjustment is an area that continues to affect quality scores.

Future Plans: To facilitate immediate corrective action and eliminate recurring errors, LQMS reviewers will provide written feedback on all reviewed cases to the case manager and agent who worked the examination. The written feedback provided will provide a detailed explanation of the results for each quality element and will stress areas that warrant improvement so field teams will correct identified process deficiencies in future examinations. Specific tools have been developed to address quality improvement, such as media devices (training materials on compact disc) that highlight the necessary actions needed to improve quality and identify partnering opportunities with industry contacts, the training office and the Case Quality Improvement Council.

7. Examination Quality – Coordinated Industry

Description: The average of the percentage of critical elements passed on Coordinated Industry cases reviewed.

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Examination Quality – Coordinated Industry				
FY 2002 Actual	FY 2003 Actual	FY 2004 Actual	FY 2005	
			Plan	Actual
78.0%	89.0%	87.0%	90.0%	89.0%

FY 2005 Performance**:** Target Not Achieved. The IRS did not meet its 2005 target despite renewed focus on identification of material issues during the planning process and documentation of them during the initial risk analysis. Root cause analysis revealed filing and compliance requirements for corporate directors and officers are not being verified and documented. In addition, procedures used during the examination are not being identified and documented during the planning process, a critical element of case quality. While improved from last year, adherence to the requirements outlined in the Administrative Procedures Document, continues to be a concern. Revenue Agents and managers are still failing to complete the document or provide a copy of the document to the reviewer during the opening review conference. Also, Examination teams need to ensure the taxpayer's and the IRS' position is fully documented in the case file.

Future Plans: To facilitate immediate corrective action and eliminate recurring errors, LQMS reviewers will provide written feedback on all reviewed cases to the case manager and agent who worked the examination. The feedback will detail the results for each quality element and will stress areas that warrant improvement so field teams will correct identified process deficiencies in future examinations. Specific tools have been developed to address quality improvement, such as media devices (training materials on compact disc) that highlight the necessary actions needed to improve quality and partnering opportunities with industry contacts, the training office and the Case Quality Improvement Council.

8. Collection Coverage - Units

Description: The volume of collection work disposed (closed) compared to the volume of collection work available.

Collection Coverage - Units				
FY 2002 Actual	FY 2003 Actual	FY 2004 Actual	FY 2005	
			Plan	Actual
--	--	--	32.0%	39.0%

FY 2005 Performance: Target Achieved. The IRS met/exceeded the FY 2005 target.

Future Plans: Building on more effective case selection and refinement of Business Master File (BMF) case selection criteria is expected to result in improvements in case cycle time, freeing up resources that will be devoted to casework. In addition, a newly established Corporate Collection Governance Board of senior leaders from collection operating units in the IRS will guide development of new strategies and approaches to collection techniques including sponsoring a study on the effects of the collection notice stream.

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9. Collection Efficiency - Units

Description: Total work (delinquent accounts, investigations, offer-in-compromise, automated substitution for return) disposed (closed) over the total FTE (full-time equivalent) realized in field collection and in campus collection.

Collection Efficiency - Units				
FY 2002 Actual	FY 2003 Actual	FY 2004 Actual	FY 2005	
			Plan	Actual
--	--	--	497	510

FY 2005 Performance: Target Achieved. The IRS met/exceeded the FY 2005 target.

Future Plans: To further reduce case cycle time, the IRS will focus on two key quality timeliness attributes: (1) reducing activity lapses and taking timely follow-up actions and (2) reengineering efforts being piloted such as a pre-populated financial statement and automated adjustments. In addition, a newly established Corporate Collection Governance Board of senior leaders from the collection operating units in the IRS will develop strategies and approaches to the collection activities including sponsoring a study on the effects of the collection notice stream.

10. Field Collection Quality of Cases Handled in Person

Description: The score awarded to a reviewed Collection case by a third-party reviewer who uses the Collection Quality Measurement System (CQMS) quality standards. CQMS composite score is computed based on 19 quality standards taken from the CQMS check sheet. Each standard has a value of four points. However, four of these standards have been designated as critical and are weighted more heavily. Failure to meet any one of the critical standard results in the deduction of 24 points from the overall composite score.

Field Collection Quality of Cases Handled in Person				
FY 2002 Actual	FY 2003 Actual	FY 2004 Actual	FY 2005	
			Plan	Actual
84.0%	84.0%	82.0%	84.0%	81.0%

FY 2005 Performance: Target Not Achieved. The IRS did not meet its FY 2005 target. Although performance improved in standards such as Publication One, Rights Notification and Case File Documentation, declines in other standards overshadowed gains. Also impacting the overall score was the IRS' emphasis on getting the inventory current by focusing on aged case inventories. Because older cases have increased chance for errors due to increased handling time, the need for repetitive actions such as re-issue of notices, and potential for more activity lapses, older cases adversely impact quality scores.

Future Plans: The IRS is currently piloting the Embedded Quality (EQ) System to replace CQMS beginning in FY 2006. EQ creates a way of doing business that builds commitment and capability among all individuals to continually improve customer service, employee satisfaction and business results by aligning quality measures and individual performance. EQ standards are linked directly to employee Critical Job Elements (CJEs) enabling employees to see how individual performance impacts objectives. EQ results will be baselined during FY 2006.

The IRS will place specific attention on quality attributes of setting clear action dates, setting clear expectations for taxpayers, timely follow-up actions and reducing activity lapses to improve quality and increase efficiency.

11. Automated Collection System (ACS) Accuracy

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

ACS Accuracy				
FY 2002 Actual	FY 2003 Actual	FY 2004 Actual	FY 2005	
			Plan	Actual
--	--	89.0%	88.0%	88.5%

FY 2005 Performance: Target Achieved. The IRS met/exceeded the FY 2005 target.

Future Plans: The IRS' focus on process and performance reviews coupled with the feedback loop and identification of training needs will continue to drive accuracy scores up and help improve the taxpayer's experience.

12. Criminal Investigations Completed

Description: Cumulative count of the number of all Subject Criminal Investigations (SCI) completed during the fiscal year by IRS Criminal Investigation Division. It includes investigations that resulted in a criminal prosecution recommendation to the Department of Justice as well as investigations that were discontinued due to a lack of evidence or to a finding that the original allegation was false.

Criminal Investigations Completed				
FY 2002 Actual	FY 2003 Actual	FY 2004 Actual	FY 2005	
			Plan	Actual
3,201	3,766	4,387	3,895	4,104

FY 2005 Performance: Target Achieved. The IRS met/exceeded the FY 2005 target.

Future Plans: Criminal Investigation will continue to aggressively enforce the criminal statutes of the Internal Revenue Code (IRC), the Bank Secrecy Act and the anti-money laundering statutes by devoting resources and special emphasis on investigations that have a strong tax administration nexus. Criminal Investigation will maintain relationships with key shareholders to continue to improve the fraud referral program and to facilitate the identification of areas of non-compliance adversely impacting tax administration. Specific priorities encompass such serious or chronic compliance challenges as abusive tax schemes and shelters, high income non-filers, employment tax fraud and refund crimes. Furthermore, the critical national law enforcement priorities of Corporate Fraud and Terrorism continue to be important areas of emphasis.

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Through its Refund Crimes Program, CI will continue to identify and pursue fraudulent return preparer and questionable refund schemes involving individual as well as business returns. CI will also increase its efficiency in verifying wages and identifying questionable claims by fully utilizing the National New Hire Database (maintained by the Department of Health and Human Services).

13. TE/GE Determination Case Closures

Description: Cases established and closed on the Tax Exempt and Government Entities Determination System (EDS) regardless of type of case or type of closing (e.g. employee plan, exempt organization or government entity)

TE/GE Determination Case Closures				
FY 2002 Actual	FY 2003 Actual	FY 2004 Actual	FY 2005	
			Plan	Actual
129,680	171,812	143,877	131,700	126,481

FY 2005 Performance: Target Not Achieved. The IRS fell short of its FY 2005 target due to increased responsibility for certain correspondence previously worked out of the call site and a substantial investment in training this year. To mitigate these impacts, the Exempt Organization office has taken steps to maximize the number of cases that can be closed on merit with minimal additional information requests.

Future Plans: The IRS targeted additional resources late in FY 2005 to hire 26 new revenue agents for determination work. These new resources are expected to help offset the increased workload in FY 2006.

The IRS is restructuring the Employee Plan determination letter process to stabilize the receipt flow. Although the mix of receipts will change annually, the new approach will dramatically reduce the workload swings previously experienced in this program, improving program management and eliminating the need to pull resources from enforcement activities to support determination work during peak periods. The IRS is also developing a new interactive application for determination requests that will improve the quality of determination requests and enable the electronic filing of these applications.

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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

Ensuring Organizational Effectiveness

The IRS faces high expectations for the level of service and enforcement required for the fair and uniform application of tax laws. Each year, IRS employees contact millions of taxpayers. In each of these contacts, the IRS strives to maintain a level of professionalism and integrity that will assure taxpayers of competent, efficient and respectful treatment. The IRS is improving accuracy of responses to taxpayer inquiries, increasing the clarity of communications and providing taxpayers and their paid preparers with requested resources on a timely basis.

Workforce planning is a significant challenge. With a diverse population of more than 100,000 employees and more than 700 duty stations across the country, the IRS works continuously to ensure that its employees are in the right place at the right time and have the skills and competencies needed to accomplish the IRS mission. The expansion of pay-for-performance provides a higher degree of accountability in the workforce and numerous training and leadership programs improve the overall level of professionalism. The IRS established a trained core recruitment group that is responsible for attracting excellence in potential employees. This cadre works to maintain partnerships with many colleges and universities and attends campus and commercial events around the country to promote the benefits of becoming an IRS employee.

The IRS continued its workforce restructuring to achieve both the optimum mix of skills within the IRS and the optimum number of employees that directly support tax processing, administration and compliance functions. The IRS continues to ensure an adequate talent pool to administer the tax law as a primary component in maintaining the integrity and excellence of the workforce. In FY 2005, the IRS achieved efficiencies in filing technology and in overhead functions. More importantly, the percentage of the IRS workforce engaged in compliance-related work increased from 48% to 50% of the workforce in FY 2005. This shift was possible because of cost reductions provided by increased electronic filing and through the restructuring of administrative areas. While the number of IRS employees has decreased overall, the IRS has been able to maintain or increase employment in the key compliance occupations of revenue agents, revenue officers, and special agents.

The IRS recognizes that its workforce is maturing and that significant numbers of employees will soon be eligible to retire. Analysis of workforce data shows that the most problematic area is the projected attrition of senior leadership. To ensure continuity of leadership, the IRS launched a comprehensive leadership succession planning initiative. The first phase of the initiative

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included an assessment of 103 executives to measure and benchmark competency strengths and weaknesses. Additional efforts to address the aging workforce challenge include hiring initiatives to ensure that the IRS maintains the appropriate level of employees in mission-critical occupations necessary to achieve its mission.

Modernization

The IRS successfully deployed the new Integrated Financial System (IFS) at the start of FY 2005. The IFS serves as the "core" administrative financial management system. The major components of IFS are accounts payable, accounts receivable, budget formulation, budget execution, general ledger, financial statements and cost accounting. The IFS is a fully integrated, customized commercial off-the-shelf (COTS) software package designed to provide IRS with more accurate and timely financial and cost information and improved compliance with legislative and regulatory requirements. Today there are thousands of procurement commitments, obligations and receipt/acceptance documents being processed through the new IFS system. The IRS successfully maintained its record of submitting the monthly SF-224 and the monthly Treasury Information Executive Repository (TIER) files to Treasury on time since going live.

The IRS Business Systems Modernization (BSM) program improved its success in delivering projects, attaining cost and schedule targets, realizing benefits to taxpayers and improving BSM program management capabilities. After re-baselining in late 2004, the BSM program delivered most projects and releases in FY 2005 on time, on budget and met or exceeded the scope of expectations.

In FY 2005, the IRS modernization efforts focused on three key tax administration systems that provided additional benefits to taxpayers and IRS employees, specifically: the Customer Account Data Engine (CADE) project; Modernized e-File; and Filing and Payment Compliance (F&PC).

CADE replaces the IRS' antiquated system called the Master File, which is the repository of taxpayer information. CADE allows faster refunds (CADE processes refunds on a daily basis), improved taxpayer service, faster issue detection, more timely account settlement, and a robust foundation for integrated and flexible modernized systems. More than 1.4 million returns were posted with more than $427 million in refunds generated. Next year, CADE should be able to process over twice as many returns. It will be the single authoritative repository for account and return data.

Modernized e-File (MeF) deployed Form 7004 (filing extension for corporations) as well as Form 990PF (information return for private foundations). This allowed the IRS to establish regulations requiring large corporations and tax-exempt organizations to electronically file their income tax or annual information returns. Through September 2005, MeF is processing 1120 and 990 returns at higher-than-expected volumes while still achieving performance goals – a significant reduction in burden and time for corporate and tax-exempt taxpayers.

The IRS completed architecture engineering analysis and development of a limited functionality release for Filing & Payment Compliance (F&PC) Release 1.1 designed to separate complex cases requiring direct IRS involvement from those that can be handled by private collection agencies (PCAs). This release will provide initial capabilities for competitive outsourcing of collection activities in FY 2006.

In 2004, Congress passed the American Jobs Creation Act, a provision of which allows the IRS to use Private Collection Agencies (PCAs). The current volume of delinquent taxpayers exceeds the IRS' capacity and results in a serious backlog of collection cases that cannot be adequately addressed with current resources. This backlog represents lost revenue opportunities and undermines the fairness of the tax system. The legislation authorized the IRS to augment its collection efforts by using PCAs to pursue undisputed, uncollectible tax liabilities. PCAs will not have enforcement authority and will only contact delinquent taxpayers to arrange voluntary, full-payment installment agreements.

In FY 2005, the IRS implemented new network management software, an off-the-shelf product called "CiscoWorks." Results of the new network management tools include:

- Improved service and network performance to all customers through reduced configuration errors, enhanced security and network management capabilities;
- Streamlined access to troubleshooting reports that a year ago would usually have required multiple logons and hours of time;
- Reduced cost of audits;
- Increased efficiency through improved configuration controls; and
- Assurance of stable and predictable network performance for all business units.

To address its modernization challenges, the IRS updated a strategic vision for the BSM's future beyond 2007 and setting goals for the year 2010 that align with and support the IRS Strategic Plan. The FY 2006 BSM portfolio will focus on delivery of three major tax administration projects (highlighted below), along with infrastructure initiatives and continued improvement to program management operations. Each Tax Administration project will address a core IRS strategic priority. Program operations will continue to focus on improving program performance; improving and streamlining management process disciplines; and ensuring delivery of projects on time, on budget, and on scope by taking a greater ownership and leadership role in managing the BSM program.

- The IRS will expand CADE to increase the number of tax returns processed and taxpayers served, targeting 33 million returns to be processed during 2007.

- Modernized e-File (MeF) continues engineering development to prepare for the expanding taxpayer base served through combined Federal and State processing of tax returns. BSM also continues working on access capabilities for disabled taxpayers through e-Services upgrade of the PeopleSoft Commercial Off-the-Shelf application.

- The IRS will develop the first release of the Filing and Payment Compliance system to analyze tax collection cases to determine uncontested cases that no longer require direct IRS involvement and can be turned over to private collection agencies.

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Following are the key indicators the Service uses to measure success in modernizing the IRS through its people, processes and technology from the IRS Strategic Plan for 2005 through 2009.

Level of Employee Engagement
The Level of Employee Engagement measures the number of IRS employees who feel they are in the right job, are managed well and are productive. Data used to determine this result is taken from the IRS' annual employee satisfaction survey.

In 2005, more than 57,000 employees participated in the annual Employee Engagement Survey. The scores improved on all questions. The IRS uses the response to the following question, "Considering everything, how satisfied are you with your job?" as a broad indicator of employee satisfaction. In 2005, over 64% of employees were very satisfied or extremely satisfied with their job compared to 60% in 2004.

The IRS continued its strong improvement on survey items especially the categories of receiving recognition and feedback on progress. The IRS will provide results of "SURVEY2005" to employees for discussions in workgroups, with subsequent action plans developed to ensure continued improved working conditions. Responses to questions about training and development also continued to improve.

For the second year in a row, over 65% of employees who took the survey reported that they participated in team feedback and action planning sessions. Team feedback and action planning sessions are a crucial part of the employee satisfaction process. Employees who participated in these meetings also reported much higher levels of satisfaction than employees who did not. Each IRS business unit is encouraged to identify one or two specific areas of the survey that will be the focus of concentrated improvement actions. In prior years, this approach proved to be very beneficial for a number of business units.

The addition to the employee scholarship program targeted at key staffing needs reinforces the IRS' commitment to employee development. The Human Resources Investment Fund (HRIF), established in response to earlier employee feedback about training needs, also continues as a complement to the scholarship program.

Index of Employee Perceptions of Performance Management System
This is an index based on how employees responded to specific questions on the Federal Human Capital Survey (FHCS) conducted annually by the Office of Personnel Management. The questions relate to employee perceptions regarding how well the organization rewards good performance and addresses poor performance. The IRS has developed target levels for this index and a 2005 goal from which to assess its current performance. The IRS has not received the results of the latest survey as of the date of this report.

Ratio of Mission-Critical Occupations (MCO) Employees to Non-MCO Employees
This is the proportion of staff employed in mission critical areas, those that support tax processing, administration and compliance, compared to non-mission critical areas. This indicator will help the IRS determine if its staffing and employee development initiatives result in the appropriate level of talent assigned to MCOs in support of the IRS' mission and goals. The IRS has developed target levels for this indicator which it uses to assess its actual performance.

The target MCO/non-MCO ratio for FY 2005 is 64%. The ratio reported at the end of FY 2005 was 62.9%.

Benchmark IT Services and Development to Private Industry Standards for Cost, Scheduling, and Functionality

MITS has developed performance measures that will be monitored from the CIO level down to the operational levels. These measures will provide comprehensive management information to executives to monitor success at meeting performance targets keyed to industry best practices. This measures development effort has been far more comprehensive than any ever conducted in MITS and includes over 250 measures and metrics at various organizational levels. In addition, MITS established a comprehensive time reporting system/work planning and control system and has undertaken the development of a comprehensive cost accounting system. Presently, the IRS is halfway through the decomposition phase on this effort and will ultimately quantify the relationship between all MITS products and services and their related costs.

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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. Contracted Program Cost and Schedule Variance

Description: Contracted Program Cost and Schedule Variance measures the improvement in the program's ability to accurately estimate cost and period of performance. The measure is derived from the program's two efficiency measures: Fiscal Year Estimated Contract Cost Variance and Fiscal Year Contract Period of Performance Variance. By calculating the efficiency rating (percentage) for the current fiscal year and comparing it to the efficiency rating of the previous fiscal year, the measure compares the two performance ratings for cost and period of performance estimation, individually, to determine the degree of improvement. The measure is reported as the lower of the two ratings. As long as the reported rating is at or above the target, the program is improving satisfactorily.

Contracted Program Cost and Schedule Variance				
FY 2002	FY 2003	FY 2004	FY 2005	
Actual	Actual	Actual	Plan	Actual
--	--	--	15.0%	Discontinued

FY 2005 Performance: Discontinued The IRS has discontinued this measure and will no longer report on it either internally or externally.

Future Plans: In FY 2006, this performance measure will be split into two measures: Contracted Program Costs Variance and Contracted Program Schedule Variance.

2. Contracted Requirements Stability and Contracted Requirements Delivered

Description: Contracted Requirements Stability and Contracted Requirements Delivered measures the improvements in the program's ability, first, to stabilize the growth of requirements during the life of a project/release and, second, to deliver those requirements for which it has contracted. The measure is derived from the program's two outcome measures: Contract Business Requirements Stability and Contract Business Requirements Delivered.

Contracted Requirements Stability and Contracted Requirements Delivered				
FY 2002	FY 2003	FY 2004	FY 2005	
Actual	Actual	Actual	Plan	Actual
--	--	--	10.0%	Discontinued

FY 2005 Performance: Discontinued. The IRS has discontinued this measure and will no longer report on it either internally or externally.

Future Plans: Business Systems Modernization is committed to managing the cost and schedule of its projects, although the methodology for their respective calculations is under revision.

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New Measures
The following measures are reported for the first time in the FY 2005 MD&A:

Timeliness of Critical Other Tax Products to the Public
Percent Business Returns Processed Electronically
Examination Coverage – Individual
Examination Coverage – Business
Examination Efficiency – Individual
Collection Coverage – Units
Collection Efficiency – Units
Field Collection Quality of Cases Handled in Person

Discontinued Measures
In the first quarter of FY 2005, the Department of the Treasury launched a process to streamline its current set of performance measures. Its purpose was to increase the value of the information provided to stakeholders, respond to congressional requests, focus priorities and reduce administrative burden. Results of the process indicated a 60-70% reduction in the number of performance measures overall at the Treasury level. At the bureau level, measures that are no longer included in the budget submission are classified as "discontinued," and are indicated as such. These measures are only discontinued for external reporting purposes; the IRS will continue to internally collect and monitor these measures.

Customer Accuracy – Customer Accounts Resolved (Adjustments)
Percent Tickets Resolved on Time
Field Assistance Accuracy of Tax Law Contacts
Percent Resolution at First Contact
Toll Free Customer Satisfaction
Field Assistance Customer Satisfaction
Field TDA Closures
Field TDI Closures
Field Collection Customer Satisfaction
Compliance Services Collection Operation Accuracy
ACS (TDA and TDI Closures)
ACS Customer Satisfaction
Automated Underreporter Case Accuracy
Automated Underreporter – Cases Closed
Correspondence Examination non EITC Returns Examined
Correspondence Exam – Customer Satisfaction
Correspondence Exam Accuracy
Business Returns Examined
Individual Returns Examined (> $100,000 and < $100,000)
Examination Customer Satisfaction (SBSE)
Examination Customer Satisfaction (LMSB)
EP/EO Examination Case Quality
EP/EO Customer Satisfaction
Number of TEGE Compliance Contacts
Appeals Closure to Receipt Ratio
Taxpayer Advocate Closure to Receipt Ratio
Contracted Program Cost & Schedule Variance (* not reported internally or externally)
Contracted Requirements Stability & Contracted Requirements Delivered (*)

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III. System Controls and Legal Compliance

Federal Managers' Financial Integrity Act (FMFIA)

During FY 2005, the Internal Revenue Service (IRS) complied with the control requirements of the Federal Managers' Financial Integrity Act (FMFIA) and the Reports Consolidation Act of 2000. The IRS also complied with the review requirements of the Federal Financial Management Improvement Act (FFMIA). The systems of management controls 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

The number of open material weaknesses for IRS is five. Because the IRS has remaining material weaknesses and the IRS' 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 2005. This assurance is provided relative to Sections 2 and 4 of FMFIA.

The material weaknesses are:

- Collection of Unpaid Taxes
- 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, 2005, the Service's 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. In FY 2005, the IRS implemented the Integrated Financial System which corrected many administrative accounting deficiencies. The IRS developed a plan to improve custodial accounting through the Custodial Detail Data Base project.

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Laws and Regulations

As of September 30, 2005, the IRS did not always comply with section 6325 of the Internal Revenue Code regarding the release of federal tax liens. An action plan to address the non compliance issue is being monitored by the Financial and Management Controls Executive Steering Committee.

Reports Consolidation Act of 2000

In accordance with the Reports Consolidation Act of 2000, the IRS provides assurance that the critical performance measures are reliable. Internal Revenue Manual 1.5, "Managing Statistics in a Balanced Measurement System Handbook," provides a detailed measures 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

During FY 2005, the IRS took action to enhance the compliance of IRS computer systems with the Federal Information Security Management Act (FISMA). The IRS established FISMA project offices in each business unit and focused attention on resolution of the computer security material weakness and other system security weaknesses. Substantial progress was made in this area, as over 90 percent of IRS general support systems completed full certification and accreditation by September 1, 2005. In addition, the IRS initiated a major effort to update the security documentation and complete rigorous security testing on all Service systems. This effort will continue through FY 2006.

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 the Office of Management and Budget, 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.

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IV. Future Challenges

As the IRS begins FY 2006, it is faced with challenges, both from within and outside of its organization. The following discussion identifies some of the most significant challenges.

Abusive Tax Shelters
Abusive Tax Avoidance Transactions (ATAT) remain a challenge and a high enforcement priority for the IRS. These tax motivated transactions are corrosive to the equity and the fairness of the tax law for all taxpayers. Specifically, the prevalence and proliferation of ATAT impacts the achievement of the IRS' mission, goals, objectives, and the success of its major strategies by impeding the IRS' ability to make gains in compliance and interfering with allocation of workforce resources. Vigorous enforcement of the criminal provisions of the Internal Revenue Code, coupled with appropriate civil sanctions, materially contributes to maintaining voluntary compliance and public confidence in the fairness of the tax system.

Tax shelter promoters continue to modify schemes, making it difficult to detect patterns and identify participants on a timely basis. Because these types of transactions present unacceptable tax avoidance behavior, the IRS needs to continue efforts to identify them timely and to make the public aware of the IRS' concerns.

Recent trends indicate that the tax shelter population will continue to expand to small to mid-size corporations where the issues will be more difficult to identify and examine. Large corporate taxpayers are increasingly engaging in structured transactions designed for them individually thereby avoiding some of the provisions allowing early identification. These structured transactions involve highly complex fact patterns and large dollar issues. Promoters of tax shelters are migrating from the large accounting firms to firms and businesses that specialize in tax shelters. These promoters (boutique promoters) are less compliant for registration and less stable in their business operations, making it more difficult to pursue them for information and for penalties.

Taxpayer Service Challenges
Delivering cost effectively and efficiently valued and effective information and services to taxpayers while meeting demands to reduce the complexity of tax law, be responsive to large and diverse taxpayer segments, and provide preferred means of delivery within budget limitations remains a challenge for the IRS. A successful approach will employ highly integrated and targeted service avenues, balancing accessibility, ease of use, content complexity, and delivery cost. The IRS will continue to research and evaluate information regarding taxpayer service needs, priorities, and preferences in order to improve delivery services that support taxpayer preferable approaches for obtaining information or services. The IRS will seek opportunities to invest in technology, process improvement, and training to achieve consistent repeatable quality service with reduced unit delivery costs. The IRS' long-term service measures will include the impact on taxpayer qualitative experience and behavior.

Technology Modernization Projects
From FY 2002 to FY 2005, the IRS has taken steps to balance the scope and pace of its technology modernization program with the management capacity of the IRS and the modernization contractor consortium. Since then, the IRS improved both its cost and scheduling performance including those projects that were not re-baselined. While these improvements do not completely eliminate all risk, they mitigate a major risk and demonstrate

that the steps the IRS took in 2004 to improve program performance are having a positive impact. As a result, FY 2004 and FY 2005 marked a reverse in trend of cost overruns that plagued the IRS in previous years.

In FY 2005, Business Systems Modernization (BSM) continues to build and improve upon its 2004 success by delivering projects, attaining cost and schedule targets, realizing benefits to taxpayers, and improving BSM program management capabilities. With the exception of the Integrated Financial System, BSM delivered the majority of projects and releases planned on time, within budget, and met or exceeded scope expectations.

Customer Account Data Engine continues to develop the expansion of the number of tax returns processed and taxpayers served, targeting 33 million returns to be processed during 2007. Modernized e-File (MeF) continues engineering development in preparation for expansion of the taxpayer base served through combined Federal and State processing of tax returns. BSM also continues working on access capabilities for disabled taxpayers through e-Services upgrade of the PeopleSoft Commercial Off-the-Shelf application from Version 8.1 to 8.8. BSM will develop the first release of the Filing and Payment Compliance system to analyze tax collection cases to determine uncontested cases that no longer require direct IRS involvement and can be turned over to private collection agencies.

The FY 2006 BSM portfolio will focus on delivery of three major tax administration projects (CADE, MeF and F&PC), along with infrastructure initiatives and continued improvement to program management operations. Each Tax Administration project will address a core IRS strategic priority. Program operations will continue to focus on improving program performance, improving and streamlining management process disciplines, and ensuring delivery of projects on time, on budget, and on scope by taking a greater ownership and leadership role in managing the BSM program.

In addition, the IRS is developing a vision for BSM's future beyond 2007 and setting goals for the year 2010 that align with and support the IRS Strategic Plan. The IRS established a team of IT and business specialists to develop an IT modernization roadmap showing how the IRS can effectively meet IT modernization goals in an incremental approach that provides near-term value.

Achieving 80 Percent e-Filing

Achieving the goal of having taxpayers submit 80% of all filings, information, and returns, electronically by FY 2007 continues to be a significant challenge. While the e-filing rate continues to increase, it is only this past year in FY 2005, that more than half of all individual tax returns were filed electronically. The IRS is considering mandating e-filing for certain groups, by regulation or legislation, to ensure increased e-filing. Also, the Administration's proposal to extend the April filing date for electronically-filed tax returns to April 30, if enacted, may also increase electronic filing. But without a legislative change to mandate electronic filing, the challenge remains one of identifying options to encourage more of the taxpaying public to e-file. For example, many taxpayers use tax preparation software to prepare their returns, but then print out and mail in the return. The IRS needs to induce more of these taxpayers and preparers to take the next step and file electronically.

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The Tax Gap
Reducing the tax gap is at the heart of the IRS' renewed emphasis on enforcement. The IRS will continue to expand enforcement by targeting its case work and enforcement activities to more effectively deliver results and drive down the tax gap. The IRS will continue to analyze tax information and data from compliance research studies to better define and quantify the tax gap. The IRS will use the results of these efforts to better understand and counter the methods and means of those taxpayers who fail to report or pay what they owe. The IRS is focusing on discouraging and deterring non-compliance with the emphasis on corrosive activity by corporations, high-income individual taxpayers, and other contributors to the tax gap.

The Complexity of the Tax Code
The December 2004 Report to Congress required by the Internal Revenue Service Restructuring and Reform Act of 1998 identifies the complexity of the Internal Revenue Code as the most serious problem facing taxpayers and the IRS alike. The Code contains well over a million words, bedeviling individual taxpayers with provisions such as the alternative minimum tax and the earned income tax credit. Business taxpayers must grapple with a patchwork of rules that cover the depreciation of equipment; numerous and overlapping filing requirements for employment taxes; and vague factors that govern the classification of workers as either employees or independent contractors. The IRS must explain the Code in a way that taxpayers can understand.

Tax Reform
In January 2005, President Bush established an Advisory Panel on Federal Tax Reform to devise options to reform the tax code and make it simpler, fairer, and more pro-growth to benefit all Americans. The Advisory Panel will submit to the Secretary of the Treasury a report containing revenue neutral policy options for reforming the Federal Internal Revenue Code. These options will:

- Simplify the tax laws to reduce the costs of compliance and to make it easier for taxpayers to plan for the future and manage their affairs;
- Share the burdens and benefits of the tax system in an appropriately fair and progressive manner while recognizing the importance of homeownership and charity in American society; and
- Promote long-run economic growth, higher wages and job creation by encouraging work effort and increased saving and investment to strengthen the competitiveness of the United States in the global marketplace.

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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 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
IRS Business Systems Modernization				X							X			X	X		X
Tax Compliance Initiatives						X			X		X	X	X	X	X		X
Strengthen Information Security; Security of the IRS										X	X						
Establish Measures Comparable Over Time and Collect Sufficient Performance Data; Integrating Performance and Financial Management	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 Customer Service Operations	X	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									
Enforcement of Tax Laws		X	X		X	X			X			X		X	X		X
Bring Treasury's Financial Management Systems into compliance with Federal Financial Management Improvement Act (FFMIA) of 1996				X													

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The following pages summarize each Management Challenge and High-Risk issue, FY 2005 accomplishments, and actions identified for completion in FY 2006 and beyond

IRS Business Systems Modernization

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

- Customer Account Data Engine (CADE) (implemented in 2004) expanded its capacity, processing more than 1.4 million of the basic 1040 EZ tax returns during the 2005 filing season. Further expanded functionality will accept returns received with an address change, allowing more returns to be processed through CADE.

- Completed architecture engineering analysis and development of a limited functionality release for Filing & Payment Compliance (F&PC) Release 1.1 designed to separate complex cases requiring direct IRS involvement from those that can be handled by private collection agencies (PCAs). This release will provide initial capabilities for competitive outsourcing of collection activities in FY 2006.

- Implemented the Integrated Financial System (IFS) as the IRS internal accounting system of record. IFS replaced the IRS' core legacy financial systems. Version 4.6C deployed expenditure controls, some of IRS' accounts payable, accounts receivable, general ledger, budget formulation, purchasing controls, 3-year rolling forecast, and statements of net cost.

- Deployed Modernized e-File (MeF) Release 3.1 which processed 7004 (corporations), 990PF (tax-exempt organizations) and tax law changes for filing season 2004. In FY 2005, MeF processed 1120 and 990 returns at higher than expected volumes while still achieving performance goals. The MeF platform speeds turnaround time for tax return submissions and uses the latest, secure Internet technology. This project is key to achieving the 80% e-filing goal mandated by Congress and is an integral part of the Administration's move towards an all-electronic government.

- Completed Modernized e-File re-sequencing plan to support Disaster Recovery requirements.

- Developed and published e-Strategy for Growth: Expanding e-Government for Taxpayers and Their Representatives. This product serves as a strategy providing IRS' plans for electronic tax administration and will be used as a communication tool for both internal and external customers.

Actions Planned or Underway

- Modernized e-File (MeF) will become the primary interface for all business filings. During FY 2006, MeF will deliver electronic filing capabilities for 1065 forms (Partnership Income),

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enabling nearly 2.7 million small business and self-employed taxpayers to be served. MeF will remedy Legacy electronic filing limitations (e-File) which do not allow partnerships to comply with the Taxpayer Relief Act of 1997 without having to seek waivers to avoid financial penalties.

- The Filing & Payment Compliance (F&PC) project is a key element of the Enforcement strategy, which will develop systems to analyze tax collection cases and separate cases requiring direct IRS involvement from those that can be handled by private collection agencies (PCAs). In FY 2006, the F&PC will stand up initial capabilities for competitive outsourcing of collection activities.

- The Customer Account Data Engine (CADE) will continue to move the IRS towards realizing its Technology Modernization strategy by establishing phased replacement of components that can no longer sustain today's tax laws, policy and taxpayer needs. In FY 2006, CADE will expand the type and number of 1040 family of returns processed on modernized systems beyond the current base of 1040EZ forms. This will provide key taxpayer benefits such as processing refunds faster, submitting daily postings of transactions and updating accounts, which will significantly improve customer service.

- Continue process improvement and development of metrics for software development.

- Modernize infrastructure components per Enterprise Architecture.

- Maintain the successful track record on on-schedule, on-budget release upgrades for the major modernization application to include CADE, IFS, MeF and e-Services.

- Accelerate modernization to maximize modernization potential and promote operational efficiencies and strengthen transition of Business Systems Modernization (BSM) systems into the operating environment.

Tax Compliance Initiatives

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.

Actions Taken

- Addressed key areas of noncompliance with enhanced enforcement of tax laws through:
  - Increased examinations of the small business corporate segment by 81%;
  - Increased examination and collection on the high-income non-filer segment;
  - Initiated settlement initiatives, such as Son of Boss, which alone resulted in the collection of $3.7 billion in enforcement revenue in FY 2005;
  - Partnered with states on abusive transactions leads;
  - Initiated educational outreach with practitioners through e-File seminars and professional responsibility (Circular 230) presentations; and
  - Standardized criteria for obtaining state revenue agent reports and established centralized classification point for making IRS assessments based on the data.

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- Deployed new Automated Underreporter (AUR) EITC selection methodology including business rules for selecting and excluding EITC cases in AUR and including Schedule C cases.

- Strengthened Field Assistance enforcement programs to increase voluntary compliance and reduce the risk of noncompliance. During the third quarter of FY 2005, an additional 245 Tax Resolution Representatives (TRR) and their managers were trained for Collection case work.

- Developed new models for Individual Master File (IMF) to assist in selecting the most productive work. This effort eliminates duplicate selection codes, facilitates the identification of the "Next Best Case" for case creation, and simplifies programming.

- Continued to identify flow-through entities used to disguise questionable structured transactions by high-income taxpayers. Identified those engaging in abusive tax practices through enforcement, full implementation of K-1 matching, education and research.

- Continued the enhancements of risk-based compliance approaches by:

    - Coding new algorithms that help determine the most appropriate treatment for cases identified by the Dependent Database so the IRS can more effectively select inventory for specific and appropriate treatment streams, and

    - Focusing on long-term solutions that meet legal requirements, are compatible with technological capabilities, and have the greatest potential to deter non-compliance. (Ongoing)

- Released updated tax gap estimates for Individual Income Tax Reporting Compliance. Preliminary findings indicate that the gross tax gap was between $312 billion and $353 billion in Tax Year (TY) 2001. Underreporting noncompliance is the largest component of the tax gap and accounts for more than 80% of the total, with non-filing and underpayment at about 10% each. Individual income tax is the single largest source of the tax gap, accounting for about two-thirds of the total. For individual underreporting, more than 80% stems from understated income, not overstated deductions.

- Delivered final TY 2003 Voluntary Payment Compliance Rates (VPCR) by type of tax, tax year and operating division. The VPCR, which is the percentage of the total tax liability reported on timely-filed returns that is paid in a timely manner, provides a valid assessment of the overall level of payment compliance and facilitates the proper allocation of resources for enforcement activities.

- Provided an estimate of the overall improper payment level (overclaim estimates) for EITC based on National Research Program individual reporting compliance data. Data will be used to help refine and evaluate EITC initiatives to reduce inappropriate claims and improve the program's effectiveness.

- Established the Office of Fraud/Bank Secrecy Act (BSA) which has end-to-end accountability for BSA policy formation, operations and data management, recognizing the

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importance of the IRS' role in the fight against terrorism and money laundering. Over 300 examiners and managers are trained and dedicated full-time to the BSA program.

- Completed a model Federal and State Memorandum of Understanding (MOU), which provides both the IRS and the participating state the opportunity to leverage resources for BSA examinations, outreach and training.
- Expanded examinations of self-employment income by earners in U.S. Possessions (Puerto Rico, Guam, etc…), closing over 10,000 Form 1040s in FY 2005.
- Made efficiency gains in the Offer-In-Compromise (OIC) program. Declining receipts and improvements in timely closures of OIC permitted reassignment of approximately a quarter of field offer specialists back to the general collection program.
- Focused criminal enforcement resources on key areas of noncompliance, including the promotion of abusive schemes such as offshore accounts to hide or improperly reduce income, the use of abusive corporate tax avoidance transactions and high-income individuals underreporting of income and/or failure to file returns.

Actions Planned or Underway

- Upgrade the Bank Secrecy Act (BSA) workload database to provide a more complete record of these institutions and to better predict which entities have a greater probability of non-compliance.
- Continue the enhancements of risk-based compliance approaches by implementing major programming changes to inventory and incorporating cost-benefit of Dependent Database selection process. (01/2006)
- Finalize plans for Tax Year 2006 Earned Income Tax Credit (EITC) compliance study to assess changes in taxpayer EITC filing volume and track EITC return math error accuracy.
- Charter EITC research efforts to identify ways to reduce EITC erroneous payments, as well as identify trends in the diverse EITC taxpayer population. Use the results of these studies for strategic planning of the EITC program. (Ongoing)
- Develop enhancements to the multifunctional non-filer strategy that will target outreach and compliance efforts; develop alternative treatments to influence non-filing taxpayer behavior and promote compliance. (09/2006)
- Continue the Federal Employee/Retiree Delinquency Initiative (FERDI) to reduce non-compliance of federal employees and retirees. (Ongoing through 09/2006)
- Utilize Individual Master File (IMF) data to track production, return characteristics and error information on volunteer-prepared returns. (Ongoing through 09/2006)
- Perform a study to establish the compliance characteristics of volunteer-prepared returns. (09/2006)

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- Initiate a Qualitative Assessment Study that analyzes the effects on taxpayer attitudes towards EITC participation and compliance. (09/2006)
- Initiate an 1120-S full reporting compliance study to analyze the accuracy of S-corporation tax returns and estimate the voluntary reporting compliance of subchapter S-corporations. (Ongoing)
- Enhance data exchange opportunities and implement national initiatives with state taxing organizations to leverage limited government resources.
- Focus on securing State Income Tax Levy program (SITLP) agreements with remaining non-participating income tax states.
- Enter into tip reporting agreements with more than 90% of gaming casinos. (12/2005)

Strengthen Information Security; Security of the IRS

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

Actions Taken

- Updated and strengthened security plans for tax payment lockbox sites for tax payment processing at the IRS campuses.
- Completed certifications and accreditations of IRS redefined General Support Systems (GSS); took steps to thoroughly review the security controls of its networks and other critical information technology assets and to correct any weaknesses that exist.
- Improved Federal Information Security Management Act of 2002 reporting process to fully and actively engage business management in meeting and reporting on security requirements for the systems within their purview.
- Participated with the Department of the Treasury in disaster simulations designed to test continuity of operations plans.
- Provided executives, managers and staff (including personnel with essential security roles) with relevant security-related training.
- Implemented program-level security controls disseminated by Mission Assurance & Security Services.
- Established a multi-agency working group including representatives from the Department of the Treasury, the Federal Trade Commission (FTC), the Social Security Administration (SSA) and the Department of Homeland Security (DHS) to better enable Federal agencies to provide consistent information and services to assist victims of identity theft:

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- Collaborated with the Social Security Administration (SSA) to improve a multi-agency process called "Scramble SSN" to dramatically reduce the time required to resolve duplicate Social Security Number (SSN) usage;
- Updated information used in correspondence with taxpayers who are impacted by identity theft including interim updates on the status of their case;
- Developed standards for documentation to be used to validate the identity of the taxpayer, the taxpayer's address and the fact of the theft that are consistent with those established by the FTC and the SSA;
- Established tracking codes to monitor taxpayer cases impacted by identity theft to develop or enhance outreach activities and communication vehicles;
- Established process to protect the SSNs of IRS employees by eliminating the use of the SSN as a unique employee identifier on IRS systems; and
- Established an Identity Theft Program office to update internal processes impacted by identity theft, to reduce taxpayer burden and to provide consistent treatment among taxpayers.

- Completed build out of the incident command structure.
- Expanded the IRS' ability to respond to emergencies through more frequent exercise of Continuity of Operations Plan (COOP) and other emergency response actions.
- Completed business resumption plans in response to changes in threat conditions.
- Fully supported government-wide and Departmental emergency response initiatives.

Actions Planned or Underway

- Complete mitigation of General Support Services (GSS) weaknesses identified during certification and other review activities sufficient to upgrade GSS with Interim Authority to Operate status to Full Authority to Operate. (09/2006)
- Conduct certification and accreditation update activities to meet government-wide guidelines for percentage of information systems certified. (09/2006)
- Define an enterprise-wide strategy for IT systems disaster recovery, including implementation of strategic testing of disaster recovery plans. (09/2006)
- Develop a back-up for the IRS incident response capability to reduce geographic vulnerability. (09/2006)
- Continue to improve Federal Information Security Management Act (FISMA) compliance by further increasing business owner participation in all areas including monitoring, review, mitigation and reporting activities. (Ongoing)

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- Develop a physical security technology "roadmap" for the IRS to improve uniformity and cost effectiveness of security technologies at IRS sites. (05/2006)

- Support Homeland Security Presidential Directive 12 (HSPD-12), which mandates a uniform approach to employee authentication and access government-wide. HSPD-12 requirements contain a timeline for all agencies to follow and requirements for meeting the objectives of the Directive. (Multi-year)

- Continue to refine both the IRS' Continuity of Operations Plan (COOP) activities and the IRS' contribution to Department/government-wide COOP activities. (09/2006)

Establish Measures Comparable Over Time and Collect Sufficient Performance Data; Integrating Performance and Financial Management

Issue: Establish long-term goals and integrate performance into decision-making and resource allocation processes to completely achieve an integrated performance budget.

Actions Taken

- The IRS budget submission for FY 2007 includes programmatic long-term goals (LTG) that combined with the program-related efficiency and outcome measures will be used as indicators of the program's long-term objectives. In FY 2005, the IRS aligned its budget programs with the objectives outlined in the IRS Strategic Plan 2005 through 2009.

- Draft long-term goals, indicating optimal performance and targets through FY 2009, were developed for each Taxpayer Service program and for a majority of the Enforcement programs.

- The IRS' Integrated Financial System (IFS) was deployed in FY 2005 to provide timely access to accurate and consistent financial data including cost data that is used to develop cost-based performance measures. The IRS cost module has captured data for 10 months of FY 2005 enabling the IRS to view direct expense data (labor, supplies, travel, etc), FTE and on-rolls data captured at the lowest cost center (group or work unit) level. In addition, the IRS developed and implemented allocation methodology to distribute support costs to the operational business units.

- The IRS completed three Program Assessment Rating Tool (PART) evaluations for the FY 2007 budget cycle: examination, criminal investigation and submission processing. All three programs received "moderately effective" ratings from OMB.

- The Chief Financial Officer and Modernization & Information Technology Services have proposed and developed a concept of enhancing the current Financial Management Information System (FMIS) to substantially comply with the requirements of FFMIA.

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Actions Planned or Underway

- The IRS will continue to analyze the cost data obtained through the Integrated Financial System to further develop robust cost-based performance measures for its major programs.
- In FY 2006 the IRS will introduce a suite of enterprise-wide goals which link directly to the IRS Strategic Plan goals of Improve Taxpayer Service, Enhance Enforcement of the Tax Laws, and Modernize the IRS Through People, Processes and Technology. The enterprise-wide goals will be consistent with the measures represented in the IRS budget. The new goals are intended to provide focus and rigor to measuring the outcome of the nation's self-assessment tax system: Improve Voluntary Compliance in all areas.
- For the FY 2008 budget cycle, the IRS will submit its non-revenue generating programs to OMB for a PART assessment. Based on the performance improvements the IRS has shown for the collection program, the IRS plans to request reassessment and removal of the prior PART rating of “Results Not Demonstrated.”
- Financial Management Information System (FMIS) enhancements are planned through four releases beginning in 2006. FMIS is currently working on Release 1, which is the development of the Unpaid Assessment and Trust Fund Recovery Penalty (TFRP) data base.

Complexity of the Tax Law

Issue: Simplifying the tax process by developing legislative recommendations to clarify tax instructions or forms and computer modernization.

Actions Taken

- Provided Congress with legislative recommendations in the upcoming National Taxpayer Advocate 2004 Annual Report to Congress (December 31, 2004), including elimination of the Alternative Minimum Tax; simplification of provisions to encourage education; and simplification of provisions to encourage retirement savings.
- Finalized the Taxpayer Rights Impact Statement, which is an assessment of an IRS program or policy by the National Taxpayer Advocate with respect to its impact on taxpayer rights.
- Participated in research initiatives such as "Abusive Tax Schemes: The 'Tipping Point' Study;” The Impact of Representation on the Outcome of Earned Income Tax Credit (EITC) Audits, Federal Case Registry Study; EITC Certification Test; EITC Pre-certification Test; EITC Recertification; Downstream Effects of Compliance Initiatives.

Actions Planned or Underway

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

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- Examine the possibility of a Unified Family Credit that will combine the provisions of the EITC, Child Tax Credit, and Dependency Exemption, thereby further reducing taxpayer compliance burdens associated with claiming these provisions. (Ongoing)

- Legislative proposal to issue regulations specifying returns that must be filed electronically. Expanding the scope of returns that are required to be filed electronically would help the IRS meet its 80% goal set by Congress.

- Legislation is being proposed to issue regulations that would extend the due date to file and pay individual taxes by April 30th, provided the taxpayer files the return electronically and pays the entire balance due electronically by the due date.

- Legislation is being proposed to expand authority of the IRS to require businesses (including corporations, partnerships and other business entities) and exempt organizations to file their returns electronically.

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

- Established new Queuing Management (Q-Matic) codes to enhance the data captured at the walk-in sites to provide additional feedback on outreach efforts involved in the EITC Qualifying Child Certification Test. This will enable the IRS to learn about taxpayer problems with certification as well as the potential burden a certification requirement could impose on IRS field assistance sites.

- Completed Phase 1 of Q-Matic to facilitate customer traffic and workload planning.

- Developed the electronic installment agreement initiative to enable taxpayers meeting certain criteria to request and set-up their own installment agreements over the Internet on IRS.gov.

- Completed a successful pilot of Contact Recording initiative to enable synchronized voice/data recordings to monitor face-to-face interactions in Taxpayer Assistance Centers (TACs) to assess quality as well as trends.

- Completed 108 Taxpayer Assistance Center Model projects, thus far, to retrofit TACs to provide adequate space to accommodate customer traffic, provide modernized workstations, integrate technology enhancements, improve privacy and enhance security.

- Deployed new Automated UnderReporter (AUR) EITC selection methodology to more precisely select cases that have a high probability of misreported income.

- Revised the e-Services incentive products minimum returns filed threshold to five (down from 100) for all return types supported by e-File or Modernized e-File (MeF) to allow more

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Electronic Return Originators (EROs) to use electronic incentive products such as Disclosure Authorization, Transcript Delivery System and Electronic Account Resolution.

- Improved and enhanced the availability of online services such as Internet Employer Identification Number (EIN), Centralized Authorization File (CAF), and Practitioner Priority Services (PPS).
- Continued work with private industry providers to expand Free File.
- Enhanced research to maximize the best use of resources for the Volunteer Income Tax Assistance (VITA) site identification, partnership development and return preparation.
- Expanded Internet Refund-Fact of Filing to include Refund Trace and Change of Address capabilities for lost and/or stolen refunds.

Actions Planned or Underway

- Expand the web-based learning program (Link and Learn Taxes) that provides online training in tax return preparation. (Ongoing through 09/2006)
- Refine “Life Cycle Products” line of publications designed to educate taxpayers about the tax impact of significant life events. (Ongoing through 09/2006)
- Incorporate multi-year Volunteer Return Preparation Program (VRPP)-Quality Improvement Process (QIP) plan to promote quality assurance for the VITA program. (Ongoing through 09/2006)
- Utilizing 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. (09/2006)
- Continue expansion of Internet Refund Fact of Filing (IRFOF) application to reduce toll-free demand and offer customers alternative methods of service. (09/2006)
- Develop a TeleFile and Internet electronic funds withdrawal (Direct Debit) application for notice payments. (09/2006)
- Develop an electronic funds withdrawal (Direct Debit) application for installment agreements. (09/2006)
- Complete Phase II rollout of Queuing Management (Q-Matic) which will automate the process of tracking employee activity and contribute to improve customer traffic and workload planning. (09/2006)
- Continue to educate EITC taxpayers through partnerships with key stakeholders and a public service campaign. (Ongoing)

- Assess the overall EITC marketing/awareness campaigns that target the eligible EITC non-claimant population and refine/refocus as necessary to improve compliance and increase overall participation. (Ongoing)

- Continue to improve the quality and clarity of computer-generated notices issued to taxpayers to reduce the number of telephone contacts and make it easier for taxpayers to understand and comply with their tax requirements. (Ongoing)

- Establish the Virtual Translation Office to develop new and revised Spanish-language tax products. (09/2006)

- Continue conducting surveys and focus groups to obtain feedback from taxpayers and tax practitioners about ways to improve tax forms, instructions and publications. (Ongoing)

- Complete an additional 25 TAC Model projects. (09/2006)

- Roll-out Contact Recording in the TACs piloted in 2005 to an additional 100 locations in FY 2006 and continuing through FY 2008 until all TACs are equipped with contact recording.

Processing Returns and Implementing Tax Law Changes During the Filing Season

Issue: Tax law changes from prior years that have not been correctly implemented.

Actions Taken

- Developed secure access for taxpayers who file electronically to enable them to review their account electronically.

- Deployed the Transcript Delivery System (TDS) to improve efficiency by implementing a “One-click process” for servicing transcript requests. From May to September 2005, 610,000 transcripts were mailed to taxpayers.

- Completed the ramp-down of the Memphis Submission Processing Center (MSPC).

- Ensured the Corporate Filing Season Readiness Process is operational for filing seasons 2005 and 2006 and covers all aspects of the filing season, including the Annual Readiness Certification. Filing Season 2005 was timely certified and the Filing Season Readiness committee is in place for filing season 2006.

- Set a record for electronic filing, reaching 68 returns, an increase of approximately 11% from 2004.

Actions Planned or Underway

- Automate the financial statement of net cost in IFS.

- Pilot an automated adjustment document to make a change or correction to a taxpayer account, reducing adjustment time and increasing the quality of required adjustments.

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- Pilot Embedded Quality Review System (EQRS), establishing common attributes and review tools for evaluating organizational performance and individual performance.

- Begin development of strategies to smoothly transition and consolidate the Philadelphia Submission Processing Center. (Multi-year initiative)

- Complete deployment of Transcript Delivery System (TDS) by December 2005.

Taxpayer Protection and Rights

Issue: The IRS has made significant progress in complying with RRA '98 and most provisions have been implemented. Significant management attention is still required to ensure that all issues situations have been addressed.

Actions Taken

- Reduced procedural barriers by making refinements to both third party notification and collection due process procedures.

- Administered an EITC survey as part of the EITC Qualifying Child Certification Test, consisting of questions regarding the time and cost associated with the certification and making an EITC claim. The survey was conducted to gather information to better understand claimants' experience with the certification process and to determine the impact of EITC certification on taxpayer participation in the EITC program.

- Implemented several EITC notice redesign efforts (CP-75 notice series, initial audit contact letters, Publication 3498-A, *The Examination Process: Examinations by Mail*). The redesign of the notices will enable taxpayers to better understand their responsibilities and entitlements under a very complicated section of tax law.

- Improved the CP 09 (*Earned Income Credit - You May Be Entitled to EIC*) and 027 (*EIC Potential for Taxpayer Without Qualifying Children*), which notifies taxpayers who have not claimed EITC that they may be eligible. Simplified the CP 09 and 027 language to improve understanding and improved the determination checklist to make the notices more user friendly.

- Improved the EITC recertification and two- and ten-year ban notices, making them easier to understand and clearly explaining the consequences of the two- and ten-year bans, including the tax years to which the bans apply.

- Implemented a solution for encrypting electronic return data during the transmission process from electronic return transmitters.

- Developed a new workload methodology that will focus on those areas of the filing population constituting the greatest increase in compliance risk with a high probability of unreported income. This strategy will promote fairness of our tax system by identifying potential noncompliance from taxpayers who would not otherwise be subject to matching document reviews.

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- Rolled out the Taxpayer Assistance Center (TAC) model, as it is critical to maintaining taxpayers' privacy and confidentiality, particularly as the IRS becomes more involved in compliance activities.
- Reviewed IRS training to ensure that employees, particularly in compliance functions, are properly and regularly trained on the protection of taxpayer rights.
- Pursued abuses in the consumer credit counseling industry, targeting for audit 60 firms representing 50% of revenue in this industry.

Actions Planned or Underway

- Focus on taxpayer groups that are at higher risk of noncompliance to maintain confidence in the integrity of the tax administration program. (Ongoing)
- Continue to educate EITC taxpayers through partnerships with key stakeholders and a public service campaign. As of June 2005, the public education campaign, through the media and grassroots community partnerships, generated almost one billion potential contacts. (Ongoing)
- Continue efforts to enhance EITC systemically generated notices.
- Ensure protection of taxpayer information entered at return preparation sites and local offices. (Ongoing)
- Refine 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)
- Work under auspices of the Electronic Tax Administration Policy Council (ETAPC) to establish security policy and address issues. Complete additional reviews requested by ETAPC of the authentication methods. Continue to implement new website functionality requested by the Business Operating Divisions. (Ongoing)
- Continue systems modernization efforts to enhance the IRS' security program. (Ongoing)
- Develop and implement the Taxpayer Rights Impact Statement to help the IRS incorporate awareness and consideration of taxpayer rights into its program planning and implementation. (Ongoing)
- Work with preparers to design a program that enables the majority of taxpayers to feel confident that their preparers are competent to prepare their taxes and that the IRS will take appropriate enforcement action on preparers when they perform negligently or recklessly. (Ongoing)
- Advocate enforcement of existing penalties for paid preparers as well as the strengthening and enhancement of penalties by Congress. (Ongoing)

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Human Capital

Issue: The IRS' ability to meet program requirements and the expectations of both external and internal customers.

Actions Taken

- Streamlining operations resulted in moving personnel from non-enforcement to enforcement positions during FY 2005 and cost savings from centralizing case processing will be directed to enforcement hires for FY 2006.
- Submitted to the IRS Oversight Board the final draft of the 2005-2009 Human Capital Strategic Plan, the primary guidance vehicle for strategic management of human capital in the IRS.
- Implemented an IRS-wide human capital governance structure, including representatives from the IRS business units, support functions and specialized units, that provides a forum for all IRS entities to jointly address and propose solutions to human capital issues and challenges resulting from the implementation of large-scale human capital programs, policies and initiatives and ensures consistent and fair treatment of employees impacted by workforce change initiatives.
- Continued work on Mission Critical Occupations (MCOs):
    - Refined competency models for MCOs as part of the IRS' ongoing effort to improve its ability to field a workforce with the full range of competencies necessary for high quality performance;
    - Implemented an automated recruitment solution, CareerConnector, for external hiring of selected MCOs, increasing the IRS' ability to fill vacancies within 45 days from the vacancy announcement; and
    - Improved the talent pool of external Mission Critical Occupation hires and provided management greater flexibility to select the most qualified candidates through the expanded use of category ratings to stratify the available applicant pool and also simulated job situation assessments.
- Implemented an IRS-wide Enterprise Learning Management System (ELMS), a web-based application that managers, employees, and the Learning and Education community will use to manage training and development.
- Negotiated a new recruitment marketing contract because previous contract, including option years, had expired. Maintained an active print and internet media campaign, produced new multi-media job previews and updated the IRS Careers website. A recruiter cadre continued to foster partnering relationships with over 200 colleges and universities across the country as part of the IRS' ongoing effort to improve recruiting performance, particularly the recruitment of applicants to fill Mission Critical Occupations.

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- To support workforce restructuring initiatives and to mitigate impact on employees involved in restructuring, the IRS used all available tools, including VERA (early outs) and VSIP (buyouts) and relocation bonuses throughout the year to support workforce restructuring initiatives and to mitigate impact on employees involved in restructuring.
- Developed a Human Capital Office (HCO) Concept of Operations that articulates HCO's vision, mission, values and role in the IRS human capital community as well as HCO's various Lines of Business, i.e., major categories of human capital work within the IRS.
- Executed Service Level Agreements with customers which describe the services HCO has agreed to provide, HCO and customer commitments relating to delivery of HCO services and how HCO's performance will be measured.
- Evaluated each new human capital initiative for workforce impact to determine effective and appropriate mitigation strategies to address the results.
- Implemented a multi-year recruitment and marketing strategy that includes the expansion of the Internet employment website, a complete print media advertising campaign, market research and an extensive Internet media advertising campaign.
- Used competency models and occupational studies to identify and target competencies necessary for successful performance in all frontline occupations; targeted competencies in the recruitment and hiring process and the individual and employee training process to address skill gaps.
- Developed a Career-Pathing process that focuses on training, application, assessment and feedback to provide opportunities to develop technical expertise needed for senior professional positions.
- Expanded QuickHire, an Internet-based tool that automates the hiring process, to include additional occupations.

Actions Planned or Underway

- Deploy the Learning Content Management System (LCMS) to permit more efficient development of training materials and ensure more consistency in training across the Service. (09/2006)
- Complete the conversion of all its Mission Critical Occupation (MCO) application processes to the CareerConnector system and begin the conversion of the non-MCO occupations. (09/2006)
- Complete development of the Human Capital Strategic Implementation Plan (HCSIP) to:
    - Identify specific human capital programs and initiatives for the next two years needed to execute the strategies and achieve the goals outlined in the Human Capital Strategic Plan;

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- Provide accountability for performance of programs and initiatives through a systematic corporate monitoring and reporting process; and
- Integrate the budget process with human capital strategies. (Ongoing)

- Conduct a study of all leadership courses (Executive Readiness Program, Senior Manager Course/Senior Manager Readiness Program, and Frontline Manager Course) to focus on delivering content in an effective and efficient manner as well as identifying and attracting "high talent" and "high potential" for leadership development. (09/2006)
- Design continuous training for managers using tailored case studies, simulations in training and work-out sessions to provide hands-on experience to realize the "stepping stone" approach. (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)
- Extend partnerships with key colleges and universities. (Ongoing)
- Improve recruiting performance through expansion of category ratings and the increased use of simulations in assessing job applicants—particularly in front- line occupations. (Ongoing)

Enforcement of Tax Laws

Issue: Address the evolving challenge of unpaid taxes and continuing Earned Income Credit noncompliance.

Actions Taken

- Improved collection processes resulted in increases in productivity, dollars collected, enforcement activity and customer satisfaction along with decreases of time between return filing and assignment and decrease of time between assignment and case closure. Adoption of clear guiding principles including revisions to key Internal Revenue Manual sections on enforcement activity, coupled with improved electronic research and guidance tools and enhancement of managerial consultations contributed to overall improvements.
- Implemented key recommendations identified by the Federal Tax Compliance Task Force (FCTC) to improve the levy process for Department of Defense (DoD) Contractors thru the Federal Payment Levy Program. Actions include:
    - Implemented 100% levy actions on 100% of the largest DoD payment file in April and the remaining DoD payment systems in July 2005;
    - Increased data exchanges with DoD resulting in the acceleration of 7,550 Collection Due Process notices; and

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- Added additional DoD payment systems to the Treasury Offset Program (TOP). To date, 18 of the 20 Defense Finance and Accounting Service (DFAS) Commercial Pay Systems have been implemented, which represents 99.7% of the total annual disbursements.

- Improved Automated Collection System (ACS) levy process by identifying new sources from Electronic Filed Returns, State Employment Commissions and through Information Return Master File and the Remittance Processing System.

- Partnered with 27 states to levy individual state refunds for outstanding federal income tax liabilities through the State Income Tax Levy Program (SITLP). An encryption software purchase for states will allow transmission of levy payment into the Electronic Federal Tax Payment System (EFTPS).

- Developed a multi-year strategy through the Federal Employee Retiree Delinquency Program (FERDI) to provide outreach and education to assist military retirees with understanding their obligations and improving compliance.

- Other than the Earned Income Tax Credit (EITC) Program, the IRS has no high-risk programs that require baseline and annual error rate measures or the development of a reduction plan with annual targets. Therefore, the IRS' focus on eliminating improper payments is placed on the Earned Income Tax Credit Program. EITC is a refundable federal income tax credit for low-income working individuals and families. In FY 2004, nearly 22 million people received almost $38 billion from the credit, making the EITC the nation's largest anti-poverty program.

- To better administer EITC, the IRS developed a detailed, long-term EITC business plan in the form of a Concept of Operations with a focus on a balanced EITC Program – one that reduces erroneous payments while increasing participation by eligible taxpayers. In keeping with the goals of the EITC program throughout FY 2005 and into FY 2006, the IRS will implement new, technology-enabled business process improvements as well as continue to test and evaluate new approaches to reduce improper payments. The IRS will use these tests to make data driven decisions about improvements to each segment of the program including customer service, outreach and compliance.

- The EITC business plan is consistent with the IRS Commissioner's five-point initiative announced in June of 2003 to reduce burden on taxpayers, improve the IRS audit processes, increase outreach efforts, address unreported income and test new approaches to reducing EITC error. The IRS' continued efforts to improve EITC compliance activities have enabled it to decrease the amount of time it takes to complete an EITC examination by 6.4%, or 12 days and to reduce the volume of aged EITC cases in inventory by 38% during last year.

- As part of the Commissioner's initiative, in FY 2005, the IRS continued several tests to evaluate new ways of reducing erroneous EITC payments while maintaining participation by eligible taxpayers:
    - Qualifying Child Test: Requires certain EITC claimants to certify that they meet the qualifying child residency requirement before paying out the refund. Initial testing results

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showed that a certification requirement had a significant effect on improper EITC claims;

- Filing Status Test: Reviews filing status claims to ensure they are correct. The IRS selected claimants whose filing status had changed to one that increased the value of the credit (generally, from married filing joint to head of household). The first test indicated that the IRS needed to modify its selection methodology to ensure a better focus on non-compliant taxpayers; and

- Misreporting Income (Automated Underreporter) Test: Enhances error detection through the Automated Underreporter program. This test focused on improved selection methodologies and showed successes in a lower no change rate and changes to the credit.

- Based on the results of the Misreporting Income (Automated Underreporter) test, in early FY 2005 the IRS implemented the improved selection methodologies for Automated Underreporter cases. During 2006, the IRS will complete the last part of the Qualifying Child test and evaluate the effects of the Filing Status and Qualifying Child tests on reducing erroneous EITC payments and maintaining participation by eligible taxpayers before making decisions to implement either on a broader scale.

- Other FY 2005/FY 2006 activities include a program to focus education and compliance efforts, as appropriate, on EITC paid preparers. As a part of the EITC Return Preparer Strategy, the IRS completed over 400 due diligence compliance visits to paid tax preparers with a probability/record of preparing erroneous EITC returns. The IRS has also implemented the selection of amended EITC returns for examination using the Dependent Database.

- The IRS is also striving to make the EITC easier to claim by eligible taxpayers. To reduce taxpayer burden, the IRS is improving communications to taxpayers, making the credit clearer and easier to understand and providing potential claimants and their paid preparers with resources to help them determine whether they are eligible. During FY 2005, the IRS launched the EITC Assistant, a web-based eligibility calculator on irs.gov; implemented enhancements to the EITC Online Toolkit for tax professionals for FY 2005 and FY 2006; delivered EITC messages on Housing and Urban Development kiosks in 106 locations nationwide; and distributed EITC educational materials to 3,300 Western Union agent locations in New York, Los Angeles, Atlanta, and San Antonio. Also in FY 2005, IRS partnerships and coalitions prepared nearly two million tax returns for low-income families, in addition to making countless taxpayer contacts through an array of EITC educational products and messages.

Actions Planned or Underway

- Launch final portion of the qualifying child certification test.

- Complete compliance analysis of TY 2001 returns claiming EITC (National Research Program).

- Develop and distribute materials to educate taxpayers and practitioners on EITC eligibility rules and compliance issues.

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- Test and report the results of the National Directory of New Hires database match.
- Plan for a FY 2007 compliance study.
- Continue to leverage partnership opportunities with states that offer tax credits comparable to EITC.
- Implement new Automated Case Selection and Assignment and Decision Support Tools. (01/2006)
- Implement new Amended Returns process. (03/2006)
- Launch additional Risk-Based Scoring Strategy and inventory management capability to improve selection and assignment of EITC returns for examination. (03/2006)
- Enhance methodology to improve the selection of EITC amended returns for examination.
- Expand the Questionable Refund Program to include prisoner returns. The IRS will continue to coordinate with prison officials to acquire complete and accurate information on the prison population to maximize the effectiveness of its automated systems in promptly identifying questionable returns filed by inmates. Furthermore, the IRS will ensure all Fraud Detection Centers have procedures in place to coordinate fraud prevention efforts with the prisons in the states they serve.
- Enhance IRS' Electronic Fraud Detection System to improve its efficiency in detecting fraudulent refund schemes involving individual as well as business returns.
- Integrate the Decision Support Tool into the Reporting Compliance Case Resolution workflow. (06/2006)
- Develop joint W&I and SB/SE Reporting Compliance Concept of Operations and system concept for coordinated workload management and resolution system to manage and move case inventory (this replaced EITC's Corporate Inventory Management Routing & Integration project). (12/2005)
- Identify new ways to administer EITC by partnering with states (New York, Massachusetts, and New Jersey) through the use of proactive research initiatives. (12/2005)
- Use data-driven scoring and selection methods to select cases for examination and apply the right compliance treatments to address taxpayers. (01/2006)
- Test new selection tools to determine more effective compliance treatments for return preparers. (03/2006)
- Initiate research to assess changes in taxpayer EITC filing volume and track EITC return math error accuracy through outreach campaigns and volunteer tax return preparation. (Ongoing)

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- Develop multi-year return preparer strategy that addresses paid preparer non-compliance and gather data on the effects of these efforts on paid preparers as well as taxpayers. (Ongoing)

- Test the use of a National Directory of New Hires (NDNH) database match in the IRS' Criminal Investigation EITC Fraud Detection Centers. (12/2006)

Bring Treasury's Financial Management Systems into compliance with Federal Financial Management Improvement Act (FFMIA) of 1996

Issue: The IRS' financial management systems remain a challenge, despite producing combined financial statements covering tax custodial and administrative activities for the seventh consecutive year. Also, the IRS has achieved an unqualified audit opinion from the Government Accountability Office (GAO) on all financial statements since FY 2000. IRS' current financial systems alone cannot produce reliable information necessary to prepare financial statements in accordance with federal accounting standards. The data produced from the current financial system has to be reconciled with other subsidiary systems to produce reliable financial statements. The IRS lacks the timely, accurate, and useful information needed to make informed management decisions on an ongoing basis.

Actions Taken

- Custodial Accounting Project (CAP) was shutdown due to funding shortfalls.

- Implemented the Integrated Financial System (IFS) as the IRS' internal accounting system of record.

- The IRS developed a strategy concept to enhance the current Financial Management Information System (FMIS) to be compliant with FFMIA requirements.

- FMIS enhancement concept was accepted by the Financial and Management Controls Executive Steering Committee and has been presented to Treasury CFO, OMB, and GAO.

- The IRS developed a less costly alternative strategy to down grade custodial reporting weakness via implementation of new custodial database project.

Actions Planned or Underway

- FMIS enhancements are planned to be accomplished through four releases beginning in 2006 through 2008.

- MITS is currently developing on Release 1 which is the Unpaid Assessment and Trust Fund Recovery Penalty (TFRP) database and sub-ledger functions.

- Full funding requirements for the FMIS enhancements have been included in the FY 2007 E-300 submission.

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Success is measured by a set of key milestones for each project identified in the detailed project plans developed for all Tier A projects. Success is also measured by the Office of Management and Budget through the President's Management Agenda. The IRS receives scores for both Plan and Status on a quarterly basis.

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Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2005

V. Financial Highlights

Stewardship Information Analysis

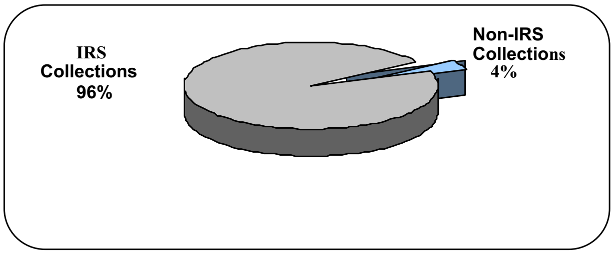
a. Overview of Revenue and Administrative Accounts

The IRS' financial statements and footnotes received an unqualified audit opinion for the sixth consecutive year for administrative accounts and the ninth consecutive year for revenue accounts. Administrative accounts reflect resources used and expenses incurred in administering the tax laws. Revenue accounts reflect net taxes receivable and net taxes collected to support the federal government.

The Balance Sheet reflects total assets of $27 billion. Of these assets, 77.8% are Federal Taxes Receivable. These receivables are the amounts expected to be collected from past due accounts. The increase in assets of $1.4 billion is primarily attributable to increases in the amounts due from Treasury for tax refunds due taxpayers, taxpayer deposits for unpaid assessments and federal taxes receivable. The majority of the liabilities, 83.7%, consist of amounts due to Treasury related to Federal Taxes Receivable.

The Statement of Custodial Activity shows that IRS programs resulted in $2.267 trillion in Federal receipts. IRS collections constitute 96% of the Federal Government receipts, as shown in the chart below.

Total Federal Receipts – (Percent)

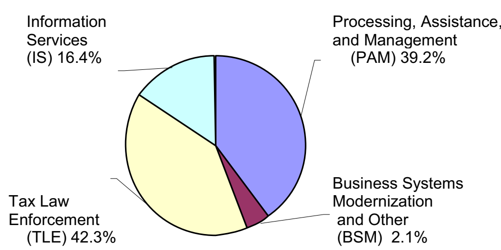


INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2005

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 the processing of tax returns and related documents, assistance for taxpayers in the filing of their returns and paying taxes due, matching information with returns, conducting internal audit reviews and security investigations and managing financial resources. The Tax Law Enforcement appropriation provides funds for the examination of tax returns and the administrative and judicial settlement of taxpayer appeals of examination findings, as well as providing resources for expanded customer service and education, strengthened enforcement and enhanced research 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 information and telecommunications support for the Service's 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.

Budget Fiscal Year 2005 Appropriations – (Percent)

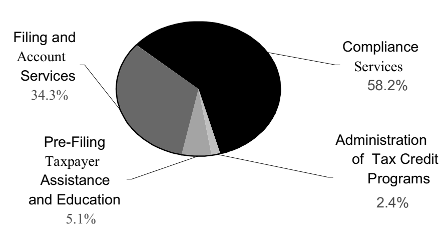


Besides appropriations, the Service utilizes other financing sources. These include net transfers from other federal agencies, User Fees for direct services provided to customers (for example, installment fees, photocopy fees, and letter rulings and determinations fees) and imputed financing (subsidies from other federal funds that cover specific expenses such as retirement benefits).

c. Use of Resources

The Statement of Net Cost reflects the use of resources in carrying out the agency's major programs.

How the Service Used Its Resources - (Percent)



INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2005

The major programs are Pre-filing, Filing and Account Services, Compliance and Administration of Tax Credit Programs (EITC and HCTC). Pre-filing activities include taxpayer education and outreach, pre-filing agreements and tax publication issuance and distribution. Filing and Account Services activities include the filing of tax returns, current account status and processing of taxpayer information. Compliance activities include document matching, audits, and criminal investigation activities. Administration of the Tax Credit programs includes EITC pre-filing, filing and account services, and compliance activities 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. Overall revenue receipts ($2.267 trillion) for FY 2005 increased by approximately 12% from FY2004 to FY2005. Individual income taxes, which include both FICA and SECA taxes, increased by 10%. Corporate income taxes increased by 33%. Collections from all other tax sources increased 3% from FY2004 to FY2005.

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 2004 liabilities. Contributing factors include the higher 2004 incomes, lower 2004 deductions and a higher effective tax rate on 2004 taxable income reported in Fiscal Year 2005. Net corporate receipts increased due to the growth in gross corporate tax receipts and the decrease in refunds. Net IRS excise tax receipts increased in line with the expansion of the economy.

Federal tax refund activity, which includes tax, interest, payments for Earned Income Tax Credit and Child Care Tax Credit in excess of the tax liability was $267 billion. In fiscal year 2005, the Service issued $62 million in advance payments of the Earned Income Tax Credit. Overall refund disbursements decreased by 4% from FY2004 to FY2005.

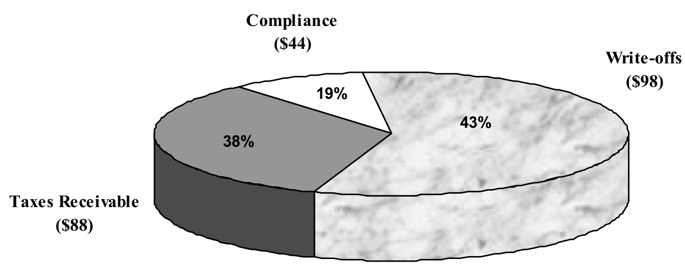
Analysis of Unpaid Assessments
Most Unpaid Assessments Are Not Receivables and Are Largely Uncollectible

This unpaid assessment balance represents assessments resulting from taxpayers filing returns without sufficient payment; as well as from the Service's enforcement programs such as Examination, Underreporter, Substitute for Return and Combined Annual Wage Reporting. As reflected in the supplemental information to the IRS' fiscal year 2005 Financial Statements, the unpaid assessment balance was about $230 billion as of September 30, 2005.

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.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2005

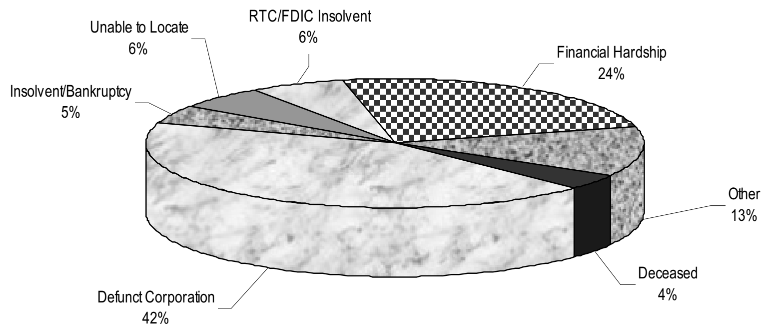
Components of the IRS' $230 Billion of Unpaid Assessments



Of the $230 billion balance of unpaid assessments, $98 billion represents write-offs. Write-offs include amounts owed by defunct corporations with no assets and include many 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. Write-offs at September 30, 2005 ($98 billion) decreased about 15% from September 30, 2004 ($115 billion) due primarily to the expiration of the statute for collections on amounts owed by defunct corporations and failed financial institutions. In FY2005, statutes expired for $21 billion of failed financial institution unpaid assessment accounts assisted by the RTC and the FDIC.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2005

Components of the IRS' $98 Billion of Write-offs



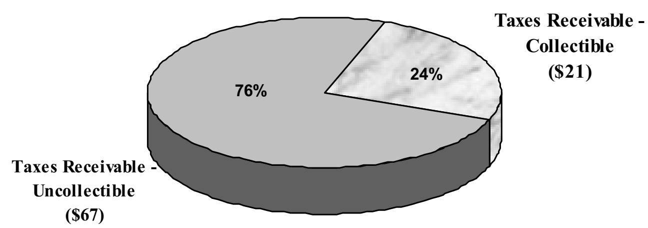
The $44 billion of the unpaid assessments representing compliance assessment are amounts that have not been agreed to by either the taxpayer or a court. These assessments result primarily from various Service enforcement programs promoting voluntary compliance. Due to the lack of agreement, they have less potential for future collection than the unpaid assessments considered federal taxes receivable.

The remaining $88 billion of unpaid assessments represent federal taxes receivable. About $67 billion (76%) 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. However, under certain conditions, 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 (24%) of federal taxes receivable is estimated to be collectible. Components of the collectible balance include 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, 2004 ($89 billion) to September 30, 2005 ($88 billion) decreased by $1 billion. The percent estimated to be collectible at September 30, 2005 (24%), increased from September 30, 2004 (22%).

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2005

Components of the IRS' $88 Billion of Taxes Receivable

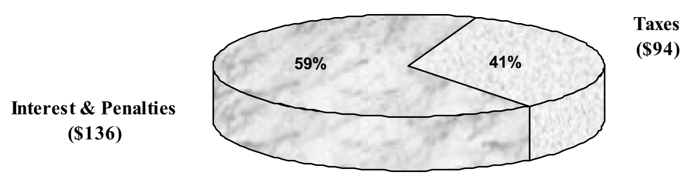


It is important to note that the unpaid assessment balance contains unpaid assessed tax, penalty, and interest and accrued penalty and interest computed through September 30, 2005.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2005

About $136 billion (59%) of the unpaid assessment balance as of September 30, 2005, consists of interest and penalties and is largely uncollectible.

Unpaid Taxes and Interest and Penalty Components of $230 Billion in Unpaid Assessments



Interest and penalties are such a high percentage of the balance of unpaid assessments because the IRS must continue to accrue them through the 10-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 FDIC and RTC cases, and on exam assessments where taxpayers have not agreed to the amount assessed. The overall decrease in unpaid assessments during fiscal year 2005 was mostly attributable to expiration of the statute for collections on amounts owed by failed financial institutions assisted by the RTC and the FDIC.

FY 2005 Management Discussion and Analysis

ADDENDUM: President's Management Agenda Scorecard

The IRS made steady progress on the President's Management Agenda (PMA) this year, earning "Green" in progress and status on Competitive Sourcing, and "Green" in progress on Human Capital and Budget and Performance Integration. The IRS adjusted its "getting to green plans" to reflect the new "proud to be" criteria to achieve these goals during 2005. In FY 2005, Eliminating Improper Payments became a separate initiative in the President's Management Agenda. Eliminating Improper Payments is geared toward reducing erroneous payments in the Earned Income Tax Credit (EITC) program. EITC is a refundable Federal income tax credit for low-income working individuals and families and is the IRS' only program impacted by the Improper Payments and Information Act of 2002 (IPIA).

IPIA requires agencies to annually review programs and activities to identify those susceptible to significant erroneous payments. Under implementing OMB guidance, "Significant" means the estimated error rate and dollar amount exceed the threshold of 2.5% of program payments and $10 million. Once agencies identify high-risk programs, a method for systematically reviewing them is developed using statistically valid sampling to determine error rates. If those rates, when applied to total program funding, result in a level of improper payments greater than or equal to $10 million, then an action plan is developed for resolving identified problems and reducing errors.

The table below summarizes OMB's scorecard for Treasury for FY 2005.

Initiative		1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
Competitive Sourcing	Status	Green	Green	Green	Green
	Progress	Yellow	Green	Green	Green
Human Capital	Status	Yellow	Yellow	Yellow	Yellow
	Progress	Green	Green	Green	Green
Budget and Performance Integration	Status	Yellow	Yellow	Yellow	Yellow
	Progress	Green	Green	Green	Green
E- Gov	Status	Red	Red	Red	Red
	Progress	Green	Green	Yellow	Green
Eliminating Improper Payments	Status	NR	Red	Red	Red
	Progress	NR	Green	Yellow	Yellow
Financial Performance	Status	Red	Red	Red	Red
	Progress	Yellow	Red	Yellow	Yellow

Green = Meets OMB Scorecard criteria
Yellow = Partially meets scorecard criteria
Red = Does not meet criteria
NR = Not Rated

Major Accomplishments and Future Plans

Human Capital

Accomplished

- Drafted for implementation, pending the IRS Oversight Board approval, the 2005-2009 Human Capital Strategic Plan, which will serve as primary guidance for strategic management of human capital in the IRS.
- Continued workforce restructuring and transition initiatives to achieve optimum mix of skills and optimum ratio of employees in Mission Critical Occupations (MCOs) that directly support tax processing, administration and compliance to non-MCO employees.
- Refined MCO competency models to improve ability to field a high-performing workforce; incorporated results into recruitment marketing; and used results to evaluate competency of MCO applicants.
- Implemented automated recruitment solution CareerConnector for external hiring of selected MCOs enabling the IRS to meet, for certain vacancies, OPM-recommended 45 day standard for filling vacancies.
- Improved talent pool of external MCO hires and provided management greater flexibility to select most qualified candidates through expanded use of category ratings and simulated job situation assessments.
- Partnered with OPM's *Go Learn* initiative to implement web-based Enterprise Learning Management System that managers, employees, and the Learning & Education community will use to manage training and development.
- Launched comprehensive leadership succession planning initiative—first phase of initiative included assessment of 103 executives Servicewide to measure and benchmark competency strengths and weaknesses.
- Implemented human capital governance structure to address issues resulting from large-scale human capital initiatives and to ensure fair treatment of impacted employees.
- Executed new recruitment marketing contract, maintained active media campaign, produced new multi-media job previews, updated the IRS careers website and continued fostering partnering relationships with over 200 colleges and universities.
- Used all available tools (e.g., early outs, buyouts) and developed new tools (e.g., relocation bonuses) to support and mitigate impacts of workforce restructuring.
- Developed, at direction of the Chief Human Capital Officer, HCO Concept of Operations that articulates HCO's vision, mission, values, role, responsibilities and Lines of Business.
- Executed Service Level Agreements with internal customers describing services HCO will provide, HCO and customer commitments and measurement of HCO performance.

Planned

- Develop Human Capital Strategic Implementation Plan to include significant human capital programs that will implement IRS' Human Capital Strategic Plan over the next two years and provide accountability for program performance.
- Continue study of leadership development training to ensure training provides leadership with skills and knowledge needed to be effective in today's environment, focusing on curriculum and content delivery, attracting employees with high leadership potential, and building a supportive learning environment.

FY 2005 Management Discussion and Analysis

- Deploy a Learning Content Management System that will permit more efficient development of training materials and ensure more consistency in training across the IRS.
- Complete the conversion of all MCO application processes to the CareerConnector system and begin the conversion of the non-MCO occupations.

Competitive Sourcing

Accomplished

- Received the 2004 President's Quality Award for Innovation in Competitive Sourcing (CS).
- Recognized in March 2005 with the 2004 NISH organization's Government Award for Services for Service-wide Mail and Toll Free Forms Taxpayer virtual call center contracts issued under the Javits-Wagner-O'Day Act providing work opportunities for disabled individuals including first time home-based employment for people with disabilities.
- Implemented National Distribution Center (NDC) competitive sourcing initiative enabling the IRS to cancel leases releasing approximately 395,000 square feet and reducing rent by $4.1 million.
- Launched Competitive Sourcing Internet knowledge sharing content at www.irs.gov and Share A-76.
- Developed "Managing an Effective Competitive Sourcing Program" DVD training sponsored by the Federal Acquisition Institute.
- Completed 2005 FAIR Act Inventory for all of Treasury on schedule.
- Implemented Microsoft Project Server enhancing project management discipline across all support functions—HR, Procurement, Business Divisions, etc.
- Implemented virtual team rooms using SharePoint software improving team knowledge sharing through secure shared document creation and version control.
- Participated in the HR Connect System walkthrough activity leading to the use of HR Connect for FY 2006 FAIR Act inventory.
- Awarded Campus Files competition to IRS employees who were deemed Most Efficient Organization (MEO).
- Awarded Building Designation contract to private contractor.

Planned

- Conduct Preliminary Planning on Seat Management and Fuel Compliance.
- Continue Business Case Analysis (BCA): Real Estate and Facilities Management.
- Announce Solicitation: Logistics.
- Develop Learning and Education Business Process Re-engineering design.
- Implement approved Shared Services recommendations.
- Lead the development of the second Competitive Sourcing Training DVD.
- Brief the Strategy and Resource Council on proposed potential CS projects to begin BCA planning schedules.
- Capture baseline costing in COMPARE and verify projected economic savings.
- Continue Expert Contractor Delivery of Competitive Sourcing Training (all phases) to IRS employees and managers.

Budget & Performance Integration

FY 2005 Management Discussion and Analysis

Accomplished

- Improved Program Assessment Rating Tool (PART) rating to "Moderately Effective" for Submission Processing Program.
- Received PART rating of "Moderately Effective" for Criminal Investigation and Examination Programs.
- Used IFS cost module capabilities to capture cost data for FY 2005, enabling the IRS to analyze direct expense data (labor, supplies, travel, etc), FTEs and on-rolls data from the lowest cost center.
- Completed allocation to distribute support costs to the operational business units.
- Improved performance and efficiency for over half of IRS programs.
- Included programmatic long-term goals in FY 2007 budget submission.
- Developed draft set of strategic long-term goals.

Planned

- Reach agreement with the Administration and the Appropriators on the structure of the FY 2007 budget request.
- Link resource needs with expected performance and long term goals in the FY 2007 Congressional Justification.
- Continue to assess and use the cost data obtained through IFS to further develop robust cost-based performance measures for major programs.
- Continue efforts to identify long-term goals for Regulatory Compliance and Research.
- Introduce enterprise-wide goals linking directly to the IRS Strategic Plan.
- Expand the pay for performance system to frontline managers linking performance results with salary increases.
- Develop FY 2008 congressional request linking resource needs with expected performance and long term goals.
- Submit remaining programs to OMB for an initial PART assessment.

E-Government

Accomplished

- Processed over five million Free File returns in 2005, representing a 43% increase over the prior year.
- Expanded support of electronic filing of business forms by completing agreements with New York and Georgia to link state registration applications to the federal Internet Employer Identification Number (EIN) application for a one-stop experience.
- Expanded electronic filing of additional business forms: 1120, 990, and 94X series.
- Actively supported other e-gov initiatives, such as Business Gateway, grants.gov, and GovBenefits.gov.
- Implemented an eCatalog (eCat) pilot program to begin an Integrated Acquisition Environment which will use Contract Optimization and Strategic Contracts as tools to incur savings.
- Identified IFS alternative from Line of Business Initiative to implement as the IFS Go Forward Strategy.
- Completed the security certification and accreditation of its network infrastructure general support systems making substantial progress in improving the Federal Information System Management Act (FISMA) compliance status of all IRS information systems.
- Developed General Support Systems (GSS) and Major Applications' Plans of Actions and Milestones (PoAMs) to manage, monitor and track corrective actions.

FY 2005 Management Discussion and Analysis

Planned

- Ensure all GSS certification and accreditations and Major Applications conform to IRS and National Institute of Standards and Technology (NIST) standards.
- Develop and test an Enterprise Information Technology Contingency (Disaster Recovery) Strategy.
- Monitor GSS and Major Applications' Plans of Actions and Milestones quarterly for identified corrective actions.
- Participate in Business Gateway Advisory and Governance Boards to come to agreement on scope and next steps for Business Gateway components.
- Define high level resource requirements and timeline for the IFS Go Forward Strategy.
- Ensure that all Non Major Applications attain NIST compliant Certification and Accreditation.

Financial Performance

Accomplished

- Continued to meet Treasury's TIER 3-day close financial reporting requirements.
- Achieved full operating capability for Release 1.0 of the Integrated Financial System (IFS).
- Developed a Computer Security material weakness plan that addresses deficiencies in access controls, rules of behavior, contingency planning and disaster recovery, audit trails, training and certification and accreditation.
- Maintained clean audit opinion on FY 2004 financial statements.
- Performed a cross-walk of the Interim Revenue Accounting Control System (IRACS) to a compliant US Standard General Ledger (US SGL) structure for year-end financial statements.
- Identified and assigned financial information executives need to facilitate critical decision making.
- Continued implementation of NIST compliant training program.
- Conducted IFS Cost workshop to gather operational needs and establish process for reports development August 2005.

Planned

- Meet administrative financial statement reporting deadlines through IFS.
- Complete IFS Milestone 5 and implement plan to transition from PRIME to the IRS.
- Develop and test a new data base to store Trust Fund Recovery Penalty (TFRP) and Unpaid Assessment data which will become the foundation of the Custodial Detailed Data Base (CDDB) and the subsidiary ledger for all unpaid assessments.
- Put the CDDB revenue transaction database into production and test reports.
- Maintain current parallel processes and implement changes as needed to ensure a clean audit opinion on the Statement of Custodial Activity.
- Identify systems that enable us to link cost to performance.
- Produce the automated Statement of Net Cost in IFS.

Eliminating Improper Payments

Accomplished

- Developed a detailed, long-term EITC business plan, a Concept of Operations, based on a balanced approach.
- Developed an estimate of the overall EITC error rate.

FY 2005 Management Discussion and Analysis

- Completed FY 2004 qualifying child certification and Filing Status test.
- Finalized new participant selection methodology for FY 2005 qualifying child certification test.
- Completed final report to Congress on results of FY 2004 qualifying child certification and filing status tests.
- Evaluated research initiatives and assessed prior year studies to improve EITC outreach, compliance initiatives, program delivery and measurement strategies.

Planned

- Launch the final phase of the qualifying child certification test—focus on improved selection methodology.
- Complete compliance analysis of TY 2001 returns claiming EITC (National Research Program).
- Continue to develop and distribute materials to educate taxpayers and practitioners on EITC eligibility rules and compliance issues.
- Report results of the National Directory of New Hires database match test.
- Plan for TY 2006 compliance study.
- Launch integrated decision support tool for EITC examiners.
- Launch new risk-based scoring strategy and inventory management capability to improve selection and assignment of EITC returns for examination.
- Complete evaluation of FY 2004 certification, filing status and income misreporting tests.
- Test new selection tools to determine more effective compliance treatments for return preparers.
- Complete evaluation of FY 2005 certification and filing status tests.
- Launch significantly enhanced methodology to improve the selection of EITC amended returns for examination.
- Update EITC Strategy and Program plan and identify EITC education and outreach targets based on results from FY 2004, FY 2005 and FY 2006 tests.

Financial Statements

Balance Sheets

Internal Revenue Service
Balance Sheet
As of September 30, 2005 and 2004

(In Millions)

Assets	**2005**	**2004**
Intragovernmental:		
Fund balance with Treasury (Note 2)	$ 1,990	$ 1,725
Due from Treasury (Note 13)	1,946	1,801
Other assets (Note 4)	150	149
Total Intragovernmental	**4,086**	**3,675**
With the Public:		
Cash and other monetary assets (Notes 3, 13)	466	86
Federal Taxes receivable, net of allowance for doubtful accounts (Notes 5, 13)	21,000	20,000
Other assets (Note 4)	12	21
Total with the Public	**21,478**	**20,107**
Property and equipment, Net (Note 6)	1,422	1,775
Total Assets	**$ 26,986**	**$ 25,557**
Liabilities		
Intragovernmental:		
Due to Treasury (Notes 5, 13)	$ 21,000	$ 20,000
Other liabilities (Note 7)	174	165
Total Intragovernmental	**21,174**	**20,165**
Federal tax refunds payable (Note 13)	1,946	1,801
Other liabilities (Notes 7 to 10)	1,973	1,524
Total Liabilities	**$ 25,093**	**$ 23,490**
Net position		
Unexpended Appropriations	$ 1,538	$ 1,255
Cumulative Results of Operations	355	812
Total Net Position	**$ 1,893**	**$ 2,067**
Total Liabilities and Net Position	**$ 26,986**	**$ 25,557**

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, 2005 and 2004

(In Millions)

Program	2005	2004
Pre-Filing Taxpayer Assistance and Education		
Full cost	$ 627	$ 673
Exchange revenue	(46)	(59)
Net cost of program	**581**	**614**
Filing and Account Services		
Full cost	3,970	3,452
Exchange revenue	(43)	(69)
Net cost of program	**3,927**	**3,383**
Compliance Services		
Full cost	6,859	6,280
Exchange revenue	(183)	(159)
Net cost of program	**6,676**	**6,121**
Administration of Tax Credit Programs		
Full cost	279	280
Exchange revenue	-	-
Net cost of program	**279**	**280**
Net Cost of Operations (Note 17)	**$ 11,463**	**$ 10,398**

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, 2005 and 2004

(In Millions)

	2005 Cumulative Results of Operations	2005 Unexpended Appropriations	2004 Cumulative Results of Operations	2004 Unexpended Appropriations
Beginning Balances	**$ 812**	**$ 1,255**	**$ 647**	**$ 1,139**
Budgetary Financing Sources:				
Appropriations received		10,318		10,245
Canceled appropriations and rescissions and other	(129)	3		(138)
Appropriations used	10,038	(10,038)	9,991	(9,991)
Other Financing Sources:				
Imputed financing from costs absorbed by others	1,121		611	
Transfers in/out without reimbursement	15		15	
Transfers to General Fund	(39)		(54)	
Total Financing Sources	**11,006**	**283**	**10,563**	**116**
Net Cost of Operations	**(11,463)**		**(10,398)**	
Net Change	**(457)**	**283**	**165**	**116**
Ending Balances	**$ 355**	**$ 1,538**	**$ 812**	**$ 1,255**

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, 2005 and 2004

(In Millions)

	2005	2004
Budgetary Resources:		
Budget authority:		
Budgetary appropriations received (Note 11)	$ 10,408	$ 10,329
Unobligated balance, beginning of period	570	473
Spending authority from offsetting collections (Note 19)	161	173
Recoveries of prior year obligations	59	154
Permanently not available	(126)	(138)
Total Budgetary Resources	**$ 11,072**	**$ 10,991**
Status of Budgetary Resources:		
Obligations incurred (Note 18)	$ 10,584	$ 10,421
Unobligated balance – available (Note 2)	252	178
Unobligated balance – not available (Note 2)	236	392
Total Status of Budgetary Resources	**$ 11,072**	**$ 10,991**
Relationship of Obligations to Outlays:		
Obligated balance, net, beginning of period	$ 1,161	$ 1,266
Obligated balance, net, end of period (Note 12)	(1,511)	(1,161)
Outlays:		
Disbursements	$ 10,179	$ 10,372
Less: collections	(164)	(173)
Less: offsetting receipts	(91)	(89)
Net Outlays	**$ 9,924**	**$ 10,110**

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, 2005 and 2004

(In Millions)

	2005	2004
Resources Used to Finance Activities:		
Budgetary Resources Obligated:		
Obligations incurred (Note 18)	$ 10,584	$ 10,421
Less: spending authority from offsetting collections and recoveries	(220)	(327)
Less: offsetting receipts	(91)	(89)
Net obligations	**10,273**	**10,005**
Imputed financing from costs absorbed by others	1,121	611
Transfers in/out without reimbursement	15	15
Other resources used to finance activities, net	91	(48)
Total Resources Used to Finance Activities	**$ 11,500**	**$ 10,583**
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	$ (340)	$ (40)
Resources that finance the acquisition of assets	(286)	(572)
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	**(626)**	**(612)**
Total Resources Used to Finance the Net Cost of Operations	**$ 10,874**	**$ 9,971**
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	$ 6	$ 22
Other	(28)	15
Components Not Requiring or Generating Resources in Future Periods		
Depreciation and amortization	464	390
Revaluation of assets or liabilities	147	-
Total Components of Net Cost of Operations That Will Not Require or Generate Resources in the Current Period	**$ 589**	**$ 427**
Net Cost of Operations	**$ 11,463**	**$ 10,398**

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, 2005 and 2004

(In Billions)

	2005	2004
REVENUE ACTIVITY		
Collections of Federal Tax Revenue (Note 15)		
Individual income, FICA/SECA, and other	$ 1,865	$ 1,696
Corporate income	307	230
Excise	58	55
Estate and gift	26	26
Railroad retirement	4	4
Federal unemployment	7	7
Total Collections of Federal Tax Revenue	**2,267**	**2,018**
Increase/(Decrease) in federal taxes receivable, net	1	-
Total Federal Tax Revenue	**2,268**	**2,018**
Distribution of Federal Tax Revenue to Treasury	**2,267**	**2,018**
Increase/(Decrease) in amount due to Treasury	1	-
Total Disposition of Federal Tax Revenue	**2,268**	**2,018**
NET FEDERAL REVENUE ACTIVITY	**$ -**	**$ -**
FEDERAL TAX REFUND ACTIVITY (Note 16)		
Total Refunds of Federal Taxes	**$ 267**	**$ 278**
Appropriations Used for Refund of Federal Taxes	**(267)**	**(278)**
NET FEDERAL TAX REFUND ACTIVITY	**$ -**	**$ -**

The accompanying notes are an integral part of these statements.

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Notes to the Financial Statements

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2005 and 2004

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 accounting principles generally accepted in the United States (GAAP) 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 2005 and FY 2004 information.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2005 and 2004

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.

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 Services

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 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

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2005 and 2004

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.

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), health coverage tax credits (HCTC), and child care credits, as well as overpayments of taxes.

C. Financing Sources and Exchange Revenue

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:

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.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2005 and 2004

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

These budgetary accounts 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 and was included in the Trade Act of 2002.

In addition, the Service incurs certain costs that are paid in total or in part by other federal entities, such as pension costs administered by the Office of Personnel Management and legal judgments paid by the Treasury Judgment Fund. These constitute subsidized costs and are recognized by the Service on its Statement of Changes in Net Position and Statement of Financing as imputed financing sources equal to the cost paid by other federal entities. Pursuant to FASAB Interpretation Number 6 of the Statement of Federal Financial Standards Number 4, in fiscal year 2005, the Service began recording additional imputed financing sources for costs that are paid in total or in part by other entities within the Department of Treasury, notably Financial Management Services for electronic funds transfers.

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.

E. Other Assets – Accounts Receivable and Advances

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. Accounts receivable are also recorded, and transfers-in are recognized, when notices are received from official representatives of the Treasury Forfeiture Fund (TFF) advising IRS of the amount and availability of planned discretionary nonreciprocal distributions of TFF assets to IRS. 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 to government agencies primarily represent funds paid to the Treasury Working Capital Fund (WCF). Amounts in the fund are available for expenses of operating and maintaining common administrative services of Treasury that can be performed more economically as a centralized service. Centralized services funded through the WCF for the Service consist primarily of telecommunications services, payroll processing, and depreciation of property and equipment owned by the WCF.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2005 and 2004

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

The net book values of Property and Equipment as of September 30, 2005 and 2004 consist of the following components:

Property and Equipment Acquisitions

Property and equipment is recorded at historical cost. The Service acquires property and equipment through direct purchase, construction, development of software and systems, and through capital lease agreements. Property and equipment consists of tangible assets and software that are intended for use by the Service and have an estimated life of two years or greater. 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 with a half year depreciated 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 equipment: 1) mainframe computers and related equipment, 2) minicomputers and related equipment, 3) local area network (LAN) servers and related equipment, 4) desktop and laptop computers and related equipment, and 5) telecommunications equipment. ADP equipment includes all related software, including commercial off-the-shelf software, except as separately stated under Internal Use Software discussed below. Mainframe computers and related equipment, minicomputers and related equipment, and telecommunications equipment have an estimated useful life of seven years. LAN servers and equipment have an estimated useful life of four years. Desktop and laptop computers and related equipment have an estimated useful life of three years.

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. The estimated useful life of office equipment and investigative equipment is ten years. Furniture has an estimated useful life of eight years, and vehicles have an estimated useful life of five years.

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. Major systems capitalized prior to September 30, 2000, had an estimated useful life of seven years, and continue to be depreciated over their remaining useful lives.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2005 and 2004

Internal Use Software

In accordance with Statement of Federal Financial Accounting Standards No. 10 (*SFFAS No. 10*), *Accounting for Internal Use Software*, beginning in FY 2001, the Service capitalizes all internal use software projects recognized and authorized by management as major development projects. Only projects with useful lives of two years or more and recognized as major development projects by the Modernization and Information Technology Services Executive Governance Council are capitalized.

The Service capitalizes direct and indirect costs of internal use software incurred in the development phase of a project as defined in the *SFFAS No. 10*. 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. Direct costs exclude maintenance contracts in effect at any time during development or thereafter.

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.

In accordance with *SFFAS No. 10*, costs incurred for the development phase of a project are capitalized, while costs incurred for design (prior to the development phase) and operations (after the development phase) are expensed. The design phase, defined by *Standard No. 10,* includes conceptual formulation of alternatives, determination and testing of alternatives, determination of existence of needed technology, and final selection of alternatives. The development phase includes developing the software configuration and interfaces, coding, installation of hardware and software, and testing. The operational phase begins upon successful completion of testing.

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. Internal use software has an estimated useful life of seven years with no residual value, and is depreciated using the straight-line method with a half-year convention in the first and final years.

In accordance with *SFFAS No. 10*, disposals are recognized when software is determined to be obsolete or nonfunctional. The IRS treats terminated projects and/or subprojects as 100% obsolete. Obsolete projects are adjusted to reduce both the asset and accumulated depreciation accounts, and record any losses as a result of the disposal.

Leasehold Improvements

All leasehold improvement projects are capitalized regardless of cost. Leasehold improvements have an estimated useful life of ten years.

G. Capital Lease Liability

Capital lease liability includes amounts for non-ADP equipment and computer software leased under software licensing agreements. The liability reported represents the lesser of the net present value of future lease payments or the fair market value of the asset acquired. The liability for non-ADP equipment acquired under a capital lease is included in funded liabilities. The liability for software licenses is generally included in Liabilities Not Covered by Budgetary Resources.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2005 and 2004

H. 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.

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

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.

J. 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 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

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2005 and 2004

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.

Note 2. Fund Balance with Treasury (In Millions)

Fund balance with Treasury as of September 30, 2005 and 2004, consist of the following:

Fund Balance	2005	2004
Appropriated funds and other	$ 1,990	$ 1,725
Fund Balance with Treasury	**$ 1,990**	**$ 1,725**

Status of Fund Balance with Treasury	2005	2004
Unobligated balances:		
Available	$ 252	$ 178
Unavailable	236	392
Obligated balances not yet disbursed	1,508	1,161
Other funds	(6)	(6)
Fund Balance with Treasury	**$ 1,990**	**$ 1,725**

The Business Systems Modernization (BSM) fund represents $297 million and $340 million of the appropriated fund balance as of September 30, 2005 and 2004, 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.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2005 and 2004

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

Cash and other monetary assets with the public as of September 30, 2005 and 2004, consist of the following:

	2005	2004
Imprest fund	$ 4	$ 3
Other custodial assets	462	83
Total Cash and Other Monetary Assets	**$ 466**	**$ 86**

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, 2005 and $1 million as of September 30, 2004, 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.

Note 4. Other Assets (In Millions)

Other assets as of September 30, 2005 and 2004, consist of the following:

	2005		2004	
	Intra-Governmental	**With the Public**	**Intra-Governmental**	**With the Public**
Advances	$ 130	$ 8	$ 129	$ 12
Accounts receivable, net	16	7	19	7
Federal tax lien revolving fund	-	2	-	1
Suspense	4	(5)	1	1
Total Other Assets	**$ 150**	**$ 12**	**$ 149**	**$ 21**

Note 5. Federal Taxes Receivable, Net

Federal taxes receivable (gross) were $88 billion and $89 billion as of September 30, 2005 and 2004, 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 and $20 billion as of September 30, 2005 and 2004, 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 $67 billion and $69 billion was established in FY 2005 and FY 2004, respectively, for the difference between the gross federal taxes receivable and the portion estimated to be collectible. Due to

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2005 and 2004

Treasury is the offsetting liability to federal taxes receivable, representing amounts to be transferred to Treasury when collected.

Note 6. Property and Equipment (In Millions)

Property and Equipment as of September 30, 2005 and 2004, is shown in the schedule below. The Cost column primarily represents the actual cost of property and equipment, net of disposals. The cost basis for FY 2005 and FY 2004 is $3,502 million and $3,422 million, respectively. Accumulated depreciation for FY 2005 and FY 2004 is $2,080 million and $1,647 million, respectively.

Category	Useful Life	Cost	Accumulated Depreciation	2005 Net Book Value	2004 Net Book Value
ADP assets	3 to 7 Years	$ 1,730	$ (1,228)	$ 502	$ 534
Furniture and non-ADP equipment	8 to 10 Years	59	(39)	20	24
Investigative equipment	10 Years	12	(9)	3	3
Vehicles	5 Years	86	(60)	26	25
Major systems	7 Years	422	(333)	89	150
Internal use software	7 Years	653	(145)	508	104
Internal use software – work in process		35	-	35	635
Leasehold improvements	10 Years	423	(221)	202	225
Assets Under Capital Lease	4 to 10 Years	82	(45)	37	75
Total Property and Equipment		**$ 3,502**	**$ (2,080)**	**$ 1,422**	**$ 1,775**

Prior to FY 2001, the Service captured the costs of major systems consulting and contractual services in the category "Major Systems". The Service has ten systems it considers major systems as of September 30, 2005 and 2004. As of September 30, 2005, major systems consisted largely of costs associated with re-engineering the Martinsburg and Tennessee Computing Centers, known as the Mainframe Consolidation project, and a system to convert paper tax documents and remittances into electronic records, known as the Integrated Submission and Remittance Processing System.

Major systems consist of the following:

Category	Cost	Accumulated Depreciation	2005 Net Book Value	2004 Net Book Value
Mainframe consolidation	$ 201	$ (158)	$ 43	$ 72
Integrated Submission and Remittance Processing System	97	(76)	21	35
Other	124	(99)	25	43
Totals	**$ 422**	**$ (333)**	**$ 89**	**$ 150**

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2005 and 2004

After FY 2000, the Service captured development of major systems as Internal Use Software. As of September 30, 2005 and 2004, the Service has 15 internal use software projects, including deployed and work in process. Several projects are being deployed in phases (releases) as those releases become functional and are placed into service. Deployed projects include Customer Account Data Engine (Release 1), E-Services, Modernized E-File (Releases 1, 2, and 3.1), Security and Technology Infrastructure Release (STIR), Integrated Financial System (IFS), Internet Refund Fact of Filing, Enterprise Systems Management (ESM), and Customer Communications. 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 to communicate with the public and expand electronic filing of returns and requests. Modernized E-File is an electronic filing system for corporate tax returns. STIR is a project to modernize and standardize the information technology security infrastructure throughout the Service. IFS is an administrative financial system that was deployed at the start of fiscal year 2005. Internet Refund Fact of Filing is a project to allow taxpayers to review the status of their refund. ESM is a project that created a new information technology infrastructure, and Customer Communications is a customer service telephone system.

Deployed internal use software projects consist of the following:

Category	Cost	Accumulated depreciation	2005 Net book value	2004 Net book value
Integrated Financial System	$ 148	$ (10)	$ 138	$
Modernized E-File	113	(22)	91	
E-Services	142	(30)	112	
CADE	107	(23)	84	
STIR	76	(27)	49	60
Customer Communications	25	(15)	10	14
Enterprise Systems Management	16	(6)	10	12
Internet Refund Fact of Filing	15	(5)	10	12
Other	11	(7)	4	6
Totals	**$ 653**	**$ (145)**	**$ 508**	**$ 104**

Until deployed, internal use software projects are carried as work in process. Major projects in process include Customer Account Data Engine (Release 2) (CADE Release 2) and Modernized E-File Release 3.2. All development work on Custodial Accounting Project (CAP), a project that was in work in process, was stopped in fiscal year 2005 due to funding issues. The costs accumulated in work in process for CAP were $143 million when the project ended. These costs have been recognized as a loss on disposal in the current fiscal year.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2005 and 2004

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

Category	2005	2004
Customer Account Data Engine	$ 18	$ 119
Integrated Financial Systems	-	140
Custodial Accounting Project	-	130
E-Services	-	147
Modernized E-File	15	96
Other	2	3
Totals	**$ 35**	**$ 635**

Equipment and software licenses acquired through capital leases are included in the categories below. Disclosures concerning associated capital lease liabilities are provided in Notes 7 and 8.

Category	Useful Life	Cost	Accumulated Depreciation	2005 Net Book Value	2004 Net Book Value
ADP Assets – Software Licenses	7 Years	$ 77	$ (43)	$ 34	$ 73
ADP Assets - Equipment	4 Years	3	(1)	2	-
Equipment – Photocopiers	10 Years	2	(1)	1	2
Totals		**$ 82**	**$ (45)**	**$ 37**	**$ 75**

Note 7. Other Liabilities (In Millions)

Other liabilities as of September 30, 2005 and 2004, consist of the following:

	2005		2004	
	Intra-Governmental	With the Public	Intra-Governmental	With the Public
Accounts payable	$ -	$ 81	$ -	$ -
Accrued expenses	30	201	30	188
Accrued payroll and benefits	51	222	42	199
Workers' compensation	92	520	92	547
Accrued annual leave	-	462	-	456
Other custodial liabilities	-	462	-	83
Capital leases	1	25	1	51
Total Other Liabilities	**$ 174**	**$ 1,973**	**$ 165**	**$ 1,524**

Other custodial liabilities (the offsetting liability to other custodial assets) primarily consist of liabilities to taxpayers for deposits pending application of the funds to outstanding tax deficiencies and liability for seized monies.

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INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2005 and 2004

Note 8. Leases (In Millions)

The capital lease liability as of September 30, 2005 and 2004, is $26 million and $52 million, respectively, for photocopiers and software licenses. In FY 2005 and FY 2004, photocopiers were leased under Lease-To-Ownership-Plans (LTOPs). The terms of the LTOPs provide for 48 to 60 monthly payments for photocopiers. Under each LTOP, the equipment is owned as of the last monthly payment. Capital lease treatment is accorded to computer software leased under software licensing agreements. These licensing agreements provide for payments over periods ranging from four to six years. During 2005, final payments were made on two leases for software licenses. In FY 2005, ADP Equipment was acquired under a 48 month capital lease, with payments in the first and second year of the agreement. The ADP equipment will be returned to the vendor after the end of the 48 months. Interest rates for capital leases range from 6 to 15 percent.

Future payments due on capital leases are as follows:

	Total	2006	2007	2008	2009	2010 and beyond
Photocopiers	$ 1	$ 1	$ -	$ -	$ -	$ -
Software licenses	24	13	11	-	-	-
ADP Equipment	2	2	-	-	-	-
Total Lease Obligations	**$ 27**	**$ 16**	**$ 11**	**$ -**	**$ -**	**$ -**
Less: interest	(1)					
Present Value of Lease Payments	$ 26					
Lease Liabilities covered by budgetary resources	$ 3					
Lease Liabilities not covered by budgetary resources	$ 23					

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. Contingencies

The Service is subject to contingent liabilities involving litigation cases whose ultimate disposition is unknown. Based on the information currently available, however, it is management's opinion that the expected outcome of these matters, either individually or in the aggregate, will not have a material effect on the financial statements.

As of September 30, 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, 2005 and 2004

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

Liabilities not covered by budgetary resources as of September 30, 2005 and 2004, consist of the following:

	2005		2004	
	Intra-Governmental	With the Public	Intra-Governmental	With the Public
Workers' compensation	$ 92	$ 520	$ 92	$ 547
Accrued annual leave	-	462	-	456
Capital lease liability	-	23	-	51

Note 11 Appropriations Received

Appropriations received reported in the Statement of Budgetary Resources in FY 2005 and FY 2004, include $90 million and $84 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, 2005 and 2004, in the Statement of Budgetary Resources are as follows:

	2005	2004
Undelivered orders – unpaid	$ (941)	$ (718)
Budgetary accounts payable	(587)	(462)
Budgetary accounts receivable	17	19
Total Obligated Balances	**$ (1,511)**	**$ (1,161)**

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2005 and 2004

Note 13. Nonentity Assets (In Millions)

Nonentity 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. Nonentity assets as of September 30, 2005 and 2004, consist of the following:

	2005		2004	
	Intra-Governmental	With the Public	Intra-Governmental	With the Public
Due from Treasury	$ 1,946	$ -	$ 1,801	$ -
Federal taxes receivable, net of allowance for doubtful accounts	-	21,000	-	20,000
Other custodial assets	-	462	-	83

Due from Treasury represents tax refunds due to taxpayers but not disbursed as of September 30, 2005 and 2004.

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)

Statement of Federal Financial Accounting Standards No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting,* calls for explanations of material differences between budgetary resources available, status of those resources and outlays as presented in the Statement of Budgetary Resources (SBR) to the related actual balances published in the *Budget of the United States Government*. However, the *Budget of the United States Government* that will include FY 2005 actual budgetary execution information has not yet been published. The *Budget of the United States Government* is scheduled for publication in January 2006. Accordingly, information required for such disclosure is not available at the time of publication of these financial statements.

Balances reported in the FY 2004 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.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2005 and 2004

	FY 2004	
	Statement of Budgetary Resources	**President's Budget**
Processing, Assistance, and Management, Tax Law Enforcement, and Information Systems:		
Total budgetary resources	$ 10,317	$ 10,070
Status of budgetary resources:		
Obligations incurred	10,041	9,992
Unobligated balances – available	74	78
Unobligated balances – unavailable	202	-
Total status of budgetary resources	$ 10,317	$ 10,070
Outlays	$ 9,764	$ 9,764
Business Systems Modernization Fund:		
Total budgetary resources	$ 571	$ 567
Status of budgetary resources:		
Obligations incurred	335	334
Unobligated balances – available	91	233
Unobligated balances – unavailable	145	-
Total status of budgetary resources	$ 571	$ 567
Outlays	$ 391	$ 391

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. Outlays are reported the same in both statements.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2005 and 2004

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, 2005 and 2004, and by tax year for fiscal year ended September 30, 2005, is as follows:

	Tax Year				Collections Received	Collections Received
	2005	2004	2003	Prior Years	FY 2005	FY 2004
Individual income, FICA/SECA, and other	$ 1,212 *	$ 621	$ 14	$ 18	$ 1,865	$ 1,696
Corporate income	210 **	83	1	13	307	230
Excise	42	15	-	1	58	55
Estate and gift	-	17	1	8	26	26
Railroad retirement	3	1	-	-	4	4
Federal unemployment	5	2	-	-	7	7
Total	**$ 1,472**	**$ 739**	**$ 16**	**$ 40**	**$ 2,267**	**$ 2,018**
	65%	32%	1%	2%	100%	

* Includes other collections of $574 million.
** Includes tax year 2006 corporate income tax receipts of $9 billion.

In FY 2005, Individual income, FICA/SECA, and other taxes include $68 billion in payroll taxes collected from other federal agencies. Of this amount, $11 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, 2005 and 2004, and by tax year for fiscal year ended September 30, 2005, is as follows:

	Tax Year				Refunds Disbursed	Refunds Disbursed
	2005	2004	2003	Prior Years	FY 2005	FY 2004
Individual income, FICA/SECA, and other	$ 1	$ 211	$ 13	$ 6	$ 231	$ 231
Corporate income	1	7	6	22	36	47
Excise	-	-	-	-	-	-
Estate and gift	-	-	-	-	-	-
Railroad retirement	-	-	-	-	-	-
Federal unemployment	-	-	-	-	-	-
Total	**$ 2**	**$ 218**	**$ 19**	**$ 28**	**$ 267**	**$ 278**
	1%	82%	7%	10%	100%	

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

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2005 and 2004

Note 17. Net Cost By Budget Functional Classification (In Millions)

Gross cost and earned revenue for the Service are classified under the budget functional classification of General Government under the President's Budget. Gross cost and earned revenue are categorized as follows:

	Intragovernmental		With the Public		Total	
	2005	2004	2005	2004	2005	2004
Gross cost	$ 3,856	$ 3,374	$ 7,879	$ 7,311	$ 11,735	$ 10,685
Earned revenue	(118)	(123)	(154)	(164)	(272)	(287)
Net cost	**$ 3,738**	**$ 3,251**	**$ 7,725**	**$ 7,147**	**$ 11,463**	**$ 10,398**

Note 18. Obligations Incurred

Each fiscal year, the Office of Management and Budget apportions the Service's budgetary resources under apportionment Category B by activities and/or projects. 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. In FY 2004, the Service incurred $10,256 million in obligations funded by direct appropriations and $165 million funded by reimbursable revenue and transfers from the Treasury Asset Forfeiture Fund.

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

Spending authority from offsetting collections as of September 30, 2005 and 2004, in the Statements of Budgetary Resources and Financing is as follows:

	2005	2004
Reimbursable Revenue	$ 142	$ 150
Receipts for Tax Lien Revolving Fund	5	6
Refunds from Vendors	-	2
Treasury Asset Forfeiture Fund Transfers	14	15
Total Spending Authority From Offsetting Collections	**$ 161**	**$ 173**

INTERNAL REVENUE SERVICE

Supplemental Information - Unaudited

For the Years Ended September 30, 2005 and 2004

Statement of Net Cost by Responsibility Segment (In Millions):

	Net Cost 2005	Net Cost 2004
Operating divisions:		
WAGE	$ 2,422	$ 2,210
SBSE	2,734	2,905
LMSB	771	725
TEGE	251	231
Total	6,178	6,071
Functional support:		
Appeals	210	205
Chief Counsel	308	298
Criminal Investigation	539	472
Taxpayer Advocate	186	180
Communications	24	47
Total	1,267	1,202
Operating Net Cost	**7,445**	**7,273**
General and Administration	1,841	1,400
Information Technology	1,566	1,335
Depreciation/Loss on Disposal	611	390
Total Net Cost	**$ 11,463**	**$ 10,398**

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 2005, the total estimated payout (including principal and interest) for claims pending judicial review by the Federal courts is $11.9 billion and by Appeals is $11.1 billion. In FY 2004, the total estimated payout (including principal and interest) for claims pending judicial review by the Federal courts was $1.7 billion and by Appeals was $6.7 billion. Although these refund claims have been deemed to be probable, they do not meet the criteria in SFFAS No. 5 for reporting the amounts in the balance sheet or for disclosure in the notes to the financial statements; however, they meet the criteria in SFFAS No. 7 for inclusion as supplemental information. 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, 2005 and 2004

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, 2005 and 2004, were as follows:

	2005	2004
Total unpaid assessments	$ 230	$ 237
Less: Compliance assessments	(44)	(33)
Write-offs	(98)	(115)
Gross federal taxes receivable	88	89
Less: Allowance for doubtful accounts	(67)	(69)
Federal taxes receivable, net	**$ 21**	**$ 20**

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 $13 billion as of both September 30, 2005 and 2004, 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 2005, the Service issued $35 billion in EITC refunds. In FY 2004, the Service issued $33 billion in EITC refunds. An additional $5.3 billion and $5.2 billion of the EITC was applied to reduce taxpayer liability for FY 2005 and FY 2004, respectively.

INTERNAL REVENUE SERVICE

Supplemental Information - Unaudited

For the Years Ended September 30, 2005 and 2004

Intra-Governmental Assets (In Millions)

Fiscal Year 2005

Agency	Fund Balance with Treasury	Due from Treasury	Accounts Receivable, Net	Advances to Government Agencies
Treasury	$ 1,990	$ 1,946	$ 16	$ 105
Dept of Interior	-	-	-	25
Other	-	-	-	-
Total	**$ 1,990**	**$ 1,946**	**$ 16**	**$ 130**

Fiscal Year 2004

Agency	Fund Balance with Treasury	Due from Treasury	Accounts Receivable, Net	Advances to Government Agencies
Treasury	$ 1,725	$ 1,801	$ 18	$ 128
Other	-	-	1	1
Total	**$ 1,725**	**$ 1,801**	**$ 19**	**$ 129**

INTERNAL REVENUE SERVICE

Supplemental Information - Unaudited

For the Years Ended September 30, 2005 and 2004

Intra-Governmental Liabilities (In Millions)

Fiscal Year 2005

Agency	Due to Treasury	Accrued Expenses	Accrued Payroll and Benefits	Workers' Compensation
General Fund of the Treasury	$ -	$ -	$ 13	$ -
Treasury	21,000	1	-	-
Department of Labor	-	17	-	92
Office of Pers. Mgmt	-	-	38	-
National Archives	-	2	-	-
GSA	-	5	-	-
US Postal Service	-	3	-	-
Other	-	2	-	-
Total	**$ 21,000**	**$ 30**	**$ 51**	**$ 92**

Fiscal Year 2004

Agency	Due to Treasury	Accrued Expenses	Accrued Payroll and Benefits	Workers' Compensation
General Fund of the Treasury	$ -	$ -	$ 8	$ -
Treasury	20,000	1	-	-
Department of Labor	-	17	-	92
Office of Pers. Mgmt	-	-	34	-
National Archives	-	5	-	-
GSA	-	5	-	-
Other	-	2	-	-
Total	**$ 20,000**	**$ 30**	**$ 42**	**$ 92**

INTERNAL REVENUE SERVICE

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For the Years Ended September 30, 2005 and 2004

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

	Fiscal Year 2005				
	Processing Assistance and Management	Tax Law Enforcement	Information Systems	Business Systems Modernization and Other	Total
Budgetary Resources:					
Budget authority:					
Appropriations received	$ 4,082	$ 4,405	$ 1,711	$ 210	$ 10,408
Unobligated balance – beginning of period	117	79	79	295	570
Spending authority from offsetting collections	46	104	6	5	161
Recoveries of prior year obligations	30	14	12	3	59
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**
Relationship of Obligations to Outlays:					
Obligated balance, net, beginning of period	$ 432	$ 247	$ 358	$ 124	$ 1,161
Obligated balance, net, end of period	(476)	(311)	(533)	(191)	(1,511)
Outlays:					
Disbursements	$ 3,997	$ 4,415	$ 1,492	$ 275	$ 10,179
Less: 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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INTERNAL REVENUE SERVICE

Supplemental Information - Unaudited

For the Years Ended September 30, 2005 and 2004

	Fiscal Year 2004				
	Processing Assistance and Management	**Tax Law Enforcement**	**Information Systems**	**Business Systems Modernization and Other**	**Total**
Budgetary Resources:					
Budget authority:					
Appropriations received	$ 4,092	$ 4,145	$ 1,646	$ 446	$ 10,329
Unobligated balance – beginning of period	88	71	109	205	473
Spending authority from offsetting collections	41	116	10	6	173
Recoveries of prior year obligations	66	34	35	19	154
Permanently not available	(45)	(43)	(47)	(3)	(138)
Total Budgetary Resources	**$ 4,242**	**$ 4,323**	**$ 1,753**	**$ 673**	**$ 10,991**
Status of Budgetary Resources:					
Obligations incurred	$ 4,123	$ 4,244	$ 1,674	$ 380	$ 10,421
Unobligated balance – available	33	26	15	104	178
Unobligated balance not available	86	53	64	189	392
Total Status of Budgetary Resources	**$ 4,242**	**$ 4,323**	**$ 1,753**	**$ 673**	**$ 10,991**
Relationship of Obligations to Outlays:					
Obligated balance, net, beginning of period	$ 498	$ 194	$ 369	$ 205	$ 1,266
Obligated balance, net, end of period	(426)	(247)	(363)	(125)	(1,161)
Outlays:					
Disbursements	$ 4,130	$ 4,156	$ 1,644	$ 442	$ 10,372
Less: collections	(41)	(116)	(9)	(7)	(173)
Less: offsetting receipts	-	-	-	(89)	(89)
Net Outlays	**$ 4,089**	**$ 4,040**	**$ 1,635**	**$ 346**	**$ 10,110**

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INTERNAL REVENUE SERVICE

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For the Years Ended September 30, 2005 and 2004

Child Tax Credit

The child tax credit 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 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. In FY 2004, the Service issued $9 billion in child tax credit refunds. An additional $23 billion of child tax credits were applied to reduce taxpayer liability.

Tax Gap

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 Service currently projects that the annual Federal gross tax gap is somewhere between $312 billion and $353 billion. This estimate is based on the preliminary results of the National Research Program (NRP). The NRP was a study conducted to measure the compliance rate of individual filers based on examination of a statistical sample of their filed returns for tax year 2001. The tax gap arises from three types of noncompliance: not filing timely tax returns (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. Some of the tax gap arises from intentional (willful) noncompliance, and some arises from unintentional mistakes. The tax gap does not include underpayments by corporate taxpayers or include taxes that should have been paid on income from the illegal sector of the economy.

Of the three components, underreporting of income tax, employment taxes and other taxes represents about 80 percent of the tax gap. The single largest sub-component of the underreporting involves individuals understating their incomes, taking improper deductions, overstating business expenses and erroneously claiming credits. Individual underreporting represents about half of the total tax gap. Individual income tax also accounts for about half of all tax liabilities.

The collection gap is the cumulative amount of assessed tax, penalties, and interest that 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).

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Supplemental Information - Unaudited

For the Years Ended September 30, 2005 and 2004

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

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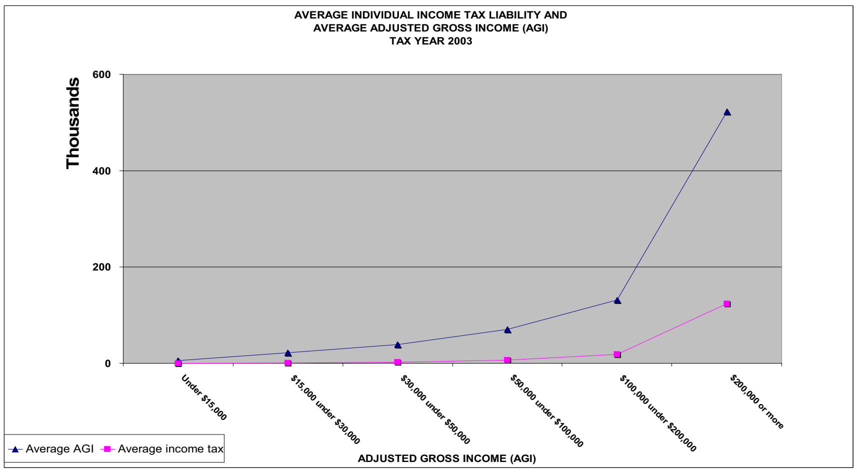
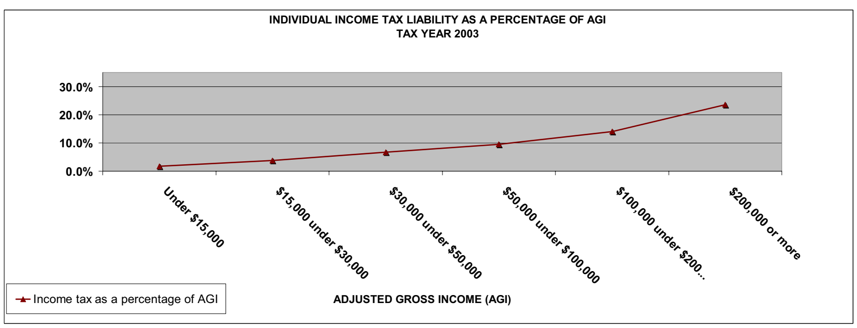
For the Years Ended September 30, 2005 and 2004

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





Adjusted gross income (AGI)	Number of taxable returns (1) (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..	37,985	211,227	3,645	5,561	96	1.7%
$15,000 under $30,000.............................	29,739	653,834	24,728	21,986	832	3.8%
$30,000 under $50,000.............................	24,469	954,681	64,430	39,015	2,633	6.7%
$50,000 under $100,000...........................	26,935	1,889,302	178,640	70,142	6,632	9.5%
$100,000 under $200,000.........................	8,902	1,174,675	164,509	131,966	18,481	14.0%
$200,000 or more.....................................	2,541	1,329,254	314,073	523,154	123,610	23.6%
(1) Includes returns with negative AGI........						
Total...	130,571	6,212,973	750,025	-	-	-

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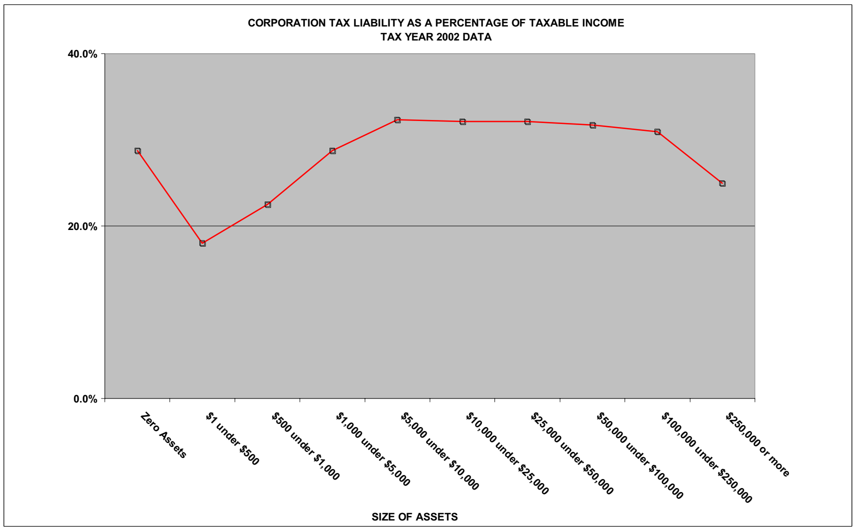
For the Years Ended September 30, 2005 and 2004

(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	8,045	2,311	28.7%
$1 under $500	8,072	1,453	18.0%
$500 under $1,000	3,745	843	22.5%
$1,000 under $5,000	11,750	3,377	28.7%
$5,000 under $10,000	6,413	2,073	32.3%
$10,000 under $25,000	9,358	3,007	32.1%
$25,000 under $50,000	8,640	2,774	32.1%
$50,000 under $100,000	10,090	3,198	31.7%
$100,000 under $250,000	21,072	6,524	31.0%
$250,000 or more	513,369	128,052	24.9%
Total	600,554	153,612	25.6%

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Material Weaknesses, Reportable Conditions, and Compliance Issues

Material Weaknesses

During our audits of the Internal Revenue Service's (IRS) fiscal years 2005 and 2004 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 its 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 2005, 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 2005, IRS (1) did not have an adequate general ledger system for financial reporting purposes, (2) could not determine and report on the specific amount of revenue collected for each of several of the federal government's largest revenue sources, and (3) did not have timely and reliable cost information related to its activities and programs. Although labor-intensive compensating procedures yielded financial statements that were fairly stated as of September 30, 2005 and 2004, they do not afford real-time data needed to assist in managing operations on a day-to-day basis, such as cost-based performance information to assist in making or justifying resource allocation decisions.

[1]GAO, *Financial Audit: IRS's Fiscal Years 2004 and 2003 Financial Statements*, GAO-05-103 (Washington, D.C.: Nov. 10, 2004).

As we noted in last year's report,[2] during fiscal year 2005, 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 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. During fiscal year 2004, we also reported that IRS's general ledger for its tax administration activities did not use the standard federal accounting classification structure, which is documented in the SGL. In fiscal year 2005, IRS implemented an SGL crosswalk for its general ledger for tax administration activities, and this has brought this general ledger into conformance with the SGL classification structure at the account level.

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. IRS expects that IFS will ultimately provide it with an integrated financial management system to account for and control resources. However, this will be achieved only with the implementation of all four of the planned releases of IFS and its integration with the financial management systems that account for its tax administration activities. 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. The remaining future releases of IFS are planned to include property

[2]GAO-05-103.

[3]JFMIP, *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 (OMB), the Department of the Treasury, the Office of Personnel Management, GAO, and 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.

management, procurement, a workload management system, software and functional upgrades, and significant cost accounting enhancements.

If successfully implemented as originally planned, and if integrated with IRS's tax administration activities, IFS may enable IRS to address many of its most long-standing financial management issues, such as the inability to perform meaningful cost benefit analysis to support decision making. However, IRS has indefinitely deferred future releases of IFS due to funding constraints and pending resolution of issues related to implementation of the first phase of IFS, such as ensuring ongoing maintenance support. IRS also experienced technical difficulties recording some types of transactions in IFS during fiscal year 2005. In addition, implementing such a large and complex automated financial system entails substantial learning for personnel responsible for using the system, and this familiarization will take time to accomplish. Consequently, while IRS has begun to see some of the benefits of IFS, such as more readily accessible detailed transaction information and improved audit trails for significant balances, obstacles remain to be overcome before the full potential of the system can be realized. 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 or benefit from its implementation.[4]

In prior years, we reported that IRS did not timely record taxes receivable and the related balances due to Treasury in its general ledger. During fiscal year 2005, IRS began calculating taxes receivable on a monthly basis and reported the balances on its interim financial statements. However, these

[4]IRS is also in the process of implementing the Customer Account Data Engine (CADE). CADE is intended to ultimately replace the legacy master file, which is the database of taxpayer account information. However, during fiscal year 2005, CADE was still in the early stages of implementation and processed less than $1 billion in refunds related to simple individual returns. IRS does not have detailed plans or schedules for completion of this project, and it is unclear when it will be fully implemented.

amounts are derived through statistical projections and do not reflect the total of actual transactions throughout the year.[5]

During fiscal year 2005, IRS continued to be unable to determine the specific amount of revenue it actually collects for three of the federal government's four largest revenue sources—Social Security, hospital insurance, and individual income taxes. 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 makes the federal government reliant on a complex, multistep process to distribute excise taxes to the recipient trust funds that continues to be susceptible to error.

Now that all federal agencies are required by OMB to meet a reporting date of November 15, IRS's inability to timely report specific amounts of excise tax revenue to recipient trust funds is even more significant for these funds and their administrators. The annual excise tax receipts reported by recipient trust funds now 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

[5]At the end of each fiscal year, IRS uses statistical sampling techniques to estimate the portion of its total balance of unpaid assessments that should be classified as compliance assessments, write-offs, and taxes receivable, and to estimate the portion of the taxes receivable balance that is likely to be collectible. Throughout the following year, the resultant rates derived through the sampling process are applied monthly to the total unpaid assessment balance to update these amounts for reporting purposes.

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.[6] 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 2 years to determine the extent to which an acceleration of the process would affect the amounts distributed to the trust funds. Our comparison of the precertification and actual certification amounts for the Highway Trust Fund and the Airport and Airway Trust Fund, which are the two largest trust funds receiving excise tax distributions, showed that over the past 2 years there was little difference between precertification amounts and actual certification amounts.[7] This indicates that the certification timeline could be accelerated without significantly affecting the accuracy of excise tax distributions to these trust funds, thereby reducing reliance on estimates and the inherent risk that actual collections will be materially different.

During fiscal year 2004, we reported that IRS did not have a cost accounting system (1) capable of accurately and timely tracking and reporting the costs of IRS's programs and projects to assist it in managing its costs and (2) meeting the JFMIP *System Requirements for Managerial Cost Accounting*.[8] During fiscal year 2005, IRS implemented a cost accounting module as part of the first release of IFS. Although this module has much potential and has begun accumulating cost information, IRS management has not yet determined what the full range of its cost information needs are or how best to utilize the module's existing capabilities to serve those needs. IRS has also not yet implemented a

[6]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.

[7]In implementing the American Jobs Creation Act of 2004, IRS issued guidance providing a one-time filing extension of 1 month for tax returns affecting the Highway Trust Fund and the Airport and Airway Trust Fund for the quarter ended March 31, 2005. *See* I.R.S. Notice 2005-4, § 4(i), 2005-2 I.R.B. 296-97 (Jan. 10, 2005); *see also* Pub. L. No. 108-357, § 853, 118 Stat. 1418, 1609 (Oct. 22, 2004). Therefore, the quarter ended March 31, 2005, was not included in our comparison.

[8]Joint Financial Management Improvement Program, *System Requirements for Managerial Cost Accounting* (Washington, D.C.: February 1998).

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. In addition, because the cost module was implemented in fiscal year 2005, it does not yet contain the historical cost information needed to support meaningful future estimates and projections. Consequently, IRS cannot yet rely on this system as a significant planning and decision-making tool. It will likely require several years and implementation of additional components of IFS, such as the 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 will continue to be hampered by a lack of meaningful underlying cost information.

As a result of these financial reporting weaknesses, IRS was compelled to expend far more time and effort to maintain its accounting records and generate financial management information than would otherwise have been necessary, and despite these monumental efforts, IRS continued to lack reliable and timely financial information to assist in managing operations throughout fiscal year 2005. 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 2005, we continued to find serious internal control issues that affected IRS's management of unpaid assessments. Specifically, we continued to find (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.[9]

[9]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 due to 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.

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. As a result, IRS must continue 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 apply statistical sampling and estimation techniques to data in its master files[10] to estimate the balances at year-end. While IRS continues to refine this process, it continued to take several months to complete, required adjustments totaling tens of billions of dollars, and produced amounts that, after adjustments, were only reliable as of the last day of the fiscal year. Consequently, this information is not useful for ongoing management decisions. In addition, the lack of a subsidiary ledger inhibits IRS's ability to timely develop reliable financial and management reports and promptly identify and focus collection efforts on accounts most likely to prove collectible.

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 assessed over $2 million in penalties and interest against a business for failing to provide a required supporting schedule along with its quarterly payroll tax return. When IRS reviewed this case as part of the fiscal year 2005 financial audit process, it determined that the required schedule was in fact attached to the return. However, IRS had sent out a notice of taxes due to the business and, at the time of our testing, this amount was recorded as a valid tax assessment in IRS's records. In another example, IRS assessed over $48 million in interest against the estate of a deceased taxpayer for tax year 2005. When IRS reviewed the case as part of the fiscal year 2005 financial audit process, it determined that the interest assessment should have been about $1 million.

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

However, as of September 30, 2005, IRS had not corrected this error on the taxpayer's account.

Some input errors and posting delays can cost the government money. For example, IRS erroneously abated[11] the entire amount of a $26,000 penalty assessment when only $6,000 of the assessment should have been abated. When the taxpayer made a subsequent payment of $20,000 to satisfy the tax liability, IRS erroneously refunded the $20,000 to the business. IRS found this error as part of the fiscal year 2005 financial audit process and was ultimately able to recover this amount from the taxpayer.

As in prior years,[12] the most prevalent errors we continued to find involved IRS's failure to properly record payments to all related taxpayer accounts associated with unpaid payroll taxes.[13] 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 an 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 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, in August 2001, IRS established new procedures to more clearly link each penalty assessment against an officer to a specific tax period[14] 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-

[11]Abatements are reductions to taxpayers' tax liabilities that can either result in reducing or eliminating a taxpayer's outstanding tax liability and, in some cases, may generate a refund to the taxpayer. IRS is authorized to abate assessments under certain conditions. For example, section 6404 of the Internal Revenue Code authorizes IRS to abate erroneous assessments, which can be caused by either IRS or taxpayer error.

[12]GAO-05-103.

[13]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.

[14]A tax period is the period over which the tax liability was created. For payroll taxes, this period is typically a calendar quarter.

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 2005, as in prior years, continued to find errors. In our testing of 80 statistically selected payments recorded on trust fund recovery penalty accounts established since August 2001, we found 6 instances in which IRS did not properly record payments received on all related taxpayer accounts. Of these 6 payments, 5 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 7.5 percent of trust fund recovery payment transactions posted to accounts established since August 2001 and still outstanding during fiscal year 2005 could contain inaccuracies.[15]

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 2005, 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 2005 Federal Managers' Financial Integrity Act of 1982 (FIA) assurance statement to the Treasury, in which it reported material weaknesses in the collection of unpaid taxes and in earned income tax credit (EITC) noncompliance. IRS's taxpayer compliance programs identify billions of dollars of potentially underreported taxes and erroneous EITC claims each year. However, due in large part to 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

[15]We are 95 percent confident that the error rate does not exceed 14.3 percent.

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,[16] 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.[17] 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.[18]

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.[19] When performed before refunds are disbursed, these examinations are an important control to 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.

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

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

[18]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).

[19]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.

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 $40.3 billion in fiscal year 2005, of which approximately $35 billion was refunded to taxpayers and approximately $5.3 billion was used to reduce assessed taxes. During fiscal year 2005, 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. 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 2005 were improper. This error rate indicates that of the approximately $35 billion of EITC-related refunds disbursed during fiscal year 2005, at least $8 billion, and potentially as much as $9.8 billion, was likely to have been improper.

Due to 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 and, as a result, cannot be used to prevent improper refunds from being disbursed. In addition, although IRS's matching program for individual tax returns identifies billions of dollars of potentially underreported taxes each year, IRS only follows up on a portion of these cases to determine how much tax is actually due and to pursue collection of those amounts. For example, for tax year 2003, IRS's matching program for individuals identified 14.5 million individual tax returns, with potential underreported taxes totaling $15 billion.[21] 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

[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. OMB, *Implementation Guidance for the Improper Payments Implementation Act of 2002, P. L. 107-300*, M-03-13 (Washington, D.C.: May 21, 2003).

[21]Tax year 2003 is the most recent year for which complete matching program results are available.

result of follow-up efforts. 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. Based on its analysis for tax year 2003, IRS investigated 4.1 million (28 percent) of these returns, which accounted for about $10.1 billion (67 percent) of the total potential underreported taxes. 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 responsibilities, IRS relies extensively on interconnected computer systems to perform various functions, such as collecting and storing taxpayer data, processing tax returns, calculating interest and penalties, generating refunds, and providing customer service. Consequently, weaknesses in controls over its information systems could impair IRS's ability to perform these vital functions and increase the risk of unauthorized disclosure, modification, or destruction of taxpayer data.

Information security weaknesses—both old and new—continue to impair the agency's ability to ensure the confidentiality, integrity, and availability of financial and other sensitive data. During our fiscal year 2005 audit, we identified continuing and new serious information security weaknesses in IRS's general controls intended to protect computing resources such as networks, computer equipment, software programs, data, and facilities. For example, access controls did not adequately prevent unauthorized access to taxpayer and other sensitive data by users granted access to IRS computer systems. Further, monitoring activities over critical computer systems were not adequately performed to record and track security-related events. As a result, sensitive data and computing resources are at increased risk of unauthorized use, modification, loss, and disclosure, possibly without detection.

A key reason for IRS's information security weaknesses was that it has not yet fully implemented an agencywide information security program to ensure that controls are effectively established and maintained. In December 2002, Congress enacted the Federal Information Security Management Act of 2002 (FISMA),[22] which is intended to strengthen the information security of federal information and systems by requiring agencies to develop, document, and implement agencywide information security programs. Some of the information security program elements required by FISMA are

- periodic testing and evaluation of the effectiveness of information security policies, procedures, and practices;
- security awareness training for agency personnel, including contractors;
- a process for planning, implementing, evaluating, and documenting remedial action to address information security deficiencies; and
- plans and procedures to ensure continuity of operations for information systems that support the operations and assets of the agency.[23]

Although IRS had begun implementing elements required by FISMA, we identified several shortcomings. For example, (1) certain system tests and evaluations were insufficient, (2) security awareness training was not consistently established across the agency, (3) remedial plans to address information security deficiencies were lacking, and (4) disaster recovery and business resumption plans for critical systems were not completed. IRS has taken actions to improve information security management; however, it still needs to take additional steps to address all key elements of an information security program. Such a program is critical to provide IRS with a solid foundation for resolving existing information security problems and continuously managing information security risks.

While IRS has corrected many previously identified information security weaknesses, we continued to observe weaknesses identical or very similar to those we previously identified, in addition to several new ones. Collectively, these problems represent a material weakness in IRS's internal controls over information systems and data. Specifically, the continuing

[22]FISMA was enacted as title III of the E-Government Act of 2002, Pub. L. No. 107-347, 116 Stat. 2946 (Dec. 17, 2002).

[23]*See* 44 U.S.C. § 3544.

and newly identified weaknesses increase the risk that data processed by IRS's computer systems are not reliable. If IRS does not adequately mitigate these weaknesses, unauthorized individuals could gain access to critical hardware and software, where they may intentionally or inadvertently add, alter, 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 using taxpayers' names (identity fraud), such as fraudulently establishing credit and running up debts. Until IRS successfully manages its information security risks, management will not have assurance of the integrity and reliability of the information generated from the new financial management systems. We will be issuing a separate report on issues we identified regarding information security at IRS.

Reportable Conditions

In addition to the material weaknesses discussed above, we identified two reportable conditions concerning weaknesses in IRS's internal controls over (1) hard-copy tax receipts and taxpayer information and (2) P&E, both of which we have reported on in prior audits.

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 and field offices and at commercial lockbox banks that operate under contract with Treasury's Financial Management Service (FMS) to provide tax receipt processing services on behalf of IRS. In previous audits, we reported that weaknesses in IRS's controls designed to safeguard these 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.[24] IRS has continued to take actions to address these weaknesses, such as conducting periodic security reviews of receipt processing areas and improving its policies and procedures. For

[24]GAO, *Internal Revenue Service: Status of Recommendations from Financial Audits and Related Financial Management Reports*, GAO-05-393 (Washington, D.C.: Apr. 29, 2005); *Management Report: Improvements Needed in IRS's Internal Controls*, GAO-05-247R (Washington, D.C.: Apr. 27, 2005); *IRS Lockbox Banks: More Effective Oversight, Stronger Controls, and Further Study of Costs and Benefits Are Needed*, GAO-03-299 (Washington, D.C.: Jan. 15, 2003); *Financial Audit: IRS's Fiscal Years 2002 and 2001 Financial Statements*, GAO-03-243 (Washington, D.C.: Nov. 15, 2002); and *Internal Revenue Service: Progress Made, but Further Actions Needed to Improve Financial Management*, GAO-02-35 (Washington, D.C.: Oct. 19, 2001).

example, to enhance security over disposal of taxpayer information at lockbox banks, IRS changed its policy during fiscal year 2005 to require that the shredding of such information be conducted on bank premises rather than at the premises of an offsite contractor, as had been common practice. However, during our testing in fiscal year 2005, we continued to find that IRS's controls over receipts and related hard-copy taxpayer information received from taxpayers were inadequate to sufficiently limit the risk of theft, loss, or misuse of such funds and information. This condition resulted primarily from inconsistencies in the establishment and implementation of, and compliance with, policies at IRS service center campuses, field offices, and lockbox banks.[25] 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 audit we observed (1) weaknesses in physical safeguards intended to control access to IRS facilities (at one lockbox bank and one service center campus) and to the facility itself (at one lockbox bank); (2) alarms that were either not working or not working properly (at one lockbox bank, one service center campus, and one taxpayer assistance center); and (3) security guards who did not respond timely to door alarms during our tests (at two service center campuses and one lockbox bank). These weaknesses increase the risks that the integrity of IRS facilities and the taxpayer receipts and information they process may be compromised.

- *Weaknesses in the implementation and execution of procedural safeguards and controls designed to account for, control, and protect taxpayer receipts and related taxpayer information while they are being processed within IRS facilities.* For example, during our audit we found (1) inadequate segregation of duties in that the tasks of receiving payments from taxpayers, logging them in for internal control purposes, and preparing documents to record the payments in IRS's records were

[25]IRS's field office structure includes 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; and other business operating divisions that provide taxpayer audit and assistance services. These 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. In addition, commercial lockbox banks operate under contract with FMS to provide tax receipt processing services on behalf of IRS.

often performed by the same person (at six of the eight taxpayer assistance centers we visited);[26] (2) inadequate security over mail containing taxpayer receipts and related taxpayer information and over the security of this information once extracted from the envelopes (at four Small Business/Self-Employed groups, three service center campuses, two taxpayer assistance centers, and one Tax Exempt/Government Entities group); and (3) weaknesses in controls over access to controlled or restricted areas in which taxpayer receipts are received and processed (at four taxpayer assistance centers and one service center campus). These weaknesses increase the risk that taxpayer receipts and information may be compromised during processing at IRS facilities.

- *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 audit we found internal control weaknesses relating to (1) couriers who physically deliver hard-copy taxpayer receipts and related taxpayer information to IRS from post offices and between lockbox banks and associated service center campuses, and who deliver receipts to depository institutions (at three lockbox banks and one service center campus); (2) compiling and preparing taxpayer receipts and related taxpayer information for shipment to the associated service center campuses (at three taxpayer assistance centers); and (3) tracking hard-copy taxpayer receipts and related taxpayer information shipped to the service centers for processing or archiving, and verifying that they are received by the respective service center campuses (at all eight taxpayer assistance centers we visited, 18 Small Business/Self Employed groups, four Large and Mid-Sized Business groups, and two Tax-Exempt/Government Entities groups). 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.

[26]Many taxpayer assistance centers are operated at times by only one IRS employee, or tasks are performed by Revenue Agents or Officers working away from the field office. In these situations, segregation of these duties is problematic. IRS recognized these situations and is considering potential solutions.

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. While IRS has made progress in this area, our findings from our fiscal year 2005 audit indicate that much more remains to be done to effectively address these matters, which are critical to IRS's success in meeting its customer service goals.

During fiscal year 2005, IRS implemented two initiatives to help address weaknesses at its lockbox banks and taxpayer assistance centers. In conjunction with FMS, IRS developed and implemented a joint pilot program of lockbox performance measures aimed at providing quantitative measures of performance in, and holding bank management more accountable for, among other areas, physical security, courier and other personnel security, and internal controls over receipts and receipt processing. IRS also implemented a pilot program at the field office taxpayer assistance centers with the objective of improving internal controls and creating, where feasible, segregation of duties over receiving, preparing the posting documents, reviewing, and transmitting taxpayer receipts and related taxpayer information to the service center campuses. These initiatives, if effectively implemented, could improve IRS's controls over hard-copy taxpayer receipts and data at these offices in future years.

Property and Equipment

In prior years, we identified significant internal control deficiencies that hampered IRS's ability to have reliable and timely information on its balance of P&E throughout the year.[27] Over the past several years, IRS has made substantial progress in addressing internal control deficiencies related to its P&E. In fiscal year 2005, we noted further improvements in IRS's controls and procedures that enhanced its ability to account for P&E. Specifically, IRS improved the timeliness of recording P&E activity in its accounting system. However, fundamental deficiencies in IRS's financial management system continued to exist, which precluded IRS from generating detailed property records that reconcile to the financial records.

Prior to the implementation of the first release of IFS in November 2004, IRS recorded all property purchases as operating expenses and later extracted the costs of property acquisitions from operating expenses by

[27] GAO-05-103.

recording adjustments to remove property purchases from expenses and capitalize them as P&E. IRS performed this analysis and updated the P&E accounting records monthly. With implementation of the first release of IFS, IRS is now able to record the majority of P&E activities as assets at the time of acquisition. However, because of funding constraints, IRS deferred indefinitely implementation of a property management module of IFS. This module was intended to generate detailed property records that reconcile to the financial records. Due to uncertainty over implementation of a property management module, IRS continues to refine its compensating procedures to address the lack of an integrated accounting and property system. However, significant and costly efforts are required to perform these compensating procedures. For example, IRS must still go through a labor-intensive and time-consuming process to link the detailed property records to the financial records. In addition, some P&E activity, such as internal use software projects, are still initially recorded as expenses and later extracted and capitalized as P&E because of the complexity of measuring the full costs of the projects.[28] An integrated accounting and property system would provide management with the ability to maintain control over P&E to ensure that assets are properly accounted for and safeguarded.

Compliance Issues

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 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. The lien serves to protect the interest of the federal government

[28]For internal use software, capitalized costs include direct costs, such as salaries of IRS employees assigned to the project and contractor fees, and indirect costs, such as overhead incurred during the development phase. The development phase includes developing the software configuration and interfaces, coding, installing the software to the hardware, and testing.

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 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.

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.[29] We found that this condition continued to exist in fiscal year 2005. Specifically, in our testing of 59 statistically selected tax cases with liens in which the taxpayers' total outstanding tax liabilities were either paid off or abated during fiscal year 2005, we found 13 instances in which IRS 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 36 days to 233 days. In 4 cases, the lien still had not been released at the time of our review. In 1 of these cases, it had been 269 days since the taxpayer had fully satisfied the tax liability. Based on our work, we estimate that for 22 percent of unpaid tax assessment cases in which IRS had filed a tax lien that were resolved in fiscal year 2005, IRS did not release the lien within 30 days.[30]

In at least 5 of the 13 cases in which liens were not released timely, the release was delayed because 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 initiation of the lien release process for these cases. 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

[29] GAO-05-103.

[30] We are 95 percent confident that the percentage of cases in which the lien was not released within 30 days does not exceed 33 percent.

issues.[31] 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.

Financial Management Systems' Noncompliance with FFMIA

In fiscal year 2005, 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), applicable 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 represents a major step forward. If fully implemented as planned, it has the potential to address many of the issues IRS has experienced in the past with its automated financial management systems, such as the inability to provide current, reliable information for managers' use to support decision making. However, as noted earlier in this report, primarily because of funding constraints, IRS has put on hold future releases of IFS that were to include features essential to IRS's ability to realize the system's full potential. 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

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

statement to Treasury, IRS reported that its financial management systems did not substantially comply with the requirements of FFMIA in fiscal year 2005.

IRS has established a remediation plan to address the conditions affecting its systems' ability to comply substantially with the requirements of FFMIA. This plan outlines the actions to be taken to resolve these issues, but future corrective actions are on hold and are currently unfunded. Due to 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 Internal Revenue Service's (IRS) 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, property and equipment, accounts payable, and undelivered order transactions. These statistical samples were selected primarily to substantiate balances and activities reported in IRS's financial statements. Consequently, dollar errors or amounts can and have been statistically projected to the population of transactions from which they were selected. In testing 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 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 the 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.

- 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, and Independent Agencies Appropriations Act, 2004, Pub. L. No. 108-199, div. F, tit. II, 118 Stat. 314 (Jan. 23, 2004); and Transportation, Treasury, Independent Agencies, and General Government Appropriations Act, 2005, Pub. L. No. 108-447, div. H, tit. II, 118 Stat. 3235 (Dec. 8, 2004).

- 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 7, 2005

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 review and comment on your draft report titled, *Financial Audit: IRS' Fiscal Years 2005 and 2004 Financial Statements.* We agree that your report fairly presents our financial progress and our remaining management and systems challenges. We are pleased that your report recognizes that the IRS continues to make great strides in addressing financial management, and our dedication to improvement has earned the IRS an unqualified opinion on our combined financial statements for a sixth consecutive year. This is an extremely satisfying achievement for the IRS this year because we accomplished this while deploying a new internal core financial management system. Our record clearly demonstrates to our stakeholders that the Service can consistently account for the approximately $2.3 trillion in revenue receipts, $267 billion in refunds, and $11 billion in appropriated funds.

We appreciate your recognition of our efforts in successfully deploying the Integrated Financial System (IFS) this year. The initial release of IFS provides capability for general ledger management, budget execution, budget formulation, accounts payable, accounts receivable, cost management, and financial and tax reporting. IFS enhances the accuracy, timeliness, and availability of data. It reduces reconciliation and produces subsidiary ledgers with audit trails to the transaction level. We recognize this first phase of IFS is the cornerstone for building a fully integrated financial management system and agree that additional enhancements will be required to meet all our financial management objectives.

We recognize that we need to continue to address identified problems and focus on our modernization efforts. Our commitment to enhance our financial management is demonstrated by the numerous improvements that we have undertaken over the years. During fiscal year (FY) 2005, we instituted a number of financial management reforms and improvements:

- Implemented a crosswalk to convert the Interim Revenue Accounting Control System trial balance accounts into the United States Standard General Ledger compliant account format

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- Implemented statistical projections to calculate taxes receivable on a monthly basis, and reported these balances on our interim financial statements
- Developed an alternative to the Custodial Accounting Project to remediate the custodial financial weaknesses over the next several years
- Centralized all Small Business/Self Employed Automated Trust Fund Recovery work in September 2005 to two campuses to improve efficiency and reduce TFRP assessment errors by improving the cross-referencing and posting of the payments process
- Increased the functionality in the Customer Account Data Engine to post accounts on a daily basis resulting in faster refunds, and to accept Form 1040EZ tax returns with address changes, and to detect fraudulent returns and unpostable conditions
- Developed Security and Internal Control Performance Measures for physical security, courier, personal security, and internal controls over receipts and receipt processing at Lockboxes

We agree with the Government Accountability Office's (GAO) findings and opinions related to information security. We have developed an action plan to address deficiencies in access controls, rules of behavior, contingency planning and disaster recovery, audit trails, training, and certification and accreditation. We have also made progress in correcting many of the issues identified during the audit. Because of its importance, improving information security will continue to be a priority for the IRS.

I appreciate GAO's acknowledgement of our significant improvements over the last several years. We wish to recognize GAO's dedication and professionalism throughout this year's audit process, especially as our staffs and executives worked to meet the requirements of the audit process during the first year operation of our new financial system. We thank you for your support of our efforts, your excellent counsel, and your willingness to work with us to promote the highest standard of financial management in the IRS.

In closing, while challenges remain, I believe the IRS has demonstrated its ability to consistently produce accurate and reliable financial statements. We have a deep and continuing commitment to improving financial management and will aggressively pursue appropriate actions to improve processes and systems.

Sincerely,

John M. Dalrymple

John M. Dalrymple

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