



November 2014

FINANCIAL AUDIT

IRS's Fiscal Years 2014 and 2013 Financial Statements

GAO Highlights

Highlights of [GAO-15-173](#), a report to the Secretary of the Treasury

Why GAO Did This Study

In accordance with the authority granted by the Chief Financial Officers Act of 1990, GAO annually audits IRS's financial statements to determine whether (1) the financial statements are fairly presented and (2) IRS management maintained effective internal control over financial reporting. GAO also tests IRS's compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements.

IRS's tax collection activities are significant to overall federal receipts, and the effectiveness of its financial management is of substantial interest to Congress and the nation's taxpayers.

What GAO Recommends

Based on prior financial statement audits, GAO made numerous recommendations to IRS to address internal control deficiencies. GAO will continue to monitor and will report separately on IRS's progress in implementing prior recommendations that remain open. Consistent with past practice, GAO will also be separately reporting on the new internal control deficiencies identified in this year's audit and providing IRS recommendations for corrective actions to address them.

In commenting on a draft of this report, IRS indicated that it is dedicated to continuing to improve its financial management and internal controls, and has taken steps to implement its financial reporting responsibilities under the Patient Protection and Affordable Care Act.

View [GAO-15-173](#). For more information, contact Cheryl E. Clark at (202) 512-3406 or clarkce@gao.gov.

November 2014

FINANCIAL AUDIT

IRS's Fiscal Years 2014 and 2013 Financial Statements

What GAO Found

In GAO's opinion, the Internal Revenue Service's (IRS) fiscal years 2014 and 2013 financial statements are fairly presented in all material respects. However, in GAO's opinion, IRS did not maintain effective internal control over financial reporting as of September 30, 2014, because of a continuing material weakness in internal control over unpaid tax assessments. GAO's tests of IRS's compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements detected no reportable instances of noncompliance in fiscal year 2014.

The material weakness in internal control over unpaid tax assessments was primarily caused by financial system limitations and errors in taxpayer accounts that rendered IRS's systems unable to readily distinguish between taxes receivable, compliance assessments, and write-offs in order to properly classify these components for financial reporting purposes. These deficiencies necessitated the use of a compensating estimation process to determine the amount of taxes receivable, the most material asset on IRS's balance sheet. Through this compensating process, IRS made almost \$17 billion in adjustments to the 2014 fiscal year-end gross taxes receivable balance produced by its financial systems. Serious control deficiencies related to unpaid tax assessments are likely to continue to exist until IRS significantly enhances the capabilities of the systems it uses to account for unpaid tax assessments, and improves controls over the recording of information in taxpayer accounts so that reliable transaction-based balances for taxes receivable can be ultimately recorded in its general ledger system. However, IRS's current corrective action plan does not fully address all of the system enhancements needed to accurately classify unpaid tax assessment transactions, and IRS has yet to identify the underlying control deficiencies causing the errors in taxpayer accounts.

During fiscal year 2014, IRS continued to make important progress in addressing deficiencies in internal control over its financial reporting systems. However, GAO identified new and continuing deficiencies in internal control over information security, including missing security updates, insufficient monitoring of financial reporting systems and mainframe security, and ineffective maintenance of key application security, that constituted a significant deficiency in IRS's internal control over financial reporting systems. Until IRS fully addresses existing control deficiencies over its financial reporting systems, there is an increased risk that its financial and taxpayer data will remain vulnerable to inappropriate and undetected use, modification, or disclosure.

In addition to its internal control deficiencies, IRS faces significant ongoing financial management challenges associated with (1) safeguarding the large volume of sensitive hard copy taxpayer receipts and related information, (2) its exposure to significant invalid refunds from identity theft, and (3) implementing the tax provisions of the Patient Protection and Affordable Care Act. The difficulties confronting IRS in its efforts to effectively manage each of these challenges are further magnified by the need to do so in an environment of diminished budgetary resources.

Contents

Letter	1
Independent Auditor's Report	3
Report on the Financial Statements and on Internal Control over Financial Reporting	4
Report on Compliance with Laws, Regulations, Contracts, and Grant Agreements	24
Agency Comments	25
Management's Discussion and Analysis	27
Financial Statements	106
Required Supplementary Information	133
Other Information	137
Appendix I	Management's Report on Internal Control over Financial Reporting 148
Appendix II	Comments from the Internal Revenue Service 149

Abbreviations

CADE 2	Customer Account Data Engine 2
CFO	Chief Financial Officer
CMS	Centers for Medicare & Medicaid Services
FASAB	Federal Accounting Standards Advisory Board
FMFIA	Federal Managers' Financial Integrity Act of 1982
FTE	full-time equivalent
HCERA	Health Care and Education Reconciliation Act of 2010
IRS	Internal Revenue Service
PPACA	Patient Protection and Affordable Care Act
RSI	required supplementary information
TFM	Treasury Financial Manual

This is a work of the U.S. government and is not subject to copyright protection in the United States. The published product may be reproduced and distributed in its entirety without further permission from GAO. However, because this work may contain copyrighted images or other material, permission from the copyright holder may be necessary if you wish to reproduce this material separately.



November 12, 2014

The Honorable Jacob J. Lew
Secretary of the Treasury

Dear Mr. Secretary:

The accompanying report presents the results of our audits of the fiscal years 2014 and 2013 financial statements of the Internal Revenue Service (IRS). Specifically, we found

- the financial statements are presented fairly, in all material respects, in accordance with U.S. generally accepted accounting principles;
- IRS's internal control over financial reporting was not effective as of September 30, 2014, because of a continuing material weakness¹ in internal control over unpaid tax assessments; and
- no reportable noncompliance in fiscal year 2014 with the laws, regulations, contracts, and grant agreements we tested.

This report also provides a discussion of a continuing significant deficiency² in IRS's internal control over financial reporting systems that we believe merits the attention of those charged with governance of IRS. We will be separately reporting more detailed information to IRS concerning the material weakness and significant deficiency along with any new recommended corrective actions. In addition, this report discusses ongoing financial management challenges that IRS faces related to (1) safeguarding hard copy taxpayer receipts and associated information, (2) its exposure to significant invalid refunds from identity

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

²A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit the attention of those charged with governance.

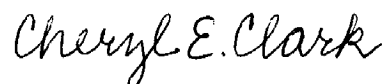
theft, and (3) implementation of the tax-related provisions of the Patient Protection and Affordable Care Act (PPACA).³

We performed our audit pursuant to authority conferred by the Chief Financial Officers Act of 1990, as amended by the Government Management Reform Act of 1994.

We are sending copies of this report to the Chairman and Vice Chairman of the Joint Committee on Taxation, the Chairmen and Ranking Members of the Senate Committee on Finance and the House Committee on Ways and Means, and other interested congressional committees and subcommittees. We are also sending copies of this report to 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. In addition, the report is available at no charge on the GAO website at <http://www.gao.gov>.

If you or your staff have any questions concerning this report, please contact me at (202) 512-3406 or clarkce@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report.

Sincerely yours,



Cheryl E. Clark
Director
Financial Management and Assurance

³Pub. L. No. 111-148, 124 Stat. 119 (Mar. 23, 2010), as amended by the Health Care and Education Reconciliation Act of 2010 (HCERA), Pub. L. No. 111-152, 124 Stat. 1029 (Mar. 30, 2010). In this report, references to PPACA include any amendments made by HCERA.



Independent Auditor's Report

To the Commissioner of Internal Revenue

In our audits of the 2014 and 2013 financial statements of the Internal Revenue Service (IRS), we found

- IRS's financial statements as of and for the fiscal years ended September 30, 2014, and 2013, are presented fairly, in all material respects, in accordance with U.S. generally accepted accounting principles;
- IRS's internal control over financial reporting was not effective as of September 30, 2014; and
- no reportable noncompliance for fiscal year 2014 with the provisions of applicable laws, regulations, contracts, and grant agreements we tested.

The following sections discuss in more detail (1) our report on the financial statements and internal control over financial reporting, other matters related to required supplementary information (RSI),¹ other information² included with the financial statements, and three significant financial management challenges confronting IRS related to safeguarding hard copy taxpayer receipts and information, its exposure to significant invalid refunds from identity theft, and its new responsibilities under the Patient Protection and Affordable Care Act (PPACA); (2) our report on IRS's compliance with laws, regulations, contracts, and grant agreements; and (3) IRS's comments.

¹RSI consists of Management's Discussion and Analysis and other supplementary information that is required by federal accounting standards to be included with the financial statements.

²Other information consists of information included with the financial statements, other than RSI and the auditor's report.

Report on the Financial Statements and on Internal Control over Financial Reporting

We have audited IRS's financial statements pursuant to our authority conferred by the Chief Financial Officers (CFO) Act of 1990, as amended by the Government Management Reform Act of 1994.³ IRS's financial statements comprise the balance sheets as of September 30, 2014, and 2013; the related statements of net cost, changes in net position, budgetary resources, and custodial activity for the fiscal years then ended; and the related notes to the financial statements. We have also audited IRS's internal control over financial reporting as of September 30, 2014, based on criteria established under 31 U.S.C. § 3512(c), (d), commonly known as the Federal Managers' Financial Integrity Act (FMFIA).

We conducted our audits in accordance with U.S. generally accepted government auditing standards. We believe that the audit evidence we obtained is sufficient and appropriate to provide a basis for our audit opinions.

Management's Responsibility

IRS management is responsible for (1) the preparation and fair presentation of these financial statements in accordance with U.S. generally accepted accounting principles; (2) preparing, measuring, and presenting the RSI in accordance with U.S. generally accepted accounting principles; (3) preparing and presenting other information included in documents containing the audited financial statements and auditor's report, and ensuring the consistency of that information with the audited financial statements and the RSI; (4) maintaining effective internal control over financial reporting, including the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; (5) evaluating the

³See the CFO Act of 1990, Pub. L. No. 101-576, 104 Stat. 2838 (Nov. 15, 1990), codified, in relevant part, as amended, at 31 U.S.C. § 3521(g); see also the Government Management Reform Act of 1994, Pub. L. No. 103-356, 108 Stat. 3410 (Oct. 13, 1994), codified, in relevant part, as amended, at 31 U.S.C. § 3515(c). Under the authority of 31 U.S.C. § 3515, the Office of Management and Budget requires IRS to issue annual audited financial statements that are separate from those of the Department of the Treasury. Although the CFO Act designates the agency's inspector general, or where applicable, an independent external auditor, as the responsible auditor of an agency's financial statements, the act also gives GAO the authority to perform such audits at its discretion. Based on that authority, we audit IRS's financial statements because of the significance of IRS's tax collections to the consolidated financial statements of the U.S. government, which GAO is required to audit. See 31 U.S.C. § 331 (e)(2).

effectiveness of internal control over financial reporting based on the criteria established under FMFIA; and (6) providing its assertion about the effectiveness of internal control over financial reporting as of September 30, 2014, based on its evaluation, included in the accompanying Management's Report on Internal Control over Financial Reporting in appendix I.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements and an opinion on IRS's internal control over financial reporting based on our audits. U.S. generally accepted government auditing standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from material misstatement, and whether effective internal control over financial reporting was maintained in all material respects. We are also responsible for applying certain limited procedures to the RSI and other information included with the financial statements.

An audit of financial statements involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the auditor's assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances. An audit of financial statements also involves evaluating the appropriateness of the accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, evaluating the design and operating effectiveness of internal control over financial reporting based on the assessed risk, and testing relevant internal control over financial reporting. Our audit of internal control also considered the entity's process for evaluating and reporting on internal control over financial reporting based on criteria established under FMFIA. Our audits also included performing such other procedures as we considered necessary in the circumstances.

We did not evaluate all internal controls relevant to operating objectives as broadly established under FMFIA, such as those controls relevant to

preparing performance information and ensuring efficient operations. We limited our internal control testing to testing controls over financial reporting. Our internal control testing was for the purpose of expressing an opinion on whether effective internal control over financial reporting was maintained, in all material respects. Consequently, our audit may not identify all deficiencies in internal control over financial reporting that are less severe than a material weakness.⁴

Definitions and Inherent Limitations of Internal Control over Financial Reporting

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, the objectives of which are to provide reasonable assurance that (1) transactions are properly recorded, processed, and summarized to permit the preparation of financial statements in accordance with U.S. generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition, and (2) transactions are executed in accordance with laws governing the use of budget authority and with other applicable laws, regulations, contracts, and grant agreements that could have a direct and material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct, misstatements due to fraud or error. We also caution that projecting any evaluation of effectiveness to future periods is subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Opinion on Financial Statements

In our opinion, IRS's financial statements present fairly, in all material respects, IRS's financial position as of September 30, 2014, and 2013, and its net cost of operations, changes in net position, budgetary resources, and custodial activity for the fiscal years then ended in accordance with U.S. generally accepted accounting principles.

⁴A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis.

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

In accordance with federal accounting standards, the financial statements do not include an estimate of the dollar amount of taxes that are owed the federal government but have not been reported by taxpayers or identified through IRS's enforcement programs, often referred to as the tax gap, nor do they include information on tax expenditures.⁵ Further detail on the tax gap and tax expenditures, as well the associated dollar amounts, is discussed in other information included with the financial statements.

Opinion on Internal Control over Financial Reporting

In our opinion, because of a material weakness in internal control over unpaid tax assessments,⁶ IRS did not maintain, in all material respects, effective internal control over financial reporting as of September 30, 2014, based on criteria established under FMFIA.

Despite the material weakness in IRS's internal control over unpaid tax assessments, which also existed in prior years, IRS made necessary and appropriate adjustments to its records and was therefore able to prepare financial statements that were fairly presented in all material respects for fiscal year 2014. However, the material weakness may adversely affect any decisions by IRS's management that are based, in whole or in part, on information that is inaccurate because of this weakness. The issues constituting this material weakness, which are discussed in more detail below, were also disclosed by IRS in its fiscal year 2014 (1) FMFIA assurance statement to the Department of the Treasury and (2) Management's Report on Internal Control over Financial Reporting. We

⁵As described in the other information to IRS's financial statements, the estimated magnitude of the tax gap is based on a study conducted to measure the compliance rate of taxpayers based on an examination of a statistical sample of tax returns filed for tax year 2006. The tax gap does not include actual or estimated refund payments disbursed due to identity theft-based fraudulent refund claims, which are financial management challenges for IRS and are discussed later in this report. Tax expenditures represent the amount of revenue that the government forgoes resulting from federal tax law provisions that (1) allow a special exclusion, exemption, or deduction from gross income or (2) provide a special credit, preferential rate, or deferred tax liability.

⁶An unpaid tax assessment is a legally enforceable claim against a taxpayer and consists of taxes, penalties, and interest that have not been collected or abated (i.e., the tax assessment reduced by IRS).

considered this material weakness in determining the nature, timing, and extent of our audit procedures on IRS's fiscal year 2014 financial statements.

In addition, our fiscal year 2014 audit identified continuing and new deficiencies concerning IRS's financial reporting systems that while not considered a material weakness, are important enough to merit the attention of those charged with governance of IRS. Therefore, we considered these remaining and new issues affecting IRS's internal control over financial reporting systems collectively to be a significant deficiency⁷ in internal control in fiscal year 2014. This significant deficiency is discussed in more detail below.

In addition to the material weakness and significant deficiency in internal control, we also identified other deficiencies in IRS's internal control over financial reporting that we do not consider to be material weaknesses or significant deficiencies. Nonetheless, these deficiencies warrant IRS management's attention. We have communicated these matters to IRS management and, where appropriate, will report on them separately.

Material Weakness in Internal Control over Unpaid Tax Assessments

During fiscal year 2014, we continued to find serious control deficiencies that affected IRS's management and reporting of unpaid tax assessments. Specifically, we continued to find (1) IRS's reported balances for taxes receivable and other unpaid tax assessments were not supported by its core general ledger system for tax transactions;⁸ (2) system deficiencies in IRS's subsidiary ledger⁹ and supporting financial systems for unpaid tax assessments did not allow it to produce reliable and useful information with which to manage and report; and (3) various other control deficiencies that led to errors in taxpayer accounts. Because of these deficiencies, IRS's financial systems currently do not provide the accurate and complete transaction-level financial information necessary

⁷A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit the attention of those charged with governance.

⁸IRS's Redesign Revenue Accounting Control System is the general ledger system IRS uses for tax-related transactions.

⁹IRS's Custodial Detail Data Base functions as its subsidiary ledger for unpaid tax assessments.

to enable IRS to reliably classify and report unpaid tax assessment balances in accordance with federal accounting standards.¹⁰

General ledger system. As we have reported in prior audits,¹¹ IRS's balance for federal taxes receivable,¹² which comprised over 80 percent of total assets reported on IRS's fiscal year 2014 balance sheet, was not produced from its general ledger, but rather was the product of a compensating, labor-intensive, and manual estimation process. This compensating process involves IRS testing statistical samples of data extracted from its master files¹³ and extrapolating the results to estimate the year-end balances to be reported as (1) taxes receivable in its financial statements and the RSI and (2) compliance assessments and write-offs in the RSI. While IRS reports the taxes receivable balance derived from this process on its balance sheet, and the balances of compliance assessments and write-offs in its RSI, IRS essentially replaces the amounts produced by its systems with the results of this process for year-end financial reporting purposes. Thus, the amounts reported by IRS are the product of an annual statistical estimation process rather than a summation of taxpayer account transaction data.¹⁴

¹⁰Federal accounting standards classify unpaid tax assessments into one of the following three categories for reporting purposes: federal taxes receivable, compliance assessments, and write-offs. Federal taxes receivable are taxes due from taxpayers for which IRS can support the existence of a receivable through, for example, taxpayer agreement or a court ruling determining an assessment. Compliance assessments are proposed tax assessments where neither the taxpayer (when the right to disagree or object exists) nor the court has affirmed that the amounts are owed. Write-offs represent unpaid tax assessments for which IRS does not expect further collections because of factors such as the taxpayer's death, bankruptcy, or insolvency. Federal accounting standards require only federal taxes receivable, net of an allowance for uncollectible amounts, to be reported on the financial statements. See Statement of Federal Financial Accounting Standards No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, May 10, 1996.

¹¹See for example, GAO, *Financial Audit: IRS's Fiscal Years 2013 and 2012 Financial Statements*, [GAO-14-169](#) (Washington, D.C.: Dec. 12, 2013).

¹²IRS reports federal taxes receivable on its balance sheet, net of an allowance for amounts considered uncollectible.

¹³IRS's master files contain detailed records of taxpayer accounts.

¹⁴For financial reporting, in order to reflect its compensating statistical estimate for its gross taxes receivable amount, IRS records an adjusting journal entry to correct the gross taxes receivable amount produced by its systems, and then adjusts the allowance for uncollectible amounts from the adjusted gross taxes receivable amount to report the amount of net taxes receivable on its balance sheet.

As a result, IRS does not have records to trace transactions from the taxes receivable amount and other unpaid assessment amounts reported on IRS's financial statements and its RSI, through its general ledger system, and back to underlying transaction-level taxpayer source documents. Such traceability is necessary to enable IRS to ensure that recorded transactions are complete, accurate, and supported by underlying records.

System deficiencies. Because of system deficiencies in both its subsidiary ledger for unpaid tax assessments and the underlying master files, IRS cannot use the subsidiary ledger for recording transaction-based unpaid tax assessment information to its general ledger in a manner that provides reliable financial reporting. IRS's subsidiary ledger analyzes and records unpaid tax assessment balances from the master files to its general ledger on a weekly basis by the three financial reporting categories (taxes receivable, compliance assessments, and write-offs). During fiscal year 2014 as in prior years, while the subsidiary ledger analyzed and classified unpaid tax assessment balances from the master files into the various financial reporting categories, the analysis and classification continued to contain material inaccuracies because IRS's classification program was unable to sort through, identify, and analyze all the relevant transaction-level information required for proper classification, recording, and reporting. For example, when IRS records multiple tax assessments against a taxpayer,¹⁵ its subsidiary ledger is currently unable to always accurately distinguish among and separately classify the various assessments among the three financial reporting categories. While IRS has made progress in addressing this issue for simpler taxpayer accounts, we found that for more complex taxpayer accounts, the subsidiary ledger is still not designed to distinguish between tax assessments that have been agreed to by the taxpayer and therefore represent a taxes receivable and those that have not been agreed to by the taxpayer and therefore represent a compliance assessment. For more complex accounts containing multiple assessments, IRS's systems defaulted to classifying the entire account balance as either a tax receivable or a compliance assessment, thus requiring manual

¹⁵When a taxpayer files a tax return, IRS records the taxpayer's self-reported tax liability as one assessment on the taxpayer's master file account. If IRS later audits the taxpayer and determines that the taxpayer owes additional taxes, IRS will record a separate assessment on the taxpayer's account, resulting in multiple assessments on the taxpayer's account.

adjustments to properly classify the individual assessments within the taxpayer account for financial reporting purposes.

In addition, while the master files contain detailed records of taxpayer accounts, the master files do not contain all the details necessary to properly classify or estimate collectability for unpaid tax assessment accounts and are not properly designed to always function in accordance with the intent of established policies. For example, as we previously reported,¹⁶ IRS's master file programs cannot always accurately calculate the amount of penalties assessed against taxpayers that have unpaid tax debt. For instance, IRS's master file computer program cannot accurately calculate the failure-to-pay penalty¹⁷ when IRS audits a taxpayer and determines the taxpayer was ineligible for certain refundable tax credits that IRS had initially paid to the taxpayer in the form of a larger refund,¹⁸ thus requiring IRS to manually determine and record the correct penalty amount in the taxpayer's master file account.

Errors in taxpayer accounts. IRS's management and reporting for unpaid tax assessments also continued to be hindered by inaccurate tax records. During our fiscal year 2014 audit, we found errors in taxpayer records due to (1) IRS not recording information accurately in taxpayers' accounts, (2) ineffectively designed processes that caused errors or misclassifications in the amounts taxpayers owed, and (3) staff not always following established procedures. Such errors directly affected the accuracy of the unpaid tax assessment information classified by the subsidiary ledger. For example, we identified that IRS erroneously recorded an entry in a taxpayer's account indicating that the taxpayer was

¹⁶GAO, *Management Report: Improvements Needed in IRS's Internal Controls*, [GAO-08-368R](#) (Washington, D.C.: June 4, 2008).

¹⁷A failure-to-pay penalty is a penalty that IRS assesses against taxpayers when taxpayers fail to pay their outstanding tax liability by the return due date. The failure-to-pay penalty is calculated based on the amount of taxes outstanding in the taxpayer's account module, a penalty rate stipulated in the Internal Revenue Code, and the number of months the taxes remain unpaid.

¹⁸To offer tax relief to targeted individuals and businesses, Congress provided assistance in the form of tax credits. For the majority of tax credits, the economic benefit is limited to the taxpayer's tax liability. Credits limited in this manner are termed nonrefundable tax credits. Refundable tax credits, such as the Additional Child Tax Credit, in contrast, are fully payable to the taxpayer, even if the credit exceeds the tax liability. These types of credits provide greater economic benefits because the taxpayer realizes the full benefit of the credit, regardless of the underlying tax liability.

involved in litigation. In accordance with federal tax law and implementing IRS procedures, when a taxpayer is in litigation, the statutory time period that IRS has to collect on the outstanding tax debt is suspended until such time as the litigation is resolved.¹⁹ In this specific example, by recording the account as being in litigation, the account was incorrectly reflected as an account for which IRS could continue to pursue collection, when in fact the statutory collection period for this taxpayer's account had already expired and thus the account balance should have been removed from IRS's records.

Another type of error both IRS and we identified during this year's audit involved instances where IRS's financial systems misclassified taxpayer accounts because its processes were not effectively designed. For example, IRS programmed its subsidiary ledger to classify a taxpayer's account as a taxes receivable when a taxpayer's master file account contained a specific status code that indicated that the taxpayer had entered into a voluntary installment agreement to pay off outstanding taxes. In essence, the agreement to enter into the installment agreement constitutes the taxpayer's acknowledgment of the outstanding tax debt.²⁰ However, IRS also used this same status code when IRS placed a continuous levy on the taxpayer's wages with the taxpayer's employer, and it had collected a levy payment. In this case, the taxpayer has not necessarily agreed to the outstanding tax debt,²¹ a key requirement under federal accounting standards for classifying an account as taxes receivable. Therefore, programming its subsidiary ledger to automatically classify an account with this code as a tax receivable without considering additional information did not always result in a correct classification.

¹⁹IRS has a statutory limitation on the length of time it can pursue unpaid taxes, generally 10 years from the date of the tax assessment unless certain statutory exceptions apply. If, however, IRS timely commences litigation for the collection of the tax, then the statutory collection period shall be extended and shall not expire until the tax liability (or the judgment against the taxpayer arising from such liability) is satisfied or becomes unenforceable. See 26 U.S.C. § 6502.

²⁰In accordance with federal accounting standards, taxpayer agreement is necessary for an account to be classified as taxes receivable unless there is a court order in favor of IRS.

²¹When IRS places a continuous levy on a taxpayer's wages, there is initially no agreement from the taxpayer. However, if a taxpayer does not take action to stop IRS's levy after a reasonable amount of time, in this case after IRS takes three levy payments, then IRS takes the position that the taxpayer has agreed to the unpaid taxes that IRS is levying to pay off.

We also found this year that IRS staff did not consistently follow its procedures for manually calculating and recording failure-to-pay penalties against taxpayers in situations where IRS's computer program could not compute the correct amounts, as discussed above. As a result, numerous taxpayer accounts contained incorrect penalty amounts. Further, during this year's audit, we observed instances where IRS could not locate documentation such as a tax return or examination results to support information recorded in the master files. Without such documentation, for these specific cases, IRS was not able to support the subsidiary ledger's classification as a taxes receivable.

Current system limitations and errors that caused inaccurate tax records resulted in IRS having to make numerous adjustments as part of its process for estimating the balance of net taxes receivable and other unpaid tax assessments. When reviewing its sample of taxpayer accounts initially classified by its systems as taxes receivable, IRS adjusted the affected taxpayer accounts to reflect the correct value when it identified misclassified cases or inaccurate balances. Based on a statistical projection of these individual adjustments, IRS made multibillion-dollar adjustments to the year-end balances of all three categories of unpaid tax assessments generated by its subsidiary ledger in order to produce reliable amounts for external reporting on its balance sheet and the RSI. For example, through its statistical sampling and estimation process, IRS identified errors necessitating almost \$17 billion in adjustments to the 2014 fiscal year-end gross taxes receivable balance produced by its subsidiary ledger. Absent the use of this statistical estimation process, the various unpaid tax assessment balances produced by its subsidiary ledger would have been materially inaccurate.

The cumulative impact of these control deficiencies is such that a reasonable possibility exists that a material misstatement of IRS's financial statements would not be prevented, or detected and corrected, on a timely basis. Consequently, these control deficiencies collectively represent a material weakness in IRS's internal control over unpaid tax assessments. Because of this material weakness and the associated system deficiencies that existed during fiscal year 2014, IRS's financial management systems were unable to report financial information in accordance with federal accounting standards, and did not comply with federal financial management systems requirements as set forth in Treasury Financial Manual (TFM), chapter 9500, "Revised Federal

Financial Management System Requirements for Fiscal 2014 Reporting.”²²

Based on our recommendations from prior audits, IRS has taken actions over the years to improve its management and reporting of unpaid tax assessments, including the phased-in implementation of its subsidiary ledger for unpaid tax assessments, to enable it to analyze and classify unpaid tax assessment account balances from the master file into the various financial reporting categories. However, IRS’s actions to date have not been effective at fully addressing all the issues that continue to cause a lack of transaction traceability and material inaccuracies produced by this subsidiary ledger. IRS has developed an action plan intended to address the deficiencies involving unpaid tax assessments; however, the plan does not address all of the specific system enhancements that are needed to enable its subsidiary ledger to more accurately distinguish between the three categories of unpaid tax assessments so that reliable transaction-based balances for each are ultimately recorded in the general ledger. Therefore, it is unclear if IRS’s proposed actions will fully address the system issues that cause significant inaccuracies in the unpaid tax assessments information IRS uses for financial reporting. In addition, IRS has not communicated to us any specific plans to address the other existing control deficiencies that are affecting the accuracy of taxpayer accounts and proper classification of unpaid tax assessment amounts. Based on IRS’s most recent response to our open recommendation concerning such errors, IRS has yet to identify the underlying control deficiencies that have impaired its ability to prevent, or detect and correct, inaccuracies or errors in taxpayer accounts on a timely basis.²³ These serious deficiencies in internal control over unpaid tax assessments are likely to continue to exist until IRS (1) significantly enhances the capabilities of the systems it uses for recording, classifying, and reporting unpaid tax assessments to more accurately distinguish the balances among the three categories of unpaid

²²Department of the Treasury, “Revised Federal Financial Management System Requirements for Fiscal 2014 Reporting,” *ch. 9500 in Treasury Financial Manual* (Washington, D.C.: October 31, 2013). IRS’s financial management systems (1) did not substantially comply with Federal Financial Management Systems Requirements or federal accounting standards and (2) substantially complied with the *U.S. Government Standard General Ledger* at the transaction level.

²³GAO, *Management Report: Improvements Are Needed to Enhance the Internal Revenue Service’s Internal Controls*, [GAO-14-433R](#) (Washington, D.C.: July 2, 2014).

tax assessments and (2) improves controls over information recorded in taxpayer accounts so that reliable transaction-based balances for taxes receivable can be ultimately recorded in the general ledger.

Significant Deficiency in Internal Control over Financial Reporting Systems

During fiscal year 2014, IRS continued to devote attention to securing its information systems to appropriately protect sensitive taxpayer and financial information. Key among its actions during fiscal year 2014 were improving the security over the software that manages changes to its mainframe environment and upgrading secure communications enterprise-wide for sensitive data. The agency was also in the process of upgrading user workstations to a more secure operating system. These actions are important steps toward improving the overall effectiveness of its information system controls and therefore the reliability of its financial data. However, deficiencies in information security from prior years that continued to exist in fiscal year 2014, along with new deficiencies we identified during this year's audit and discuss further below, are important enough to merit the attention of those charged with governance of IRS and therefore represent a significant deficiency in IRS's internal control over financial reporting systems as of September 30, 2014.

One of the serious deficiencies from prior years' audits that remained throughout fiscal year 2014 was that IRS did not install appropriate security updates on certain databases and servers, which increased the risk that known information security vulnerabilities could be exploited. In addition, although IRS had upgraded secure communications enterprise-wide, communications between key financial applications were still at risk because the applications were not using strong encryption, limiting the agency's ability to ensure data integrity and confidentiality. Another serious deficiency that continued to exist during fiscal year 2014 was IRS's insufficient monitoring of mainframe control activities that support its financial reporting. This increased the risk that any deficiencies in internal control over these systems may not be detected in a timely manner, thereby hindering IRS's ability to effectively assess and respond to security risks.

This year's audit also identified new deficiencies in internal control over IRS's financial reporting systems. For example, IRS did not effectively maintain the secure configuration of a key application used to transfer administrative and taxpayer data from one business unit to another. The agency created another version of this application to run in parallel with the existing version in order to support its responsibilities under PPACA. However, this newly created version contained previously identified

weaknesses, even though IRS had already corrected these same weaknesses in the original version. This increased the risk that the integrity and availability of data traversing the application in the new version could be compromised. In addition, IRS did not comprehensively monitor changes to files that affect mainframe security, reducing its ability to ensure the integrity of the system. Further, IRS was not logging user access to taxpayer data in the Customer Account Data Engine 2 (CADE 2),²⁴ potentially affecting the confidentiality of sensitive taxpayer information, without any accountability in place.

Although IRS had a comprehensive framework for its information security program, some aspects of it were not yet effectively implemented. For example, IRS's testing methodology did not always determine whether required controls were operating effectively; consequently, we continued to identify control weaknesses that had not been detected by IRS. Also, IRS had not updated key mainframe policies and procedures to address issues such as audit and monitoring of access from one processing environment to another, thereby increasing the risk of unauthorized access to tax processing systems not being detected. In addition, IRS did not reassess controls for a key system after significant changes had been made in the operating environment. Our audit identified preventable weaknesses in this system, such as the use of a shared administrative account and the transmission of sensitive data without encryption. Further, IRS had not ensured that many of its corrective actions to address previously identified deficiencies were effective. For the 24 recommendations from our prior audits that IRS told us it had implemented, we determined that weaknesses associated with 10 of the 24 recommendations had not been effectively corrected. Until IRS effectively implements all key aspects of its information security program, the agency will not have reasonable assurance that computing resources are consistently and effectively protected from inadvertent or deliberate misuse.

²⁴CADE 2 is IRS's new program for processing individual taxpayer accounts that is intended to eventually replace the Individual Master File. The initial phase, which IRS began using in January 2012, modified the Individual Master File processing cycle to allow for daily (rather than weekly) processing and posting of taxpayer returns and established the database that will serve as the authoritative source for all individual taxpayer data. In the second phase, which is still in the early planning stages, IRS expects, among other things, to (1) rewrite applications so they can directly access and update the database and (2) ensure compliance with Federal Financial Management System Requirements.

In light of the control risks created by IRS's ongoing information security deficiencies, continued and consistent management commitment and attention to an effective information security program will be essential to the maintenance of, and continued improvements in, its information system controls. Until IRS takes additional steps to (1) more effectively implement its testing and monitoring capabilities, (2) ensure that policies and procedures are updated, and (3) address unresolved and newly identified control deficiencies, its financial and taxpayer data will remain vulnerable to inappropriate and undetected use, modification, or disclosure.

Other Matters

Required Supplementary Information

U.S. generally accepted accounting principles issued by the Federal Accounting Standards Advisory Board (FASAB) require that the RSI be presented to supplement the financial statements. Although the RSI is not a part of the financial statements, FASAB considers this information to be an essential part of financial reporting for placing the financial statements in appropriate operational, economic, or historical context. We have applied certain limited procedures to the RSI in accordance with U.S. generally accepted government auditing standards, which consisted of inquiries of management about the methods of preparing the RSI and comparing the information for consistency with management's responses to the auditor's inquiries, the financial statements, and other knowledge we obtained during the audit of the financial statements, in order to report omissions or material departures from FASAB guidelines, if any, identified by these limited procedures. We did not audit and we do not express an opinion or provide any assurance on the RSI because the limited procedures we applied do not provide sufficient evidence to express an opinion or provide any assurance.

Other Information

IRS's other information contains a wide range of information, some of which is not directly related to the financial statements. This information is presented for purposes of additional analysis and is not a required part of the financial statements or the RSI. We read the other information included with the financial statements in order to identify material inconsistencies, if any, with the audited financial statements. Our audit was conducted for the purpose of forming an opinion on IRS's financial statements. We did not audit and do not express an opinion or provide any assurance on the other information.

Other Financial Management Challenges

In addition to the challenge of addressing its internal control deficiencies, IRS also faces other significant financial management challenges related to (1) safeguarding of taxpayer receipts and associated information, (2) significant invalid refunds based on identity theft, and (3) implementation of the tax provisions contained in PPACA. The difficulties confronting IRS in its efforts to effectively manage each of these challenges are further magnified by the need to do so in an environment of diminished budgetary resources.²⁵

Safeguarding Taxpayer Receipts and Associated Information

IRS continues to face an ongoing management challenge from the millions of hard copy tax returns and hundreds of billions of dollars in associated taxpayer payments it receives and processes each year. As long as IRS continues to receive large volumes of hard copy taxpayer payments and supporting data, there will continue to be a significant risk to the government and taxpayers alike that loss of receipts or inappropriate disclosure or compromise of taxpayer information may occur during this process. Safeguarding these taxpayer receipts and associated taxpayer information to prevent such events is among IRS's most important and demanding responsibilities. During our financial audits of IRS, including this year's audit, we continued to identify deficiencies in IRS's internal control intended to safeguard taxpayer receipts and associated information that while not individually or in the aggregate constituting a significant deficiency or material weakness, are nonetheless sensitive matters requiring IRS management's attention. We have made numerous recommendations to address these issues, to which IRS has been responsive.²⁶ However, several deficiencies that we had reported in prior years and which IRS had resolved reemerged during this year's audit. Congressional and taxpayer expectations for safeguarding receipts and associated taxpayer information are justifiably high, and as IRS strives to create efficiencies in this area by leveraging

²⁵IRS's budget has declined approximately \$900 million from fiscal years 2010 through 2014, and its staffing has declined by about 10,000 full-time equivalents since fiscal year 2010. GAO, *IRS 2015 Budget: Long-Term Strategy and Return on Investment Data Need to Better Manage Budget Uncertainty and Set Priorities*, [GAO-14-605](#) (Washington, D.C.: June 12, 2014).

²⁶We have reported these deficiencies and recommendations to address them, as well as IRS's associated corrective actions, in various management and status of recommendations reports to IRS. See, for example, [GAO-14-433R](#).

technology and better utilizing available resources, it is critical that IRS continues to maintain effective internal control necessary to appropriately mitigate the significant risk related to this activity, including ongoing monitoring of key internal controls to ensure that they do not deteriorate over time.

Preventing and Detecting Invalid Refunds Based on Identity Theft

Tax refund fraud associated with identity theft continues to be a persistent, evolving threat, one that imposes a serious financial and emotional toll on honest taxpayers and threatens the integrity of the tax administration system. Within the tax system, identity theft refund fraud occurs when an individual or group uses a stolen taxpayer's name and taxpayer identification number (generally a Social Security number) to file fraudulent tax returns claiming tax refunds.²⁷ Identity theft refund fraud takes advantage of IRS's "look-back" compliance model. Because of pressures to issue refunds quickly, under this model, rather than holding refunds until completing all compliance checks, IRS issues refunds before fully verifying the information on tax returns.²⁸ After the refunds are issued, IRS performs further validation of the tax return information, which has enabled IRS to detect significant amounts of identity theft refund fraud after the fact.²⁹ Fraudulent refund claims are often submitted to IRS early in the filing season, before the victims, whose identities have been stolen, file their tax returns. In many such cases, the fraudulent refund claim is only discovered after the legitimate taxpayer files his or her tax

²⁷A taxpayer identification number is a number assigned to taxpayers for identification purposes. Depending on the type of the taxpayer, this can be a Social Security number, Employer Identification Number, or an Individual Taxpayer Identification Number assigned to individuals who are not eligible to obtain Social Security numbers.

²⁸IRS is required to pay interest on a tax overpayment if the refund is issued more than 45 days after the last day prescribed for filing the return or, in the case of a return filed after such last date, more than 45 days after the filing date. 26 U.S.C. § 6611(e). IRS informs taxpayers to anticipate their refunds generally within 21 days after filing and actively tries to meet this target. Therefore, IRS issues refunds after only doing some selected, automated reviews of the information the taxpayers submit to verify identity (e.g., name and Social Security number); filter out returns with indicators of fraud, such as a mismatched name and Social Security number; and correct obvious errors, such as calculation mistakes and claims for credits and deductions exceeding statutory limits. Because of the need to issue refunds quickly, some of IRS's refund validation steps are not performed until after the refund is issued.

²⁹Such validation checks consist of looking for duplicate returns and matching tax returns to third-party information provided to IRS by employers, financial institutions, and others.

return and IRS realizes that a refund has already been paid on the taxpayer's account. The legitimate taxpayer's refund is delayed while IRS spends time determining who is legitimate, thus causing an undue burden for the victim of the identity theft.

IRS management continues to face a significant challenge arising from the large numbers of identity theft refund claims it receives and continues to devote significant resources to addressing the problem.³⁰ IRS has reported a substantial increase in identity theft refund fraud; however, in August 2014, we reported that it is unclear whether this increase is due to an overall increase in identity theft refund fraud, an improvement in IRS's ability to detect identity theft refund fraud, or a combination of the two.³¹ For example, IRS instituted identity theft filters in 2012,³² which helped it find additional identity theft incidents, but it is not known how much of the reported increase can be attributed to the filters or to an increase in identity theft refund fraud. For tax filing season 2013,³³ IRS estimated that \$30 billion in identity theft refund fraud was attempted. During this same time frame, IRS estimated that it paid \$5.8 billion in fraudulent identity theft refunds while preventing or recovering about \$24.2 billion, or 81 percent, of the estimated attempted refund fraud. However, because of the challenges inherent in detecting identity theft refund fraud, the number of identity theft-based refund claims IRS did not identify or prevent during this period and their associated cost to the federal government are unknown.

³⁰See [GAO-14-605](#). Since IRS began tracking refund fraud in fiscal year 2011, it has more than quadrupled the number of full-time equivalents (FTE) allocated to refund fraud, from 1,018 FTEs in fiscal year 2011 to 4,146 FTEs in fiscal year 2014 (about 5 percent of its total workforce).

³¹GAO, *Identity Theft: Additional Actions Could Help IRS Combat the Large, Evolving Threat of Refund Fraud*, [GAO-14-633](#) (Washington, D.C.: Aug. 20, 2014).

³²Identity theft filters screen returns using characteristics that IRS has identified in previous identity theft refund fraud schemes. The filters also search for clusters of returns with similar characteristics, such as the same bank account or address, which could indicate potential fraud.

³³The tax filing season is when IRS processes most tax returns and provides services including telephone, correspondence, and website assistance for tens of millions of taxpayers. IRS's analysis on identity theft refund fraud covered filing season 2013, which ranged from January 1, 2013, to December 31, 2013.

IRS has continually enhanced its programs to detect, resolve, and prevent identity theft-based refund fraud. For example, IRS (1) offers personal identification numbers to past fraud victims to help them prevent a recurrence of identity theft,³⁴ (2) uses identity theft filters to screen returns during tax return processing, and (3) investigates third-party leads regarding suspected identity theft refund fraud after issuing a refund. However, the options available to IRS in attempting to minimize identity theft-related refund claims are affected by a number of constraints. For instance, (1) the personal information contained in tax returns and related information submitted to IRS is confidential and is protected from disclosure except as specifically authorized by statute;³⁵ (2) the benefits to be derived by more rigorous screening for potentially fraudulent tax returns must be weighed against the adverse effects of increased taxpayer burden as the closer scrutiny inevitably causes delays in the payment of valid refunds to legitimate taxpayers as IRS reviews their claims more closely; and (3) IRS cannot always match third-party information, such as employers' wage data, with tax returns before it issues the refunds because such data are not available until months after the refunds are issued.³⁶ In addition, as with last year's audit,³⁷ this year we continued to find internal control deficiencies that have contributed to tax refunds issued to identity thieves, and some of our recommendations to address these deficiencies remain open.³⁸

IRS recognizes refund fraud based on identity theft as a major challenge affecting the agency and has responded to this threat with new ways to combat fraud. If IRS is to minimize the effects of identity theft-based refund claims on taxpayers and the associated loss to the federal government, it is critical for IRS to continue to explore options available in

³⁴Personal identification numbers are single-use identification numbers sent to identity theft victims who have validated their identities with IRS.

³⁵26 U.S.C. § 6103. The statute places limitations on IRS's ability to share personal information contained in tax returns with certain other entities affected by identity theft, including law enforcement agencies.

³⁶[GAO-14-633](#).

³⁷[GAO-14-433R](#).

³⁸These deficiencies do not individually or in the aggregate constitute a significant deficiency or material weakness, but are nonetheless sensitive matters requiring IRS management's attention in order to further prevent fraudulent refunds based on identity theft.

order to effectively identify, design, and implement the most appropriate measures and internal controls to prevent and detect identity theft-related refund fraud.

Implementing Patient Protection and Affordable Care Act Tax-Related Provisions

PPACA, enacted in March 2010, includes provisions to expand access to public and private health insurance, including the creation of health insurance exchanges. In addition, PPACA made a number of changes affecting the provision of private health insurance that involved numerous complex changes to the nation's tax laws. Accordingly, PPACA's tax-related provisions have placed many new responsibilities upon IRS that will require significant implementation costs and extensive coordination not only within IRS but with multiple agencies and external partners.³⁹ For example, IRS financial management officials must coordinate closely with IRS business units to ensure that the associated costs of design and implementation of related information systems are properly accounted for and classified on its financial statements. IRS must also work closely with partner agencies, such as the Department of Health and Human Services' Centers for Medicare & Medicaid Services (CMS), to develop information systems that can share data with other agencies. CMS has overall responsibility for key federal systems supporting Healthcare.gov, the website through which consumers access the federal marketplace to shop for and enroll in private health insurance coverage.⁴⁰ IRS, along with several other federal agencies, plays a key role in maintaining systems that connect with CMS systems to perform eligibility-checking functions. A number of commercial entities, including CMS contractors, participating issuers of qualified health plans, agents, and others also connect to the

³⁹GAO, *Patient Protection and Affordable Care Act: IRS Managing Implementation Risks, but Its Approach Could Be Refined*, [GAO-12-690](#) (Washington, D.C.: June 13, 2012). PPACA involves major health care stakeholders, including federal and state governments, employers, issuers of qualified health plans, and health care providers. IRS is one of several agencies accountable for implementing the legislation and has responsibilities pertaining to 47 PPACA provisions. Some provisions took effect immediately or retroactively, while others are to take effect as late as 2018.

⁴⁰PPACA requires the establishment of a health insurance exchange—referred to as marketplaces—in each state where eligible individuals can compare and select among insurance plans offered by participating issuers of health coverage. CMS is responsible for overseeing the establishment of these marketplaces, including creating a federally facilitated marketplace in states not establishing their own.

network of systems that support enrollment in coverage offered through the federal marketplace. While CMS management administers PPACA programs that process, approve, and calculate the monthly advance premium tax credit and cost-sharing reduction payments—new tax law provisions that were established under PPACA—to qualifying individuals,⁴¹ IRS management is responsible for managing and administering the federal appropriations used to pay the issuers of health insurance plans to cover these payments.⁴² IRS is also responsible for the financial reporting of the related payment transactions. Additionally, IRS is responsible for providing guidance to taxpayers, employers, issuers, and others to ensure compliance with the new tax provisions contained in PPACA.

IRS has developed a strategic approach for implementing this massive program; however, IRS is faced with a number of management challenges and risks as it proceeds. For example, IRS must quickly design and implement large information systems to carry out provisions of the law, and the investment in resources to accomplish this is large.⁴³ Since the advance premium tax credit and cost-sharing reduction payments are reflected on IRS's financial statements,⁴⁴ IRS must also coordinate closely with CMS to ensure that CMS has effective controls in place over the integrity of the payment amounts, and must continually monitor these controls and develop compensating procedures to mitigate any risks to IRS's financial reporting. Furthermore, because of the interconnections of IRS systems with those that support Healthcare.gov,

⁴¹The advance premium tax credit is generally available to eligible taxpayers and their dependents who are (1) enrolled in one or more qualified health plans through a marketplace and (2) not eligible for other health insurance coverage that meets certain standards. If eligible, taxpayers may qualify for advance payments made directly to the issuers of the qualified health plan in which the taxpayers enrolled. The amount of advance payments is reconciled with the actual premium tax credit when the taxpayers file their tax returns. Cost-sharing reduction generally refers to costs that an individual must pay when using services that are covered under the health plan in which the individual is enrolled. Common forms of cost sharing include co-payments and deductibles. See Pub. L. No. 111-148, 124 Stat. 119, § 1401. 26 U.S.C. § 36B sets forth the refundable credit for a qualified health plan.

⁴²See 26 U.S.C. § 36B.

⁴³See [GAO-12-690](#) for a more detailed discussion of this and other challenges and risks.

⁴⁴IRS began reporting the advance premium tax credit and cost-sharing reduction payments within the *Total refunds of federal taxes and outlays* on the Statement of Custodial Activity in fiscal year 2014.

IRS is faced with significant challenges concerning the protection of the privacy and confidentiality of taxpayer information that is shared among these systems. Specifically, IRS provides federal tax information to CMS and state governments to verify applicants' incomes for determining their eligibility for insurance affordability programs,⁴⁵ including the advance premium tax credit and cost-sharing reduction programs created pursuant to PPACA. IRS and CMS have taken steps to establish policies and procedures to comply with requirements for protecting taxpayer information. However, CMS has not fully addressed security and privacy management weaknesses in the controls protecting the confidentiality, integrity, and availability of the data maintained in the system that performs key functions related to health plan enrollment.⁴⁶ Given the interconnections between CMS and IRS systems, until these weaknesses are fully addressed, increased and unnecessary risks of unauthorized access to or disclosure of taxpayer information collected and maintained by Healthcare.gov and related systems remain. Therefore, it is important for IRS to have systems in place and work closely with other agencies that are part of the network of systems that share data pursuant to PPACA to consistently identify, assess, mitigate, and monitor potential risks to taxpayer information.

Report on Compliance with Laws, Regulations, Contracts, and Grant Agreements

In connection with our audits of IRS's financial statements, we have tested compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements consistent with our auditor's responsibility discussed below. We caution that noncompliance may occur and not be detected by these tests. We performed our tests of compliance in accordance with U.S. generally accepted government auditing standards.

Management's Responsibility

IRS management is responsible for complying with laws, regulations, contracts, and grant agreements applicable to IRS.

⁴⁵See 26 U.S.C. § 6103.

⁴⁶GAO, *Healthcare.gov: Actions Needed to Address Weaknesses in Information Security and Privacy Controls*, [GAO-14-730](#) (Washington, D.C.: Sept. 16, 2014).

Auditor's Responsibility

Our responsibility is to test compliance with selected provisions of laws, regulations, contracts, and grant agreements applicable to IRS that have a direct effect on the determination of material amounts and disclosures in the IRS financial statements, and perform certain other limited procedures. Accordingly, we did not test compliance with all laws, regulations, contracts, and grant agreements applicable to IRS.

Results of Our Tests for Compliance with Laws, Regulations, Contracts, and Grant Agreements

Our tests for compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements disclosed no instances of noncompliance for fiscal year 2014 that would be reportable under U.S. generally accepted government auditing standards. However, the objective of our tests was not to provide an opinion on overall compliance with laws, regulations, contracts, and grant agreements applicable to IRS. Accordingly, we do not express such an opinion.

Intended Purpose of Report on Compliance with Laws, Regulations, Contracts, and Grant Agreements

The purpose of this report is solely to describe the scope of our testing of compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements and the results of that testing, and not to provide an opinion on compliance. This report is an integral part of an audit performed in accordance with U.S. generally accepted government auditing standards in considering compliance. Accordingly, this report on compliance with laws, regulations, contracts, and grant agreements is not suitable for any other purpose.

Agency Comments

In commenting on a draft of this report, the Commissioner of Internal Revenue stated that IRS was pleased to receive an unmodified opinion on its financial statements for the 15th consecutive year and that IRS is dedicated to continuing to improve its financial management, internal controls, and information security posture. The Commissioner also acknowledged IRS's collaboration with CMS to evaluate the internal controls over the advance premium tax credit and cost-sharing reduction payments which directly affect IRS financial reporting requirements under PPACA.

We will evaluate the effectiveness of IRS's corrective actions during our audit of IRS's fiscal year 2015 financial statements. The complete text of IRS's response is reprinted in appendix II.

Cheryl E. Clark

Cheryl E. Clark
Director
Financial Management and Assurance

November 10, 2014

Management's Discussion and Analysis



Internal Revenue Service

Management's Discussion and Analysis Fiscal Year 2014

"Taxes are what we pay for a civilized society."
Oliver Wendell Holmes, Jr., U.S. Supreme Court Justice

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

IRS VISION, MISSION, AND ORGANIZATION

Vision

We will uphold the integrity of our nation's tax system and preserve the public trust through our talented workforce, innovative technology and collaborative partnerships.

Mission

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

History

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

Strategic Goals

The IRS 2014-2017 strategic goals provide a central direction for the attainment of our mission and vision. Our strategic foundation for organizational excellence supplements the strategic goals and describes the internal initiatives required to support our taxpayer-facing actions. Our two primary strategic goals align to the service and enforcement areas.

Strategic Foundation for Organizational Excellence: Invest in our workforce and the foundational capabilities necessary to achieve our mission and deliver high performance for taxpayers and stakeholders.

Strategic Goal 1: Deliver high quality and timely service to reduce taxpayer burden and encourage voluntary compliance.

Strategic Goal 2: Effectively enforce the law to ensure compliance with tax responsibilities and combat fraud.

To promote these goals and strengthen decision-making across the agency, IRS has introduced a new Enterprise Risk Management (ERM) program to bring greater transparency to agency-wide risks for senior-level decision-makers, with a particular focus on risks that span organizational boundaries and have the highest potential impact.

Employees

In FY 2014, the IRS employed approximately 94,000 people, including over 19,800 temporary and seasonal staff.

Location

The IRS headquarters is located at 1111 Constitution Ave., NW, Washington, DC 20224. There are also over 600 offices in all states and territories and some U.S. embassies and consulates.

INTERNAL REVENUE SERVICE
 Management's Discussion & Analysis
 Fiscal Year 2014

Internet

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

Organization Structure and Accountability

The IRS has three commissioner-level organizations.

Commissioner, Internal Revenue Service <i>(Specialized IRS units report directly to the Commissioner's Office)</i>	Deputy Commissioner for Services and Enforcement <i>(Reports directly to the Commissioner and oversees the four primary operating divisions and other service and enforcement functions)</i>	Deputy Commissioner for Operations Support <i>(Reports directly to the Commissioner and oversees the IRS support functions, facilitating economy of scale efficiencies and better business practices)</i>
<ul style="list-style-type: none"> • Chief Counsel • Appeals • Taxpayer Advocate Service • Equity, Diversity and Inclusion • Research, Analysis, and Statistics • Communications and Liaison • Office of Compliance Analytics • Enterprise Risk Management Program Office 	<ul style="list-style-type: none"> • Wage and Investment Division • Large Business and International Division • Small Business/Self Employed Division • Tax Exempt and Government Entities Division • Criminal Investigation • Office of Professional Responsibility • Affordable Care Act Office • Office of Online Services • Return Preparer Office • Whistleblower Office 	<ul style="list-style-type: none"> • Information Technology • Agency-Wide Shared Services • Privacy, Government Liaison and Disclosure • Human Capital Office • Chief Financial Office

Tax Statistics Highlights

FY 2014 Tax Stats at a Glance	
Total Returns Processed	199 million
Total Returns and Other Forms Processed	242 million
Total Revenue Collected	\$3.1 trillion
Enforcement Revenue Collected	\$57.1 billion
Total Refunds and Outlays	\$374 billion
Avg. Individual Refund	\$2,719
E-File Rate – Individual	84.1%
E-File Rate – Business	43.1%
IRS.gov Page Views	1.8 billion
"Where's My Refund?" Usage	189.1 million
Number of Downloads from IRS.gov	117.8 million

INTERNAL REVENUE SERVICE
 Management's Discussion & Analysis
 Fiscal Year 2014

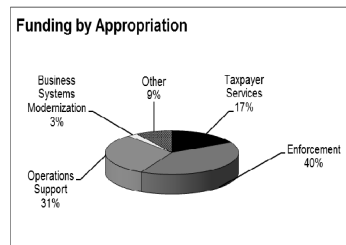
FINANCIAL RESOURCES

The IRS' FY 2014 operating level was \$11.29 billion - \$92 million above the prior year but nearly \$900 million below the FY 2010 level. The \$92 million increase over FY 2013 was designated for use in the improvement of service delivery to taxpayers and the identification and prevention of refund fraud and identity theft, as well as to address international and offshore compliance issues. In addition to the appropriated budget, IRS funding also included \$1,089 million from user fees, offsetting collections, earmarked funds, and unobligated balances from prior years for a total operating level of \$12 billion.

Funding by Appropriations (\$ thousands)

Taxpayer Services [\$2,122,521] funds the processing of tax returns and related documents, and assistance for taxpayers in filing returns and paying taxes due.

Enforcement [\$4,952,641] funds examination of tax returns, collection of balances, the administrative and judicial settlement of taxpayer appeals of examination findings, as well as providing resources for strengthened enforcement to reduce invalid claims and erroneous filings associated with the Earned Income Tax Credit (EITC) program.



Operations Support [\$3,809,994] funds administrative services, policy management and IRS-wide support. The appropriation also funds staffing, equipment, and related costs to manage, maintain, and operate critical information systems that support tax administration.

Business Systems Modernization [\$312,938] funds capital asset acquisitions of information technology systems to modernize key tax administration systems.

In addition to the core appropriations, the IRS has the following appropriations (special funds):

Other Resources: User Fees [\$366,212] from payment for services provided and [\$313,905] from prior year balances brought forward October 1; Offsetting Collections [\$97,840]; Earmarked Funds [\$9,727] and Unobligated Balances [\$300,930] brought forward October 1.

Use of Resources

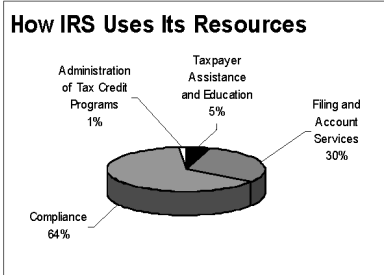
The IRS uses a cost allocation methodology to assign support and overhead costs to each program described below. The Statement of Net Cost reflects the use of IRS resources in conducting its major programs and reports the full cost of these programs in accordance with the Statement of Federal Financial Accounting Standards No. 4, "Managerial Cost Accounting."

- **Taxpayer Assistance and Education activities [5%] include taxpayer education and outreach, tax publication issuance and distribution.**

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

- **Filing and Account Services activities [30%]** include filing tax returns, maintaining customer accounts, processing taxpayer information, providing service to taxpayers, and resolving issues.
- **Compliance activities [64%]** include pre-filing agreements, document matching, examination, collection, and criminal investigation activities.
- **Administration of Tax Credit Programs¹ [1%]** primarily includes costs for Earned Income Tax Credit (EITC) program activities.

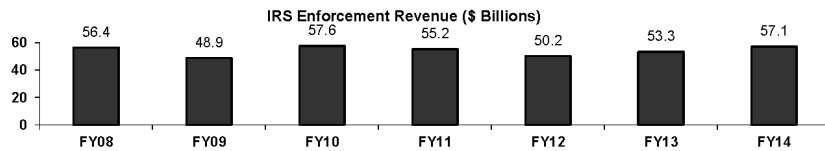
In addition to EITC, which is the single largest refundable tax credit program, the IRS also administers 16 other tax credit programs whose costs are reflected in the IRS Financial Statements.



Use of Resources (\$)		
Program	FY 2014	FY 2013
Taxpayer Assistance and Education	\$607,745	\$607,408
Filing and Account Services	\$3,828,087	\$3,828,546
Compliance	\$8,030,757	\$8,196,759
Administration of Tax Credit Programs	\$164,621	\$168,989

PERFORMANCE SUMMARY

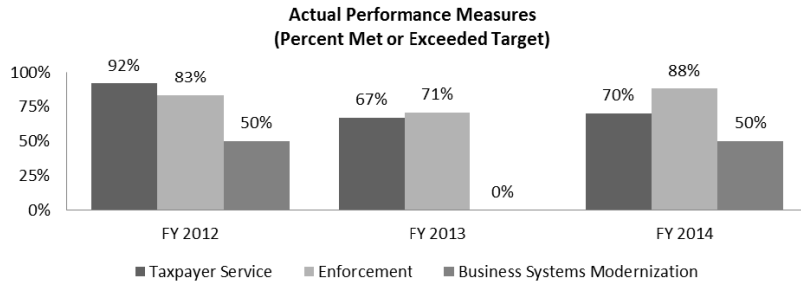
Enforcement of the tax law is an integral part of the IRS effort to enhance voluntary compliance, especially as tax administration becomes increasingly complex. The IRS has maintained a balanced and effective enforcement program despite many challenges, collecting more than \$50 billion in enforcement revenue in FY 2014, the fifth year in a row.



¹ Prior to fiscal year 2012, this program also included the costs of administering the health coverage tax credit (HCTC). Those costs are now included under Filing and Account Services activities, except for costs related to HCTC obligations made prior to FY 2012, which remain here.

INTERNAL REVENUE SERVICE
 Management's Discussion & Analysis
 Fiscal Year 2014

In FY 2014, the IRS maintained an overall success rate of 79% in meeting or exceeding the targets for 23 of its 29 performance measures. Detailed information on performance is presented in the Performance Summaries and Explanation of Shortfalls under each of Strategic Foundation, Goal 1, and Goal 2 and in Appendix A, Performance Measures Descriptions; and Appendix B, Performance Measurement Data.



The IRS National Research Program (NRP) continued to analyze reporting compliance data for various taxpayer populations, including Individual Income Tax, Corporate Income Tax, Employment Taxes, and Fuel Excise Taxes. NRP results enhance taxpayer service by improving IRS processes to reduce taxpayer burden and support enforcement activities by identifying issues with high risks for noncompliance. The IRS Joint Statistical Research Program (JSRP) uses Statistics of Income and IRS administrative tax data to study the effects of existing tax policies on individuals, businesses, and the economy. The JSRP is responsible for several research projects that require collaborating with academia, non-profit research organizations, and other government agencies on important issues affecting tax administration. In FY 2014, the JSRP expanded the IRS Databank, which provides a new way of looking at tax data at the individual level, rather than the return level. This key difference facilitates better understanding of the impact of taxes on individuals. Another research effort under this program demonstrated a relationship between taxpayer searches for IRS and third-party information on capital gains reporting requirements and the taxpayer's capital gain realizations and reporting activity. Other research is focusing on the effectiveness of tax expenditures, including the extent to which these programs improve the income of children relative to their parents, and the effect of tax rates on workforce participation.

PERFORMANCE GOALS, OBJECTIVES, AND RESULTS

The Internal Revenue Service strives to deliver a high level of performance both in serving taxpayers and in enforcing the tax laws to ensure everyone complies with their tax responsibilities. The IRS Strategic Plan guided the IRS in this work by emphasizing these two overarching goals and the strategic foundation.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

STRATEGIC FOUNDATION: Invest in our workforce and the foundational capabilities necessary to achieve our mission and deliver high performance for taxpayers and stakeholders

To achieve its service and enforcement strategic goals, the IRS must have a strong strategic foundation. The IRS strategic foundation for organizational excellence supplements the strategic goals and describes the internal initiatives required to support taxpayer-facing actions. The IRS employees are our most valuable asset in effective tax administration. To support employees, IRS invested in innovative technology, new ways to interact with taxpayers, analytic capabilities and strong defenses to protect employees, systems and data.

Strategic Foundation Facts

- IRS.gov successfully handled 437.1 million page visits.
 - CADE 2 posted over 140.1 million returns and issued over 113.2 million refunds totaling \$300.65 billion.
 - Received more than 231.4 million individual returns and 19.1 million business returns (includes both Federal and State submissions) through Modernized e-File (MeF).
 - Increased the telework participation rate from 26% in FY 2013 to 31% in FY 2014.
 - Provided 60 webinars regarding work-life balance and wellness programs, with approximately 4,800 employees participating.
 - Transitioned over 92,000 IRS workstation operating systems from Microsoft Windows XP to Windows 7.
- ♦ **Objective 1: Be the best place to work in government by building a highly talented, diverse workforce and cultivating an inclusive and collaborative environment**

The IRS made significant progress toward achieving the strategic objective of becoming the "Best Place to Work in Government" and fostering high employee engagement. IRS employees are its greatest asset and the IRS is committed to building a diverse and high performing workforce by recruiting, hiring, and retaining top talent.

One of the key opportunities for enhancing collaboration at the IRS is to involve employees in solutions. As part of this effort, the IRS enhanced visibility and communications between employees and senior leadership by executing the following:

- Issued timely updates to its workforce on critical information via email, newsletter articles, and panel discussions, which assisted employees in performing their work accurately and efficiently. These communications kept employees up-to-date on changes in policies and procedures, equipment and technology, employee benefits, safety and security, and training.
- Conducted Town Hall meetings at various IRS locations across the country and issued 83 Commissioner and Deputy Commissioner "All Employee" email messages.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

- Established "A Better IRS" online mailbox, which offered employees an opportunity to share thoughts on IRS successes and provide ideas on how to drive meaningful change.
- Revamped the Commissioners' Corner section on the IRS intranet to showcase Commissioner news and employee feedback as well as to acknowledge employees' input that resulted in organizational change.

The IRS focused on employee and leadership development to ensure employees have the requisite skills to do their jobs efficiently and effectively. The IRS provided career development and job rotation opportunities to continue the development of future leaders and improved succession planning to better leverage the vast knowledge of IRS employees. Specific examples include:

- Forty cross-functional Geographic Leadership Communities sponsored by executives, senior managers, and frontline managers serve to identify and support emerging leaders, host developmental opportunities and skill-building workshops, and increase employee engagement while leveraging talent and resources.
- Partnered with Skillsoft and American Council on Education (ACE) for the IRS College Credit Program. The program provides IRS employees with the opportunity to earn academic college credit after passing an IRS-proctored exam in 41 college-level course topics from 62 Skillsoft college-level curricula, available online at no cost. Currently 782 employees are participating in the program, with 29,266 courses enrolled. Efforts are underway to receive accreditation for web proctoring for the IRS by December 31, 2014. Since launch, the website has been visited 87,492 times.
- Continued the Leadership Succession Review (LSR) program to ensure a strong, cohesive leadership development and succession planning approach from frontline to executive development. Through the four-stage LSR process, employees and managers are assessed against the IRS leadership competencies on their readiness to compete for and be successful at their designated "Next Step" leadership level. Approximately 26,900 IRS employees participated in LSR and the IRS was recognized by The Training Officers' Consortium with the *2014 Leadership Development Award* for its Leadership Succession Review Process.

To foster a collaborative and inclusive environment that values engagement and generates innovation through diverse ideas and experiences, the IRS continued to utilize low cost recognition and reward tools to recognize employee achievements:

- Implemented an enhanced Employee Recognition Program website, which celebrated the successes of employees and teams that made a difference. Almost 55,200 employees have visited the new website.
- Provided online tools, including personalized eCards and public *Shout Out!* messages, that enable any employee to recognize another employee for their contributions. Since October 2013, 64,223 e-Cards have been sent and 4,917 *Shout Out!* forum messages have been posted.

Over the past two years, the IRS initiated a streamlined hiring approach to increase hiring efficiency and centralized recruitment efforts to ensure that hiring needs were met. The IRS

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

successfully met the demands for mission critical initiatives, filing season, and the Affordable Care Act, while aggressively recruiting and hiring persons with disabilities and veterans. In FY 2014, the IRS:

- Participated in 167 targeted virtual events to attract as applicants persons with disabilities and veterans. The IRS' efforts yielded these results:
 - The 10% veteran hiring rate and 2% disabled veteran hiring rate goals were exceeded; 11.35% of external hires were veterans and 5.36% were disabled veterans.
 - The 10% disability hiring rate goal was exceeded; 10.82% of external hires were disabled and 1.73% had targeted disabilities.
- Expanded the IRS Veteran Internship Program to include 47 new unpaid interns, 3 of whom were converted to full time positions.
- Implemented the Vets-to-Feds program sponsored by the Office of Personnel Management (OPM) and the Department of Veterans Affairs.
- Conducted an in-depth review of the three classes taught at the World Services for the Blind (WSB) facility and modified the class schedule, reducing classroom instruction time by one-third. World Services for the Blind is a program that recruits individuals who are blind or have a visual impairment for IRS training classes and careers, and assist in transitioning them into IRS workforces. In FY 2014, WSB recruited 30 students; 29 were admitted to classes and 21 completed the classes.
- Exceeded the Office of the Personnel Management and Department of the Treasury hiring cycle time requirement of 80 days by 9 days. By leveraging technology and improving hiring strategies, the IRS processed 332,003 applications, 64,001 competitive and non-competitive personnel actions, and filled 1,976 critical positions. Additionally, the IRS deployed a new application designed to improve the Personal Identification Verification pre-screening process of potential new hires.

♦ **Objective 2: Ensure a secure environment that protects the safety of our people and security of our facilities**

The security of IRS employees and facilities are critical to the IRS mission. The IRS continues to provide the necessary safety and security measures to protect its employees and facilities and proactively identify new threats and address future risks.

FY 2014 successes include:

- Renewed 22,005 employee Smart Identification cards throughout the U.S., including remote posts of duty. The timely renewal of Smart Identification cards resulted in cost avoidance of \$700,000 for reenrollment and travel by ensuring cards were renewed prior to expiration.
- Implemented the certificate rekey process for IRS Smart Identification credentials and met the FY 2014 goal by rekeying 4,002 employees and contractors. Additionally, the

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

IRS implemented an online certificate rekey tool to reach more individuals remotely, resulting in cost avoidance of \$156,000 for reenrollment and travel by ensuring timely rekeying of cards as required on a 3 year basis.

♦ **Objective 3: Implement and maintain a robust enterprise risk management program that identifies emerging risks and mitigates them before they impact performance**

The IRS initiated the Enterprise Risk Management (ERM) program to identify emerging risks and mitigate them before performance is impacted. Comprehensive training was delivered to over 400 employees (approximately 300 executives and other senior staff). ERM liaisons were established in each business operating division. The IRS completed the first enterprise-wide risk assessment, and the ERM program supported multiple business-unit specific initiatives, leveraging IRS management capabilities in support of these efforts. Two examples of how business units are incorporating ERM approaches include initiatives involving Privacy Risk Management and the Enterprise Identity Protection Strategy including eAuthentication.

As part of one major specific initiative that helps to advance goals of the ERM program, the IRS developed a Strategic Privacy Roadmap focusing on eliminating privacy risks and data loss. In November 2013, the Office of Management and Budget directed (OMB M 14-04) agency privacy heads to report on privacy controls. The IRS catalog of privacy protection safeguards (modeled on NIST Special Publication 800-53 Revision 4, *Security and Privacy Controls for Federal Information Systems and Organizations*) included a preliminary assessment of 26 controls and evaluated mitigations to reduce privacy and data breach risks.

In addition, the IRS held an eAuthentication and Identity Protection Summit to develop a strategy and implementation roadmap to significantly deter identity theft, reducing fraud and the need for victim assistance. A critical element of this strategy is an authentication process that checks credentials and validates them as appropriate for the transaction requested. The summit produced an updated Enterprise Identity Protection Strategy that reduces risk by raising decision making to an enterprise level; protecting taxpayer rights; preventing civil liberty violations; ensuring consistent, equitable and effective treatment; establishing effective metrics; conducting continual monitoring; providing both consistent reporting and increasing transparency; and providing a platform to plug in different approaches.

Refer to Focus Area: Enterprise Risk Management (page 50) for more information.

♦ **Objective 4: Realize operational efficiencies and effectively manage costs by improving enterprise-wide resource allocation and streamlining processes**

The IRS has examined and streamlined processes to improve resource allocation including the FY 2014 Service Approach, the tax-exempt determinations process, and management of retirement and benefits programs. The IRS has also reduced costs through operational efficiencies.

The vision for service is tax administration that delivers tailored efficient services where, when, and how customers want to be served. The IRS 2014 Service Approach enabled the IRS to reserve person-to-person service for those who have issues that only the IRS can

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

help resolve. Savings from these initiatives were reinvested into improving service on the phones and at walk-in sites. It allowed IRS to use the right mix of technology resources. The six components of the FY 2014 Service Approach are: Practitioner Priority Services (PPS), Employer Identification Number (EIN), Requests for Transcripts, Tax Return Preparation, Tax Law Assistance, and Tax Refund Inquiries. Comprehensive communication efforts with both internal and external stakeholders helped both employees and taxpayers migrate towards alternative self-service channels.

The IRS streamlined the determination process for tax-exempt status applications. When the application cannot be closed on its initial merit, the applicant is directed to provide additional information and sign attestations guaranteeing truthfulness. The IRS also:

- Piloted a pre-classification process to improve the content of information-request letters through the use of standardized questions for particular issues.
- Created Form 1023-EZ, a streamlined three-page version of the 26-page Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, for certain types of smaller organizations applying for tax-exempt status. To qualify to use the Form 1023-EZ, an organization must meet criteria presented as a checklist on the form instructions. The Form 1023-EZ will reduce taxpayer burden by decreasing the amount of paperwork required for these charitable groups' applications and will thereby reduce the processing time for the IRS to process applications for tax-exempt status.

The IRS made significant process changes to address concerns about *Section 501(c)(4)* applications for tax exempt status (civic leagues, social welfare organizations or local associations of employees):

- Established a process documenting reasons why applications are selected for further review.
- Developed training and workshops identifying the difference between issue advocacy and political campaign intervention and appropriately identifying applications for review of political campaign intervention activities.
- Established processing guidelines for applications involving potentially significant campaign intervention.
- Created a formal process for determinations personnel to request assistance from technical experts.

The IRS revised work processes to manage employee retirement and benefits programs moving from manual to electronic casework and submission of retirement packages and to online employee self-service calculation of retirement estimates. Changes resulted in a 50% cycle time reduction for processing a retirement case, reduced annual operating expense by \$130,000, and reduced cycle time for Retirement Benefit Estimates and associated Employee Resource Center tickets by 33%.

Across the whole organization, the IRS has realized operational efficiencies and reduced costs. Completing 54 rent reduction projects resulted in the release of 582,877 square feet

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

with an annualized savings of \$16.4 million. The IRS realized \$49.2 million in negotiated contract savings.

◆ **Objective 5: Invest in innovative, secure technology needed to protect taxpayer data and support taxpayer, partner and IRS business needs**

The IRS continued to be innovative and modernize its technology systems as taxpayers' needs changed by investing in appropriate technology and IT workforce skills to support and improve operations. The IRS committed to bolstering the security of IT systems and enhancing authentication capabilities to broaden digital services to taxpayers and stakeholders, reducing the dependence on manual processing. Recent enhancements include:

- Finalized pilot testing for the Estate and Gift Imaging System (EGIS), which will convert estate and gift tax returns filed in paper format to electronic images. The IRS is expecting to realize significant savings on shipping and storage costs of estate and gift tax returns, which are usually larger and require a 75-year retention period. EGIS will also reduce taxpayer burden by enabling the IRS to quickly retrieve historical returns requested by taxpayers and representatives preparing current year gift and estate tax returns.
- Launched the Identity Theft Protection Personal Identification Number (IP PIN) application, allowing taxpayers with an IP PIN to retrieve their PIN online. Taxpayers previously called the IRS toll-free number to replace a lost or misplaced IP PIN. The replacement allows taxpayers to file their tax return with manual verification during processing so they can quickly file their returns. Since implementation of the IP PIN web application, the IRS generated a total 118,584 IP PINs.
- Updated the E-file PIN (EFP) application. Selected taxpayers using the EFP Web application were redirected to the IP PIN web application to receive an IP PIN, enhancing the security of their tax account. This EFP / IP PIN connection was available to taxpayers from Georgia, Florida and Washington, DC, the three areas that lead the nation in ID theft; 21,500 IP PINs were generated in the three pilot areas.
- Improved the data mining models in the Electronic Fraud Detection System (EFDS), the IRS' system of record for Fraud Detection, during Filing Season 2014. In FY 2014, the system processed over 136.2 million returns and stopped a total of \$12.08 billion in fraudulent refunds.
- Partially deployed the Return Review Program (RRP) to ensure the infrastructure and application was able to meet the demands of the 2014 filing season. In FY 2014, 148.6 million returns have been loaded into RRP.
- Deployed Electronic Authentication (eAuth) Release 2.0, which allows the IRS to perform secure identity verification for online users, and allows them to establish their profile and access the business application with a fast turnaround. It also helps reduce costs through a reduction in calls and visits to taxpayer assistance centers. eAuth has handled over 13 million requests (Jan-Sep 2014) by taxpayers to gain access.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

- Identified, mitigated, and responded to more than 1,600 cyber incidents and blocked over 3,750 websites to prevent access to malicious or compromised sites via the IRS Cybersecurity Computer Security Incident Response Center (CSIRC). CSIRC also issued over 680 advisories and bulletins.

In addition to changes in IT operations to support ongoing innovation and modernization, the Affordable Care Act (ACA) drove changes. The IRS planned, managed, integrated and delivered information technology solutions that enabled the IRS to meet business responsibilities associated with the ACA legislation. In FY 2014, the IRS:

- Supported the Department of Health and Human Services (HHS) in the enrollment of millions of individuals in qualified health plans via the state and federal insurance marketplaces by providing two primary data services: income and family size verification and an advance premium tax credit calculation. The IRS also implemented and successfully operated a new transactional portal to receive and respond to requests in real time, a new coverage data repository, and new applications and computation engines.
- Added new file transfer capabilities and modifications to a current production system to receive and process summary financial data from HHS regarding advance premium tax credits.
- Deployed additional new technologies and applications, including the ACA Information Returns (AIR) system, that accepts and processes electronic information reports from insurance providers and the branded prescription drug industry, and the Insurance Provider Fee (IPF) system, which assesses an annual fee on health insurance providers, along with electronic filing capability for the Branded Prescription Drug (BPD) Industry Fee. In 2014, the IPF brought in \$8 billion in revenue, while the BPD Industry Fee brought in \$3 billion in revenue.

Additionally, the IRS greatly improved data assurance for the 2014 Filing Season with Customer Account Data Engine (CADE) 2 updates:

- Transition State 1 (TS 1) implemented the first-of-its kind data quality initiative. Various project/program stakeholders worked together to create processes, procedures, and tools to analyze, identify, and correct data discrepancies and anomalies. The success in the data quality approach is groundbreaking, as the IRS can utilize the approach and processes defined and established in CADE 2 for other program efforts.
- Transition State 2 (TS 2) deployed two incremental Penalty & Interest (P&I) Common Code Base releases to eliminate the differences in programming platforms that caused inconsistent balance due amounts issued on taxpayer notices. The application now calculates penalty and interest on individual and business accounts for taxes not received by the due date, resulting in more accurate notices and better service in helping taxpayers meet their tax obligations.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

♦ **Objective 6: Implement enterprise-wide analytics and research capabilities to make timely, informed decisions**

The IRS used strategic analysis to enable faster, more informed decision making. Key components of this strategy framework included: close collaboration between the business units and analysts from the beginning to the end of the program's implementation; a "test and learn" approach that delivers swift results with minimal risk; and quick iteration to design and refine tests that will ultimately determine the final implementation. In FY 2014, the IRS successfully employed this framework to reduce refund fraud and to improve correspondence audit case selection.

In FY 2014, over 1 million returns were stopped using fraud filters and clustering analysis to identify returns with similar characteristics. More than \$3 billion in potentially fraudulent refunds were stopped using clustering analysis alone.

To decrease the taxpayer burden that could be caused by stringent fraud controls, the IRS tested a method in Filing Season 2014 to further reduce calls to the Taxpayer Protection Program call center by reducing the number of good returns identified as potentially fraudulent. In FY 2014, the process reduced returns held due to false positive selection by 16.9%.

The IRS developed a method for estimating marginal revenue/cost functions for correspondence audit workload categories. These formulas express the marginal revenue/cost ratio as a function of the budget allocated to a given category of workload and indicate the extent to which incremental cost-effectiveness declines as the amount budgeted increases. This method is designed to guide allocation of budget to these categories of work to maximize the amount of net revenue generated from a given budget, enabling identification of the most cost-effective cases.

Strategic Foundation Missed Opportunities

While the IRS was able to make significant progress in achieving objectives, results were affected by continued budgetary restrictions. Additional investment could improve information technology, human capital, rent, and security.

Information Technology

Due to information technology budget constraints and the increased demand for system enhancements, the IRS was unable to invest in various systems and initiatives:

- **Core Infrastructure** – The IRS has delayed a number of hardware infrastructure and software upgrades due to lack of funding. As a result, currently 43 percent of IRS hardware infrastructure is severely outdated, and this will increase to 59 percent in 2015. On average, IRS system software is three releases behind current versions; operating a number of unsupported software platforms makes it difficult to correct if hardware or software issues occur. Delays in upgrading outdated software also make future upgrades more complex and expensive. Consequently, the stability and reliability of IRS information systems are in jeopardy, resulting in increased system downtime, possible system failures, and lost productivity.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

- **Enterprise-Wide Case Management** – The IRS currently has a number of case management software systems that operate on separate, legacy platforms resulting in duplicative and inefficient system processing. Until these systems (e.g. Taxpayer Advocate Service Integrated System (TASIS), Exempt Organizations-/Employee Plan Determinations System (EDS)) are migrated to a unified platform, the systems will become more costly to maintain and greatly decrease the efficiency and effectiveness of service to the taxpayer. Implementing an enterprise-wide case management approach will leverage technology to create more efficient work processes, improve case selection, utilize data analytics for decision making, increase employee collaboration, and reduce costs.
- **Return Review Program (RRP)** – Following a successful controlled production launch, the IRS paused further development of the Return Review Program, a new integrated system that adds to the Service's capability to detect, resolve and prevent criminal and civil tax non-compliance and fraud. Delaying this program affects IRS proactive efforts to identify false tax refund claims in a timely manner, prevent the issuance of false refunds, detect refund crime schemes, and refer false and highly questionable returns for audit.
- **Information Reporting and Document Matching (IRDM)** – In 2014, the IRS paused further development of the new IRDM Case Management (IRDMCM) functionality piloted in Filing Season 2014. This enables the IRS to re-plan this effort to address resource allocation among all priorities, to include other legislative requirements, and provides an opportunity for the IRS to consider an Enterprise-wide Case Management Solution.
- **eAuthentication** – In 2014, the IRS launched Get Transcripts and Identity Protection PIN using the security features made possible by the eAuthentication project. Budget reductions threaten the IRS' ability to leverage that success going forward to deliver additional online services for taxpayers. The current funding level will not allow the IRS to offer any additional features or deliver a number of operational changes to improve the current customer experience. Additionally, the IRS had to defer important security-related changes in response to observed patterns of potential fraud.
- **Electronic Check Presentation (ECP)** – ECP would provide bulk processing of paper checks in the IRS submission processing centers by converting to electronic processing using high-speed scanners, modernized data capture, and imaging technology. Most paper checks would no longer need to be shipped to banks via couriers, ensuring the protection of personally identifiable information (PII). Additionally, converting to ECP would allow the IRS to avoid possible Bureau of Fiscal Service inefficiency charges for transactions not converted to Electronic Fund Transfer.
- **Enterprise Authentication (PIV Cards)** – The IRS continues to encounter challenges in meeting Office of Management and Budget (OMB) mandates requiring agencies to shift reliance from passwords to the Federal standard Personal Identity Verification (PIV) Smartcard. The IRS will not be able to make any further progress to re-engineer legacy applications and systems to leverage Smartcard credential management and use a Single-Sign-On credential for better tracking of account usage across the enterprise. Also, a number of security-related planned corrective actions in response to reports citing weaknesses in logical and physical access controls were put on hold.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

- **Document Imaging Technology** - The 2D Barcode project for paper forms 1040 was not implemented. The project would have utilized scanning technology to read 2D barcoded information on paper returns, providing more accurate data collection for indications of fraud or incorrect reporting and lower labor and overhead costs. Projected savings would have been 100 full-time equivalents (FTE) in FY 2015 and 278 FTE in FY 2016.
- **Federal Data Center Consolidation Initiative (FDCCI)** – Decreased funding has affected the FDCCI's ability to meet the goal of a 50 percent reduction in IRS data center space by the end of FY 2015. Despite the fact funding was severely decreased in FY 2014, the IRS was able to further reduce computing space by achieving a 46% reduction. The outlook for FY 2015 is bleak and without funding for FDCCI, the 50% goal will not be met.

Human Capital

Due to human resource budget constraints, the IRS experienced limitations in staffing, training, and travel that have hampered the ability to prepare the workforce to meet current operational needs, accomplish necessary succession planning activities, and provide the highest levels of customer service to taxpayers. FY 2014 permanent end of year staffing is approximately 3,500 less than FY 2013 end of year staffing.

- **eOPF (Electronic Official Personnel Folder)** - Due to lack of funds, the IRS was unable to implement the eOPF initiative to convert approximately 84,000 Official Personnel Folders from paper files to an electronic online version to meet the OMB mandate due 12/31/13. The shortfall of between \$10-15 million left IRS as the only Treasury agency not in compliance with the OMB mandate.
- **Senior Manager Classes** – The IRS was unable to conduct the Senior Manager Class for new senior managers in the first quarter of FY 2014 because of budget uncertainties. Upon receipt of funding and Treasury approval to conduct the classes, IRS resumed the course in February, 2014. However, due to the delayed start 75 new senior managers did not receive timely training.
- **Coaching Services** – The IRS was unable to provide leadership coaching services to support executive development. Coaching for new and emerging leaders improves succession planning and positively impacts business operations. The IRS has developed a new virtual coaching course that will train IRS employees to serve as internal coaches. Virtual delivery triples the amount of time that it takes to train the coaches, reducing the ability to prepare more than one coach training class per year. As a result, fewer employees will have access to coaching than if vendor-based coaching services were available.
- **Site Visits** – Area/Deputy Directors were unable to visit area offices and conduct face-to-face meetings with employees and customers. Feedback from field office personnel indicate visits by the division's upper management substantially increase the morale and productivity of the field offices and contribute to a sense of unity within the organization. Additionally, customer service and the overall quality of relationships with customers suffered.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

Rent and Security

Apart from employees' salaries, the IRS' largest organizational operating expense is rent on its facilities. Budget constraints have impeded progress on the rent reduction initiative:

- The IRS did not receive the funds needed (\$38 million) to reduce space, and thus did not take action to reduce 311,813 rentable square feet. This reduction would have saved the IRS and taxpayers \$10 million in rent annually, with the \$38 million investment recouped in less than 4 years.

Lastly, security of taxpayer data and providing a secure environment for employees are of utmost importance to the IRS. However, budget constraints negatively affected some of those projects and/or initiatives:

- The E-Gov, Title 3 Federal Information Security Management Act, 2002 and Homeland Security Presidential Directive – 12 requires the IRS to replace and standardize its aging inventory of Physical Access Control Systems (PACS). The IRS embarked on an initiative to replace failing security systems with Enterprise Physical Access Control Systems (ePACS) at nine IRS facilities in FY 2014. However, the restricted budget has prevented the IRS from continuing to implement our 3-5 year plan of replacement.
- A \$180,000 shortfall prevented implementation of the Servicewide Emergency Alert Notification System (EANS). This funding would have been used to replace the antiquated Screen Messenger notification tool, which sends alerts to all IRS employees through a variety of communication streams so they can be made aware when emergencies occur in the local area and safety precautions may be needed.

Strategic Foundation Performance Measures

In FY 2014, the IRS exceeded its Business System Modernization Schedule Variance target but fell short on Cost Variance.

Strategic Foundation: Invest in our workforce and the foundational capabilities necessary to achieve our mission and deliver high performance for taxpayers and stakeholders

Performance Measure	FY 2014	
	Target	Actual
Percent of BSM Projects within +/- 10% Cost Variance	90.0%	66.7%
Percent of BSM Projects within +/- 10% Schedule Variance	90.0%	100.0%

Note: Starting in FY 2015, the measure will include all major investments (BSM and non-BSM).

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

Shortfall Explanations

Percent of BSM Projects within +/- 10% Cost Variance: Two out of three BSM project segments (66.7%) delivered during FY 2014 met the cost variance threshold. The one project segment that did not meet the cost variance threshold is discussed below:

- **Modernized e-File (MeF) Release 9 Milestone (MS) 4b** – Realigned funds to cover hardware and software costs that were planned/expected for MeF Release 9 Milestone 4a but did not materialize until MeF Release 9 Milestone 4b. In FY 2015, CADE 2 and MeF will continue to rigorously monitor program activities and address any issues associated with cost on a timely basis. Additionally, in FY 2015, IT will expand this measure to include all major investments (BSM and non-BSM) assessing cost estimation and management capabilities at a broader major investment level.

GOAL 1: Deliver high quality and timely service to reduce taxpayer burden and encourage voluntary compliance

Providing taxpayers top-quality service and helping them understand and meet their tax obligations remain top priorities for the IRS. The IRS focused on tailored assistance, education and services to taxpayers, and efficient processing of information and returns. The IRS provided innovative digital interactions and supported victims of ID theft, and also enhanced support and communication with the tax community and government partners.

Highlights of the 2014 Filing Season

The IRS delivered another successful filing season in 2014, rising to the challenges posed by the October 2013 government shutdown which delayed the start of the 2014 filing season to January 31, 2014. The IRS initiated and revised over 740 tax products, success is evidenced by:

- Receiving nearly 137.9 million individual returns, of which 85.8% were filed electronically.
- Achieving a 70.5% telephone level of service, while answering 13 million assistor calls.
- Answering 33.1 million automated calls.
- Processed more than 3.6 million returns from Volunteer Income Tax Assistance (VITA) sites.
- Responding correctly to 94.7% of tax law questions and 96.2% of account questions received via the telephone.

Taxpayer Service Facts

In FY 2014, the IRS provided millions of taxpayers valuable service while making it easier for them to participate in the tax system. The IRS:

- Assisted over 126,000 customers through Facilitated Self-Assistance (FSA) kiosks and 24,000 through Virtual Service Delivery.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

- Processed 18.6 million transcripts through the *GetTranscript* application on IRS.gov.
- Registered over 101,900 Foreign Financial Institutions.
- Produced 108 Tax Tips (including 81 Spanish translations) reaching 589,069 online subscribers.
- Issuing 114.8 million refunds to individuals totaling \$315.6 billion.

Assisting taxpayers with their tax questions before they file their returns prevents inadvertent noncompliance and reduces burdensome post-filing notices and other correspondence from the IRS. Accordingly, the IRS provides year-round assistance to millions of taxpayers through many sources, including outreach and education programs, issuance of tax forms and publications, rulings and regulations, toll-free call centers, IRS.gov, Taxpayer Assistance Centers (TAC), Volunteer Income Tax Assistance (VITA) sites, and Tax Counseling for the Elderly (TCE) sites.

◆ **Objective 1: Design tailored service approaches with a focus on digital customer service to meet taxpayer needs, preferences and compliance behaviors in order to facilitate voluntary compliance**

Taxpayer expectations and behaviors indicate a growing preference towards online self-service. As taxpayers' desire for improved self-service tools has increased, the IRS has enhanced online self-service offerings. By making greater use of new technologies, the IRS has become more agile and service-friendly to the taxpayer.

The FY 2014 Service Approach allowed the IRS to reserve person-to-person service for those who had issues that only the IRS can help resolve. Savings from these initiatives were reinvested into improving service on the phones and at walk-in sites. It allowed the IRS to use the right mix of technology, employees, and IRS partners to best serve customers in the face of changing resources. The six components of the FY 2014 Service Approach are as follows: Practitioner Priority Services (PPS), Employer Identification Number (EIN), Requests for Transcripts, Tax Return Preparation, Tax Law Assistance, and Tax Refund Inquiries. Comprehensive engagement and communication efforts have helped both employees and taxpayers migrate towards alternative self-service channels.

Facilitated Self-Assistance (FSA), available at some Taxpayer Assistance Centers, served an important role in educating taxpayers on alternative methods of service. FSA enables taxpayers to prepare individual tax returns and learn about Free File options in an environment where live assistance is still available, creating a bridge to help taxpayers migrate from face-to-face service to convenient, lower cost methods available on the IRS website. FSA also introduces taxpayers to new tools such as the *Get Transcript* application, available via IRS.gov, and *Direct Pay*, which provides taxpayers with an electronic online payment option. FSA usage in filing season 2014 was the highest ever with more than 169,000 returns prepared compared to over 82,000 during the same time last year, a 106% increase.

The use of Virtual Service Delivery (VSD), technology that allows a taxpayer to have face-to-face interactions with an IRS assistor who is working in a remote location, has continued to increase. Nearly 8,000 taxpayers were assisted through this service vehicle, an increase of

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

19% for the fiscal year and 14% for filing season. This was due, in part, to the repositioning of support equipment enabling more locations to provide VSD.

The IRS developed the Voluntary Classification Settlement Program (VCSP) to reduce taxpayer burden by providing an opportunity and incentive for taxpayers to reclassify some or all of their workers for employment tax purposes. Workers currently treated as independent contractors or other nonemployees can be reclassified as employees for future tax periods with partial relief from past federal employment taxes and penalties. Eligible taxpayers complete Form 8952, *Application for Voluntary Classification Settlement Program*, and enter into a closing agreement with the IRS. In FY 2014, the VCSP brought in over \$1,057,000 in settlement payments and reclassified 7,358 workers from 399 applications.

Enhancements to the Online Payment Agreement (OPA) system were successfully implemented to permit more taxpayers to enter into installment agreements through the OPA webpage. After implementation, In-Business Trust Fund (IBTF) taxpayers who owe \$25,000 or less are now able to use the OPA webpage to enter into installment agreements with the IRS. Other enhancements included revisions to the design of the OPA webpage, making it easier for the online user to navigate the site and establish payment agreements. Recent outreach and marketing actions for OPA included multiple tweets to IRS Twitter followers, talking points and presentations for use in continuing professional education sessions for IRS employee groups, IRS Newswire stories that included links to the OPA website and a YouTube video, IRS Special Edition Tax Tips, and presentations at Practitioner Liaison meetings.

The IRS developed and launched several web and mobile tools allowing taxpayers and third parties to transact with the agency including:

- **eAuthentication** provides secure access to IRS online tools and applications. Since the January 2014 launch, almost 5.8 million knowledge-based authentications have occurred.
- **Get Transcript** provides a current digital display and print of an individual's tax record across five transcript types using enterprise wide authentication. Since the January 2014 launch, 18.6 million transcripts have been generated through this application, which represents 79% of all requests during that time period.
- **IRS2Go** provided a Where's My Refund Tracker and Locator for Voluntary Tax Assistance on a re-engineered mobile tool. Since the January 2014 release, IRS2Go has been downloaded more than 2.9 million times.
- **Direct Pay** provides the first payment application in which an individual taxpayer can make a fully electronic same-day payment without paying a fee or having to pre-register. Since the November 2013 launch, the IRS has collected \$2.7 billion through this application.
- **Payment Mix Comparison Tool** enables preparers, on behalf of the business taxpayer community, to compare the portion of gross receipts from card receipts the business plans to report to results of similar businesses from prior years. This tool will encourage accurate reporting by payment recipients according to Forms 1099-K, *Payment Card and Third Party Network Transactions*, and help close the tax gap.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

The IRS continued to improve the information provided to the taxpayer experience on many key IRS.gov website pages, including:

- Rewrote content in plain language and customized page designs to make it easier for taxpayers to achieve their goals.
- Conducted cross-organizational projects to upgrade and improve existing website content to better meet the needs of online audiences. This approach reduced the number of web pages, simplified content to key information, and improved the user experience.
- Developed and executed communication programs to achieve and maintain quality online content to improve customer satisfaction, increase self-service, and drive compliance online.

Digital tools were used to facilitate taxpayer service related to the Foreign Account Tax Compliance Act (FATCA). Individual taxpayers are required to report information about certain foreign financial accounts and offshore assets on Form 8938, *Statement of Specified Foreign Financial Assets*, and attach it to their income tax return, if the total asset value exceeds the appropriate reporting threshold. Foreign Financial Institutions (FFIs) are required to report to the IRS information about accounts maintained in the financial institutions by U.S. accountholders on Form 8966, *Foreign Account Tax Compliance Act Report*. Penalties are applicable for non-compliance by either group.

The FATCA FFI Registration System generated and assigned the first identification numbers used by the FFIs to improve compliance in reporting U.S. taxpayer account information. FFI Registration ensures existing institutions register with the IRS and failure to register subjects the financial institutions to a 30 percent withholding penalty. The FFI Registration System is key to enforcing the entire FATCA legislation. After the FFIs register and receive their Global Intermediary Identification Numbers (GIINs), the process begins for ensuring individual taxpayers are in compliance with the regulations for reporting foreign financial accounts.

To target delivery of relevant information to individuals, U.S. financial institutions, FFI, and governments identified as the four groups likely to access FATCA information on IRS.gov, the IRS developed a dedicated landing page for each group. The website also provides direct links to related sites such as Forms and Publications, the Treasury FATCA Resource Center, and FATCA Regulations and Other Guidance. Most significantly, the website includes two Frequently Asked Questions (FAQ) sections, one for Individuals and one for FFIs, to address taxpayer questions and comments. A working group was put in place that meets regularly with stakeholders to identify and develop FAQs and Answers using questions and comments from the public and from within the IRS.

In FY 2014 the following steps were taken to improve the FATCA website:

- Added links to a separate page with FATCA-relevant forms and publications and to the IRS.gov Forms and Publications page.
- Created new pages for "FATCA Current Alerts and Other News" and for a summary of FATCA Timelines.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

- Provided links to International Data Exchange information, the final FFI agreement, updated registration pages, and FFI List information.
 - Developed and launched the FFI List Search and Download Tool.
 - Organized a FATCA E-help group of IRS assistors to respond to system related issues regarding the FATCA Registration Process. Regular meetings are held with stakeholders to keep the group informed and to answer stakeholder concerns. The E-help group's success resulted in the development of additional FAQs.
 - Implemented new intergovernmental XML Schema for Form 8966, *Foreign Account Tax Compliance Act Report*, based on a system already used for reporting through the Organization for Economic Cooperation and Development (OECD) and the European Union, adding new elements only where absolutely required by FATCA. The new schema was developed in close cooperation with OECD member states and the OECD business advisory group which allows direct reporting to the IRS by both the FFIs and by governments through automatic exchange of information. This new schema will be used for electronic reporting of Form 8966 works across the various FATCA jurisdictions based on Intergovernmental Agreements (IGAs).
 - Created a dedicated web mailbox for government stakeholders to facilitate timely responses to questions and a page containing information on safeguarding data.
 - Added additional web content, partly in response to inquiries submitted through the new web mailbox for government stakeholders, containing more information on the effect of not having an IGA and on modifying registration status.
- ♦ **Objective 2: Deliver clear and focused outreach, communications and education programs to assist taxpayer understanding of tax responsibilities and emerging tax laws**

The IRS continued to communicate with taxpayers to reduce their compliance burden and increase understanding of their tax responsibilities through outreach and education campaigns, including social media efforts, to reach key taxpayer segments, which include the underserved, multilingual, international, and tax-exempt communities.

The IRS conducted an extensive communication campaign for the 2014 Service Approach that increased awareness and use of online and partner services while preserving person-to-person service for those who have no other way to get help. The campaign used knowledge gained from extensive stakeholder sessions, including sessions with congressional staffers and the Government Accountability Office, along with IRS subject matter experts, to produce a series of internal and external communication products and actions that effectively positioned the new approach for great success.

In addition to broad filing season communications that directed the public to available services, the IRS avoided burdening taxpayers by mailing a post card to taxpayers who had their 2012 tax return prepared at a TAC to inform them of service changes related to the 2014 Service Approach and direct them to alternative return preparation services. The IRS coordinated with local VITA and TCE site partners to increase awareness by listing the service each local volunteer site offers. Field Media Relations specialists also supported

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

efforts to publicize local services and address any local media interest in the 2014 Service Approach.

The IRS used social media tools to share the latest information on tax changes, initiatives, products and services to help taxpayers better understand their tax responsibilities. FY 2014 highlights include:

- Produced 61 Tax Tips for the 2014 filing season, including 49 that were translated into Spanish. Subscriptions to Tax Tips have grown to more than 589,000 a 28 percent increase since last year, and an 88 percent increase since the summer of 2012.
- Displayed more than 200 filing season Tax Tips videos on the IRS YouTube channels. Podcasts for each of these videos were also available in English and Spanish as MP3 file downloads on IRS.gov.
- Issued more than 4,000 tweets to the Corporate Twitter accounts and 620 Tumblr posts.
- Developed a Filing Season Update page on IRS.gov to address filing and refund issues that surfaced in social media conversations. Updates on this page were embedded in a number of stakeholder and taxpayer-focused websites throughout the filing season.

Additional outreach efforts included the following:

- Conducted monthly meetings with the national tax professional organizations where IRS leaders and staff briefed the stakeholders on issues of current interest and delivered messages that the organization representatives communicated to their members.
- Maintained an active email listserv that provides information on policies and procedures in a timely fashion to the same audience and includes the IRS advisory group members. Both information delivered at these meetings and "as it happens" emails reach the original audience and there are multiplier effects as groups and individuals post this information on web sites, forward emails, and communicate through social media.
- Published *e-News for Tax Professionals* weekly with a current subscriber base of 307,000 tax professionals and organizations.
- Continued IRS efforts to educate taxpayers about the Earned Income Tax Credit (EITC) through EITC Awareness Day events. To help raise awareness, the IRS held two Commissioner's conference call press events – one with 21 media outlets serving the Spanish-language community and another with 15 English-only media outlets.
- Delivered informational notices about the EITC to individuals who appear to be EITC eligible, but who have not filed a return for the applicable year to encourage participation in the EITC program.

During FY 2014, approximately 1.3 million Correspondence Examination notices were mailed to taxpayers. In an effort to provide the taxpayer with clear communication regarding the Examination process, Publication 3498A, *The Examination Process (Audits by Mail)*, is provided to taxpayers to guide them through the audit process and explain their responsibilities and rights during and after a correspondence audit. The original publication

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

covered both the Correspondence Examination program and the Automated Underreporter (AUR) program. The language in the new Publication 3498B for AUR programs includes additional clarification to help the taxpayer understand the difference between an audit and a mismatch of information between what was reported to the IRS through a third party and what was reported on the individual tax return.

During FY 2014, in an effort to ensure taxpayers are more aware of alternative dispute resolution opportunities that are available to help them resolve tax controversies, the IRS redesigned the Alternative Dispute Resolution (ADR) web page on IRS.gov. The IRS also developed an online ADR Program self-help tool to assist taxpayers and practitioners to navigate their way to the alternative dispute program that best fits their needs. Feedback received from practitioners has been very positive on these changes.

The IRS also adopted a "Taxpayer Bill of Rights" to provide the nation's taxpayers with a better understanding of their rights. The Taxpayer Bill of Rights takes the existing rights embedded in the tax code and groups them into 10 broad categories, making them more visible and easier for taxpayers to find online. Publication 1, *Your Rights as a Taxpayer*, has been updated to include the Taxpayer Bill of Rights. Each year, Publication 1 is sent to millions of taxpayers when they receive IRS notices on issues ranging from audits to collection. Similar to the U.S. Constitution's Bill of Rights, the Taxpayer Bill of Rights contains 10 provisions. They are:

- **The Right to Be Informed**
 - **The Right to Quality Service**
 - **The Right to Pay No More than the Correct Amount of Tax**
 - **The Right to Challenge the IRS's Position and Be Heard**
 - **The Right to Appeal an IRS Decision in an Independent Forum**
 - **The Right to Finality**
 - **The Right to Privacy**
 - **The Right to Confidentiality**
 - **The Right to Retain Representation**
 - **The Right to a Fair and Just Tax System**
- ♦ **Objective 3: Provide timely assistance through a seamless, multichannel service environment to encourage taxpayers to meet their tax obligations and accurately resolve their issues**

The IRS has expanded its suite of online services to quickly and reliably address frequent taxpayer requests in a secure manner. To become more accessible to today's taxpayers, the IRS is providing a consistent multichannel experience that includes significantly expanded digital service delivery. Specific focuses include ACA, international taxpayer assistance, social media monitoring, and virtual service delivery.

During the 2014 Filing Season, ACA tax provision impacts were limited to the processing of individual income tax returns affected by the Net Investment Income Tax and the Additional

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

Medical Tax provisions. The ACA Marketplace provisions had limited effect on 2013 individual income tax returns filed in 2014; however, several non-exchange provisions were successfully implemented prior to Filing Season 2014. These provisions include the Small Business Health Care Tax Credit, Branded Prescription Drug Fee, Patient Centered Outcome Research Trust Fund Fee, Excise Tax on Tanning Service, Qualified Therapeutic Discovery Project, Expansion of Adoption Credit, and the Increase in Itemized Deduction Threshold for Medical Expenses. Following the FY 2014 Filing Season, the focus shifted to the 2015 Filing Season to communicate impacts of the Marketplace Provisions for individuals, employers, and insurers, in an effort to ensure compliance when filing their 2014 tax returns.

FY 2014 ACA Highlights include:

- Created a "Web-First Strategy" ACA tax-related information approach via IRS.gov/aca
- Collaborated with other government agencies (e.g. Health and Human Services/Centers for Medicare and Medicaid Services (HHS/CMS), Small Business Administration (SBA)) to develop and deliver shared messages
- Provided information to trusted partners (e.g., tax practitioners, business communities, and other third parties)
- Prepared the IRS workforce to provide expanded outreach and assistance in early FY 2014
- Used various customer communications channels and multi-channel tools, namely:
 - Web (IRS.gov/aca, Q&As, podcasts, widgets)
 - Distributed Products (Health Care Tax Tips, News Releases, Brochures, Electronic Newsletters)
 - Social Media (Twitter, Facebook, YouTube, Tumblr)
 - Events (Congressional Webinars, IRS Nationwide Tax Forums)
 - Customer Service (Call Centers, TACs, Verizon Informational Line)
- Developed, updated, or revised 157 Marketplace and over 330 non-Marketplace products
- Maintained Web content (IRS.gov/aca) in both English and Spanish
- Documented and updated 20 sets of Q&As for individuals and families, employers, and other entities and organizations
- Released 45 e-News items, Exempt Organizations updates, and guidance releases
- Provided 16 Health Care Tax Tips

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

- Collaborated with federal partners and National Taxpayer Advocate on more than two dozen communications products
- Conducted 182 Outreach events, reaching over 70,000 participants from over 100 organizations, including five IRS nationwide Tax Forums

The Affordable Care Act of 2010, Provision 1405, "Medical Device Excise Tax (MDET)" imposed a 2.3% excise tax applicable to sales of taxable medical devices after December 31, 2012. Throughout the process of implementing the MDET, IRS sought stakeholder input, tailored its business interactions to meet taxpayer needs and preferences, posted information on IRS.gov, and addressed taxpayer and industry concerns. The IRS promoted consultation through using Pre-Filing Agreements (PFA), encouraging MDET taxpayers to request consideration by IRS for a tax issue before filing a return, promoting fair price determinations for taxable medical devices and reducing taxpayer costs for post-filing examination. Prompt changes to reflect MDET tax requirements in tax documents and expedited forms processing encouraged high levels of taxpayer reporting compliance. The IRS processed 9,068 Forms 720, *Quarterly Federal Excise Tax Return*, filed for MDET during FY 2014. These 9,068 forms were filed by 3,558 taxpayers.

In response to international taxpayers' preference for online services, the IRS continued to improve international taxpayer assistance by providing clear, accessible information focused upon the individual living abroad. Adding features to IRS.gov and improving access to information that is of specific interest to the international taxpayer helped taxpayers living outside the United States more easily find answers to questions and access the forms and information that they need to satisfy their U.S. tax obligations.

A new feature was added to IRS.gov to provide a link from the *Make a Payment* main page to instructions on how to make electronic payments via a foreign bank account for taxpayers living abroad who no longer have a U.S. bank account.

In FY 2014, the IRS redesigned the international taxpayer landing page to make it more useful to the taxpayer. The various international pages are organized into one of six categories (Taxpayers Living Abroad, Resident Aliens, Nonresident Aliens, Foreign Students and Scholars, Territory Residents, and Other). The international taxpayer landing page shows these six categories with links to separate pages with relevant topics (such as Filing Requirements, Income, Deductions, Nonresident Aliens with a U.S. Trade or Business, Forms, or Resources).

The IRS recognized that heightened public awareness is critical to reporting compliance and a number of steps have been taken to educate taxpayers with foreign accounts about their filing obligations. Outreach efforts in FY 2014 include:

- Posted information to IRS.gov outlining filing obligations and issued fact sheets and public announcements outlining filing requirements.
- Published additional information published through multiple channels, including the IRS Twitter account, the IRS Tax Attachés located in U.S. consulates and embassies, and the National Public Liaison's practitioner e-mail distribution list.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

The IRS conducted daily social media monitoring of Twitter and Facebook as part of the Customer Early Warning System initiative. Identified issues included:

- A large number of early filers whose refunds were initially accepted but who suddenly started encountering an issue with *Where's My Refund?*. The issue was elevated and the IRS alerted taxpayers to the problem by posting a statement on the newly-created Filing Season Update page on IRS.gov.
- A phone scam involving persons pretending to be from the IRS calling taxpayers and demanding immediate payment. The IRS executed a comprehensive communications plan including a national press release, local press outreach, multiple tax tips, and a number of social media posts to alert taxpayers across the country to the tax scam.

During FY 2014, the IRS installed Virtual Service Delivery equipment in nine taxpayer-facing and six campus locations across the United States. This equipment allowed taxpayer and practitioners to interact virtually with IRS employees in other offices. It is especially helpful to taxpayers and practitioners who may not be on-site with the particular type of assistance they need. These individuals can be instantly connected with IRS employees in other locations who can help them meet their tax obligations or resolve their issues in a timely manner.

The IRS continued to build upon the success of the Individual Taxpayer Identification Number (ITIN) application and document authentication process. This process enabled taxpayers visiting Taxpayer Assistance Centers to have their passports and national identification cards certified and was expanded to an additional 100 locations, bringing the total to 188 locations providing this service. In FY 2014, over 106,000 taxpayers took advantage of the added flexibility to file ITIN applications and have their documents authenticated face-to-face.

♦ **Objective 4: Strengthen refund fraud prevention and provide prompt assistance to support victims of identity theft**

Tax fraud has emerged as an increasingly prevalent threat. The IRS recognizes the importance of this issue and has dedicated significant resources to address it. The IRS provided specialized outreach and education campaigns to help taxpayers avoid fraud and augmented staffing to provide assistance to taxpayers who have become victims of identity (ID) theft. The IRS strengthened its ability to identify and respond to fraud by bolstering analytics capabilities, making full use of existing data sources and exploring potential new data sources and techniques that allow better identification of anomalies and flagging of suspect accounts.

Outreach and education through social media were key components of the IRS communications strategy on ID theft. FY 2014 Highlights include:

- Produced new YouTube videos showcasing IRS efforts to combat ID theft, providing tips for victims, and highlighting how taxpayers can help go after the perpetrators. These videos were viewed more than 27,000 times.
- Created a series of different posts on Tumblr reinforcing ID theft messages through graphics and links to YouTube videos, with a number of posts translated into Spanish.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

- Included a static tab on the IRS Facebook page linking readers to the Identity Protection page on IRS.gov.
- Issued tweets from the IRS Twitter accounts on the topic of ID theft.

Attempts to obtain taxpayer information through false IRS websites and other electronic methods continue to occur. The IRS worked to identify and quickly shut down these websites in order to protect tax information and maintain public confidence. As a result, IRS shut down 1240 sites in FY 2014. This included 302 schemes related to "Get Your Refund". The IRS shut down schemes within a median of 0.5 hours for domestic sites and 10.4 hours for international sites.

The IRS saw continued phishing activity in FY 2014, shutting down 1204 sites in addition to 3,542 sites in the previous year. Phishing/Malware Sites are fake IRS websites designed to harvest a potential victim's personal and financial information. Malware sites contain malicious software designed to disrupt computer operation, gather sensitive information or gain unauthorized access to computer systems.

Through vishing schemes, the victim receives faxes or e-mails containing a fake or modified IRS request for personal information, which is used to contact the victim's bank to perform an account takeover. The IRS shut down 419 vishing incidents in FY 2014 and taxpayers continue to report fake IRS contacts with the latest iteration of this scam including threats to taxpayers if they do not comply (e.g., they will be deported or arrested).

The Identity Protection Personal Identification Number (IP PIN) is a unique identifier that authenticates a return filer as the legitimate taxpayer at the time the return is filed. For FY 2014, taxpayers who received an IP PIN could have used the online application to retrieve their original IP PIN if it was lost or misplaced. Taxpayers from high-risk identity theft areas (Florida, Georgia and Washington, DC) that used the Electronic Filing Personal Identification Number (EFP) were offered the opportunity to participate in a pilot that offered an Opt-In to the IP PIN program.

The IRS continued to refine and develop new ID theft filters based on analytical models, known schemes, and data validation. Shifting the inventory from the Electronic Fraud Detection System (EFDS), where the return is posted and identified only as fraud, to inventory in the Taxpayer Protection Program, where the return is identified as ID theft and remains unposted, allowed more expeditious resolution for ID Theft victims filing valid returns.

The enhanced ID theft filters focus on multiple tax returns filed using the same address and/or bank account. Through these clustering filters, the IRS has stopped 457,472 fraudulent returns with associated refunds of \$2.76 billion in calendar year 2014. The filters incorporate data compiled from previous taxpayer return information to improve the accuracy of the ID theft detection. The IRS coded exclusion filters that compare elements of the return to previous years and help to reduce the false-positive rate.

In addition to the ID theft prevention efforts, the IRS was also successful in stopping fraudulent refunds. The prisoner file is a vital source of information within the prisoner population which continued to provide revenue protection results. The IRS stopped more than 54,000 fraudulent prisoner returns with associated refunds of more than \$2 billion. In

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

addition, the IRS implemented new pre-refund filters through the Automated Questionable Credit program to address questionable claims, protecting or assessing more than \$109 million. Through the External Leads program, the IRS continued collaboration efforts with software developers, banks, and other industries to determine how to better partner to address ID theft and prevent federal monies from reaching the hands of identity thieves. The External Leads program continued to produce outstanding results, recovering more than \$514 million in FY 2014.

♦ **Objective 5: Reduce taxpayer burden and increase return accuracy at filing through timely and efficient tax administration processing**

The technology and procedures that the IRS uses to process returns have evolved over the course of many decades. The IRS has invested in the systems required to process electronically-filed returns, expanding the types of returns accepted through this more efficient digital channel. Further, the IRS has increased the efficiency of the filing and payment processes.

The IRS delivered another successful filing season. This included revising over 740 tax products with 99.1% of the forms critical to the filing season being completed by December 31, 2013, exceeding the timeliness goal of 95%.

For the filing season, the IRS received approximately 137.9 million total individual returns, nearly 1.8 million more than in the previous year. Electronically filed (e-File) returns accounted for nearly 118.4 million of these returns, nearly 3.4 million more than last year for an increase of 1.6% in the e-File rate. All refund numbers are up from last filing season with 116.5 million individual refunds issued for a total of \$316.9 billion dollars and an average refund of approximately \$2,719.

The IRS placed high priority on telephone assistance level of service (LOS) during the FY 2014 filing season and achieved a filing season 70.5% LOS while answering 13.0 million calls. Due to reduced staffing outside filing season, the overall FY 2014 LOS was 64.4% for 23.1 million assistor calls (FY 2013 LOS was 60.5% LOS for 30.1 million assistor calls). The IRS improved websites and applications to help provide taxpayers with important support without requiring a phone call. Along with the success of IRS websites, the number of returns requiring error resolution was down from last year, which means fewer refunds were delayed and fewer refund inquiries were made to the IRS.

More than 3.6 million tax returns were filed at Volunteer Income Tax Assistance/Tax Counseling for the Elderly volunteer sites, representing a 7.4% increase over last year while maintaining a 92.2% accuracy rate.

The 2014 Service Approach (which redirected taxpayers to virtual service channels and reserved face-to-face assistance for taxpayers who needed it) enabled critical resources to be reinvested. The IRS estimates that with this reinvestment of hours approximately 326,000 taxpayers, that may otherwise have been turned away, were assisted in Taxpayer Assistance Centers. Wait time for assistance also improved with the change in services with fewer taxpayers waiting more than 30 minutes for service. In filing season 2014, the IRS assisted nearly 2.3 million taxpayers in walk-in offices.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

The Compliance Assurance Process (CAP) Program allows large corporate taxpayers to resolve tax issues prior to filing a tax return. CAP consists of three distinct components:

- Pre-CAP – Provides interested taxpayers with clear direction on how to gain entry into CAP. In FY 2014, 20 corporations participated in Pre-CAP.
- CAP - 185 corporate taxpayers participated in CAP, with 162 of them returning from the previous year.
- CAP Maintenance – Allows taxpayers who have been in CAP, have few complex issues, and have established a track record of working cooperatively to receive a reduced level of IRS review. The program had 64 participants in 2014.

The IRS successfully incorporated three non-exchange provisions of the Affordable Care Act into the 2014 filing season: Section 9015 – Additional Medicare Tax, Section 1402 – Net Investment Income Tax and Section 9013 – Increase in the threshold for itemized deductions for medical expenses. Successful implementation of these provisions included development of two new forms and related instructions; changes to over 100 forms, publications, and tax products; updates to IRS procedures outlined in Internal Revenue Manuals; and development of training.

♦ **Objective 6: Improve service delivery and support effective tax administration by fostering strong relationships with our tax community and government partners**

The IRS works closely with the tax community to help meet the needs of taxpayers. In cooperation with other U.S. governmental entities and foreign nations, the IRS worked to ensure the correct application of the tax law and to achieve the IRS mission. The growing frequency of cross-border business transactions required close collaboration with foreign governments to ensure fair tax administration, while legislative mandates required significant new interactions with foreign governments and financial institutions.

The IRS continued to maintain strong relationships and increase dialogue with the tax professional community, including holding monthly meetings with two of the Commissioner advisory groups – the Internal Revenue Service Advisory Council and the Information Reporting Program Advisory Committee. This allowed the IRS to hear about systemic problems when they were newly identified and minor because the stakeholders were seeing outcomes first hand and were willing to report what they saw that might be a problem. The close relationships also allowed the Service to leverage the knowledge, talents, and skills of the tax professional community for feedback as the IRS considered service or enforcement initiatives and built tools for the taxpayer or the tax professional.

In response to the D.C. Circuit opinion in *Loving v. IRS*, 742 F.3d 1013 (D.C. Cir. 2014), the IRS and the Department of Justice (DOJ) have collaborated on procedures to facilitate the surrender of Preparer Tax Identification Numbers (PTINs) and Electronic Filing Identification Numbers (EFINs) in successful permanent injunctions against unlicensed/unenrolled return preparers and in connection with criminal convictions and pleas entered in tax cases for this same group. Separate language has been crafted for use in consent injunctions, convictions by plea, and court ordered injunctions. This collaboration with DOJ helps to mitigate some of the risk to return preparer oversight created by the *Loving* decision and ensures efficient use of resources by both agencies.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

To improve the ability to remove barriers to timely completion of Freedom of Information Act (FOIA) requests, the IRS aligned FOIA cases to five categories based upon case complexity to differentiate between routine and complex cases. Routine cases include requests where records should be available within the statutory 20 days for response. Complex cases reflect requests resulting in 10,000 or greater pages, multi-functional or counsel coordination, or electronically stored information that may require longer than the statutory timeframe to provide a complete response.

Disclosure managers actively engaged employees and key stakeholders to secure prompt responses to move FOIA requests to resolution. The IRS completed 10,106 FOIA cases in FY 2014, closing cases within an average of 20 days resulting in 83.2% of the cases closed timely. The IRS began FY 2014 with a backlog inventory of 217 FOIA cases, which was an increase of 83.9% over the 118 backlog cases at the end of previous year. During the government shutdown in October 2013, the backlog inventory increased to 403 cases. At the end of FY 2014, the backlog had decreased to 317 cases with Complex Cases comprising 70% of this inventory.

The IRS partnered with Treasury's Bureau of the Fiscal Service to increase the number of electronic direct deposit refunds requested by individual taxpayers. Refunds to taxpayers are one of the largest sources of paper checks issued by Treasury. The first phase pilot tested the impact of messaging the security and speed of electronic deposits via direct mailings. Test letters were sent in January 2014 with results tracked throughout the 2014 filing season. Increasing the number of electronic refunds resulted in significant cost savings to the IRS and Treasury.

In prior filing seasons, the identity theft and refund fraud filters established by the IRS to protect taxpayers have inadvertently captured and delayed the refund returns of a number of Indian tribal member taxpayers because the Forms 1099-K, *Payment Card and Third Party Network Transactions*, received for per capita income mimicked those of fraudulent claims. In an effort to reduce Indian tribal refund delays, the IRS worked diligently within the identity theft and fraud areas to develop procedures to expedite credible tribal member returns through the filter process. Through continued collaboration and comprehensive public education and outreach to Tribes and practitioners, the number of unintended refund delays has been reduced and the length of delay has been reduced to no more than an additional two weeks.

♦ **Objective 7: Enhance the quality of tax services by strengthening the outreach, education and tools provided to the tax professional community**

In recent years, the IRS has significantly expanded outreach to the tax professional community, which includes enrolled agents, certified public accountants, attorneys and other tax return preparers. The IRS has registered hundreds of thousands of paid tax return preparers since 2010 and also conducts educational visits and sends educational letters aiming to improve the accuracy of tax returns and heighten awareness of preparer responsibilities.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

During FY 2014, the IRS provided news and information to tax professionals through the following:

- A dedicated Twitter channel reaching over 28,000 individuals. The content on Twitter directs tax professionals to more detailed information on IRS.gov.
- The weekly *e-News for Tax Professionals* email newsletter which reached nearly 307,000 tax professionals and organizations.
- Annual IRS Nationwide Tax Forums that reached nearly 11,000 tax professionals, providing updates on changes to tax laws and delivering certified continuing education credits for Enrolled Agents, Certified Public Accountants, and Certified Financial Planners.

The IRS remains strongly committed to educating the tax professional demographic about their duties and restrictions under Treasury Department Circular No. 230, *Regulations Governing Practice before the Internal Revenue Service*, and their ethical obligations to taxpayers and to tax administration. During FY 2014, the IRS performed outreach activities through a combination of in-person, webinar, and telephone presentations. The IRS educated tax professionals (mainly tax return preparers) about relevant Circular 230 provisions during five IRS Nationwide Tax Forums. In FY 2014, IRS reached over 40,200 tax professionals and IRS employees during 110 events, including in-person, telephone and electronic media.

The IRS created a web-based application and payment process for the renewal of enrolled actuaries' registration, which had been a paper-intensive process since 1974. Approximately 60% of the 3,772 renewals in FY 2014 have been processed through the web-based application. The registration and renewal system experienced very limited downtime and was fully operational for 99.5% of the renewal season. The improved usability of the Preparer Tax Identification Number (PTIN) registration and renewal system resulted in an almost 50% reduction in customer call demand from an average of 405,000 calls per year to 215,000 calls per year.

The IRS offered special assistance to taxpayers through the eighth annual Earned Income Tax Credit (EITC) Awareness Day by offering special assistance to taxpayers on January 31, 2014. Over 230 successful outreach activities were hosted. News conferences, news releases, and volunteer sites hosted by IRS national and local partners promoted EITC awareness and free options for return preparation. Outreach was supplemented with social media including Facebook and Twitter.

To address the tax gap by reducing income underreporting among small businesses in FY 2014, the IRS continued the second year of a Form 1099-K, *Payment Card and Third Party Network Transactions*, pilot program to help businesses correct errors and improve income reporting compliance. As a result, the IRS significantly increased the number of taxpayers reached primarily with low-burden notices and correspondence audits. To reduce taxpayer confusion and burden, the IRS initiated form changes and regulation updates. A Payment Mix Comparison Tool was developed to help return preparers better support their customers who receive Forms 1099-K.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

Strategic Goal 1 Missed Opportunities

The IRS strives to deliver high quality and timely service to taxpayers and stakeholders. Although the IRS had significant accomplishments serving taxpayers in FY 2014, budget constraints forced the IRS to utilize scarce resources in the highest priority areas. The IRS would have liked to further improve communication, the online experience for taxpayers and stakeholders, and IRS information processing.

Communication

Budgetary limitations adversely affected communication with taxpayers, employers, and stakeholders. Although the IRS communicated with taxpayers using a seamless, multichannel service environment, the IRS would like to have responded more quickly to telephone calls, correspondence, and requests for in-person service. Additional resources would have enabled the IRS to deliver a higher Level of Service (LOS) to taxpayers on phones, respond more timely to correspondence, shorten wait times at Taxpayer Assistance Centers (TACs), clarify instructions to employers, and communicate more directly with the tax community.

The IRS delivered a 64.4% level of service (LOS) for FY 2014. The IRS answered approximately 23.1 million telephone calls with an average wait time of 19.6 minutes.

- With 478 more full-time equivalents (FTE), the IRS could have delivered a 70% LOS for the fiscal year and answered approximately 25.7 million taxpayer calls with an average wait time of 16 minutes.
- With 951 FTE, the IRS could have increased LOS to 75% and answered approximately 27.5 million taxpayer calls with an average wait time of 12.5 minutes.
- With 1,423 FTE, the IRS could have increased LOS to 80% and answered approximately 29.3 million taxpayer calls with an average wait time of 9.5 minutes.

Taxpayer correspondence ending inventory on September 30, 2013 was over 1.1 million. Ending inventory on September 27, 2014 was less than one million, so the IRS closed nearly 180,000 more cases than it received. An additional 200 FTE would have allowed the IRS to close an additional 300,000 carryover cases from FY 2013, resulting in an ending inventory of less than 700,000.

The IRS is concerned about the amount of time it takes for people to get in-person help at Taxpayer Assistance Centers (TACs). In filing season 2014, the IRS served nearly 2.3 million taxpayers at TACs with 73.4% of taxpayers waiting less than 30 minutes. Nearly 61,000 taxpayers used facilitated self-assistance (FSA) kiosks to make payments, get transcripts, and obtain forms rather than wait in line. Another 10,000 taxpayers used Virtual Service Delivery (VSD) videoconferencing where staff was insufficient to meet taxpayer demand. An additional \$9.3 million and 55 FTE would have allowed 60,000 more taxpayer contacts and thus shortened TAC lines by increasing the number of kiosks and enhancing videoconference capabilities.

Form SS-4, *Application for Employer Identification Number (EIN)*, and its corresponding instructions are outdated. While there have been several new policies impacting taxpayers applying for EINs over the past few years (e.g., daily limit of EINs, elimination of phone method), the IRS does not have the resources necessary to update these materials. As a result,

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

temporary instructions have been attached to the Form SS-4 advising employers of the changes.

Education and outreach to the tax community suffered due to budgetary constraints that have prevented the IRS from being physically present at taxpayer and industry stakeholder group events. Communicating with these business representatives by conference call was less suitable for presenting and using visual aids and less effective for relationship building. Despite these challenges, the IRS has participated in many events via conference call and provided outreach in other ways such as issue-focused pages on IRS.gov.

Online experience for taxpayers and stakeholders

The IRS has made significant advances in improving the taxpayer's online experience and expanding digital customer service offerings. Budgetary limitations delayed some improvements such as:

- Electronic filing and processing of Form 1040X, *Amended U.S. Individual Income Tax Return* – Currently taxpayers must mail Forms 1040X, which increases the time to process and issue refunds. It is estimated that electronic processing of Form 1040X would yield savings to the government of \$17.1 million.
- Upgrading *Where's My Amended Return?* (WMAR) – Enabling customer service representatives to transfer taxpayers to the WMAR phone application and expanding the types of claims available in WMAR would save telephone assistants time, allowing them to provide service for taxpayers with more complex issues.
- Clarifying error messages in the online application for Employer Identification Number (EIN) – To combat robotic attempts for obtaining EINs, the IRS implemented a systemic block. However, due to budgetary constraints, the IRS could not update error messages. Taxpayers receive a generic message that does not advise them of the true issue and what they can do to fix it.
- Implementing online automation of the application to become an acceptance agent – Acceptance agents assist taxpayers with obtaining Individual Taxpayer Identification Numbers (ITIN) and Employer Identification Numbers (EIN) from the IRS. Automation would reduce application processing time by half.

IRS information processing

The IRS strives to provide timely and efficient information processing to minimize burden on taxpayers. Budgetary limitations have interfered with improvements to processing in several areas and lower staffing levels have created challenges. Unmet software needs caused inefficiency in the Individual Taxpayer Identification Number (ITIN) and Acceptance Agent (AA) programs, slowed processing of third-party disclosure requests, delayed resolution of refunds returned by banks, and limited enhancements to revenue protection.

A growing number of individuals are renouncing their United States citizenship and long-term permanent residency. The IRS did not have sufficient compliance resources to effectively address expatriation issues. Additional funding and resources are needed to properly follow up on missing expatriation information from the Department of State and Department of Homeland

INTERNAL REVENUE SERVICE
 Management's Discussion & Analysis
 Fiscal Year 2014

Security, as well as to adequately verify and follow up on expatriation information submitted by, or lacking from, the expatriates. Additional staff dedicated to tracking, verifying and monitoring expatriation information at the front end would have allowed a more targeted and timely approach to securing the required expatriation information, issuing penalty notices for nonresponses to requests for required expatriate information, and identifying high compliance risk expatriation cases requiring further review. With additional funding, the IRS could have increased specialized training of current Revenue Agents and hired Revenue Agents with specialized training to examine expatriation cases. The IRS could also have increased audits of high-risk expatriate cases with a projected potential increase of \$12.8 million in tax assessments.

Several software enhancements to the Individual Taxpayer Identification Number (ITIN) Real-Time System (RTS) were not implemented. The requested changes would have improved oversight of the ITIN and Acceptance Agent (AA) programs. Without the system enhancements, inefficient or time-consuming manual work-arounds are required.

Budget limitations prevented replacing the retired Disclosure Authorization (DA) automated application. The DA application provided a mechanism for registered third parties to submit third party authorizations online. In FY 2014, manual processing of DA requests cost more than \$1.2 million. Converting to a paper-driven manual process decreased customer satisfaction among tax practitioners and, in some instances, delayed their ability to timely resolve taxpayer concerns.

The IRS was unable to provide an automated process to manage direct deposit refunds returned by financial institutions. Automation would facilitate detection of fraudulent refunds and result in revenue protection and faster resolution for taxpayers. The current process requires manual reviews of returned direct deposits to determine which refunds should be frozen for further research and which should be reissued. Automation could have yielded an increase of approximately \$3 million in revenue protection and reduced taxpayer refund delays.

Protecting taxpayer dollars from unscrupulous individuals is a high priority for the IRS. However, several proposed information processing enhancements designed to help prevent fraud and provide better customer service could not be implemented due to budget constraints. If implemented, an estimated \$873 million of additional revenue could have been protected in FY 2014.

Strategic Goal 1 Performance Measures

The IRS met or exceeded 70% (7 of 10) of its Taxpayer Service performance targets in FY 2014 compared to 67% (8 of 12) in FY 2013.

Strategic Goal 1: Deliver high quality and timely service to reduce taxpayer burden and encourage voluntary compliance

Performance Measure	FY 2014	
	Target	Actual
Customer Service Representative (CSR) Level of Service	61.0%	64.4%
Customer Contacts Resolved per Staff Year	22,750	21,018
Customer Accuracy – Tax Law Phones	93.0%	95.0%

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

Customer Accuracy – Customer Accounts (Phones)	95.0%	96.2%
Timeliness of Critical Filing Season Tax Products to the Public	95.0%	99.1%
Timeliness of Critical TE/GE and Business Tax Products to the Public	95.0%	98.7%
Percent Individual Returns Processed Electronically	84.1%	84.1%
Percent Business Returns Processed Electronically	44.7%	43.1%
Refund Timeliness – Individual (Paper)	97.0%	98.7%
Taxpayer Self Assistance Rate	85.0%	84.7%

Shortfall Explanations

Customer Contacts Resolved per Staff Year: The shortfall is attributed to a large decrease in the number of Web Services Completed. The decrease in Web Services is primarily due to a decrease in the number of *Where's My Refund?* inquiries, which were 86% below plan, or 3.9 million below the planned volume. The IRS attributes the smaller number of users to increased messaging to taxpayers that the *Where's My Refund?* application is only updated daily, and should not be repeatedly queried throughout the day. (Past experience showed an approximately 10% increase each year as taxpayers became acquainted with the service, though some were using it several times per day.) Future projections will take into account messaging efforts and the 2014 experience.

Percent Business Returns Processed Electronically: The IRS uses projections to set the targets for business returns processed. These projected numbers are then used to determine the target for the subset of business returns that are electronically filed. The primary reason for the shortfall was that returns in the Form 94X (Employment Tax) family did not materialize in the volumes originally projected. A team has been formed to develop a Servicewide strategy for increasing the volume of electronic returns filed by business taxpayers and a communications outreach plan is being developed to promote e-filing for business returns during the 2015 Filing Season.

Taxpayer Self Assistance Rate: The shortfall is attributed to a large decrease in Web Services Completed. The decrease in Web Services is primarily due to a decrease in *Where's My Refund?* which was 86% below plan, or 3.9 million below the planned volume. The smaller number of taxpayer accesses of the application is attributed to a concerted effort to inform taxpayers that "Where's My Refund" should only be checked once a day. Previously, IRS realized about a 10 percent increase each year as taxpayers became acquainted with this service; some were using it several times per day. Future projections will take into account this years' experience.

GOAL 2: Effectively enforce the law to ensure compliance with tax responsibilities and combat fraud

Enforcement is one of the top priorities of the IRS and is an area that is continually evolving to enable the IRS to serve taxpayers' changing needs. The IRS uses data and analysis of results to strengthen IRS capabilities in detecting and preventing tax fraud as well as enforcing compliance. The IRS has partnered with various law enforcement agencies to protect American taxpayers from identity theft, at-risk return preparers, fraud, and many other tax schemes. It is the duty of the IRS to ensure that U.S. citizens, here and abroad, understand their tax obligations and are in compliance with the tax law.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

Highlights of Enforcement Performance

Enforcement of the tax law is critically important to the IRS mission, especially as tax administration becomes increasingly complex. This importance is demonstrated both by the 64% portion of budget dedicated to enforcement activities in FY 2014, as well as the diligent efforts to ensure maximizing productivity of those expenditures.

As a result of dedicated enforcement initiatives, the IRS collected \$57.1 billion in total enforcement revenue in FY 2014. Successes were achieved in key enforcement programs including:

- Completed 4,606 criminal investigations.
- Decreased the identity theft inventory by 69% relative to FY 2013.
- Reduced the total debt owed by Federal agencies by 55% through efforts made by the Federal Agency Delinquency (FAD) program.
- Conducted 250 Bank Secrecy Act compliance visits and visited over 3,000 return preparers.
- Sent nearly 17,000 pre-filing season educational letters to Earned Income Tax Credit (EITC) return preparers.

♦ **Objective 1: Enforce domestic and international compliance by strengthening expertise, adopting innovative approaches and streamlining procedures**

The IRS engaged taxpayers early within and across tax years to promote voluntary compliance and to enforce tax obligations. The IRS used methods that balanced efficiency and effectiveness and adapted quickly as priorities evolved. In addition, the IRS saved over \$1 million in contract fees by successfully phasing out using contract support for underreported income case selection.

The IRS investigated potential criminal violations of the Internal Revenue Code and other financial crimes that adversely affect tax administration such as money laundering, currency violations, tax-related identity theft fraud, and terrorist financing. In addition, the IRS permitted taxpayers to voluntarily disclose to the IRS that they failed to report income from, or the existence of, offshore bank accounts. The IRS worked with the Department of Justice (DOJ) Tax Division to support the Swiss Bank Program, and was successful in encouraging U.S. taxpayers to report and pay taxes on offshore accounts.

The IRS made major changes to the offshore voluntary compliance programs, providing new options to help both taxpayers residing overseas or in the United States. Key expansions in the streamlined procedures were made to accommodate wider groups of U.S. taxpayers who had unreported foreign financial accounts. The changes included:

- Eliminating a requirement that the taxpayer have \$1,500 or less of unpaid tax per year.
- Eliminating the required risk questionnaire.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

- Requiring the taxpayer to certify that previous failures to comply were due to non-willful conduct.

In FY 2014, the IRS implemented several improvements to the Offshore Voluntary Disclosure Program (OVDP) by:

- Requiring additional information from taxpayers applying to the program.
- Eliminating the existing reduced penalty percentage for certain non-willful taxpayers in light of the expansion of the streamlined procedures.
- Requiring taxpayers to submit all account statements and pay the offshore penalty at the time of the OVDP application.
- Enabling taxpayers to submit voluminous records electronically rather than on paper.

The FATCA Foreign Financial Institution (FFI) Registration System generated and assigned the first identification numbers used by the FFIs to prove compliance in reporting U.S. taxpayer account information. To date, the FFI Registration System contains over 103,000 registrations, which allows FFIs to receive a Global Intermediary Identification Number (GIIN) to appear on the Approved Financial Institution List. To date, there have been 103,000 GIINs assigned with no major backend processing issues.

Other highlights of the IRS enforcement performance include:

- Completed 4,606 criminal investigations.
- Maintained a DOJ acceptance rate of 93.1% with a U.S. Attorney acceptance rate of 90.5%.
- Secured a 93.4% conviction rate.
- Obtained 3,110 convictions, which is a decrease of 6.1% compared to FY 2013.

During FY 2014, the IRS Federal Agency Delinquency (FAD) program, which ensures tax compliance by all Federal agencies, resolved 215 unpaid Federal agency accounts from 133 different agencies and reduced the total debt owed by Federal agencies by 55%. During FY 2014, 251 missing tax returns from 150 agencies were resolved by either securing a return or determining that the agency was not liable to file. In FY 2014, operating procedures for the FAD program were revised and implemented which provided guidance and timeliness requirements and enhanced managerial oversight.

The IRS used the Lean Six Sigma process along with Industry Case (IC) examination process improvements, listed below, to streamline activities, reduce administrative burdens, and improve the overall efficiency process. *Lean* is a time- and value-based process improvement philosophy designed to ensure continuous flow and eliminate waste and non-value added activities, while *Six Sigma* is a business process improvement method that uses data and facts to produce bottom line measurable results through reduction in process variation.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

In FY 2014, highlights of IC examination process improvements included:

- Revised Form 13745, *Examination Timeline*, to allow examiners to customize the timeline for each examination to depict those milestones which contribute to an effective examination process. Drop down boxes listing common examination milestones were included on the revised form as well as blank lines for unique, customized deadlines.
- Provided two revised compliance check tools to examiners. The tools consolidated compliance check guidance into streamlined documents clarifying which checks were required and provided links to detailed IRM explanations for each check.
- Developed two new letters, 950-Z and 4121-L, for examiners to transmit examination reports to taxpayers. Both letters eliminated paper enclosures and directed taxpayers to the toll-free number or IRS.gov to obtain publications and notices referenced in the letters.

♦ **Objective 2: Deter and promptly resolve noncompliance by protecting revenue from refund fraud and ensuring appropriate revenue collection**

In FY 2014, the IRS increased staffing and training, streamlined processes, and developed new technical tools that automated processes to complete identity (ID) theft cases quicker. The IRS total ID theft ending inventory on September 30, 2014 was 66,186, which was 60% less than the ending inventory for CY 2013.

When ID theft inventory increased in 2011 and 2012 and wait times for victims grew longer, manual refunds became a standard part of case resolution. As a result, a pilot program was implemented in FY 2014 to allow systemic refunds. The new automated process allowed transactions to post to accounts faster than in previous fiscal years. After implementation, taxpayers received systemic refunds in approximately 19 days compared to six weeks in prior fiscal years. The process resulted in a significant decrease in the volume of unpostable cases completed.

In calendar year 2014 (through September), the IRS protected 1.2 million potential ID theft cases worth \$7.3 billion from being paid out in fraudulent refunds. The IRS sent suspicious refunds for verification which prevented revenue loss and developed and improved identity theft filters based upon information developed from Criminal Investigation (CI) schemes.

In FY 2014, the IRS also created and performed testing on a model to detect ID theft cases during the post-filing review of taxpayer accounts. The output was analyzed to determine how the data could be used in production. When the model was applied against unworked underreporter inventory potential ID theft cases not previously detected by existing systemic processes were identified.

INTERNAL REVENUE SERVICE
 Management's Discussion & Analysis
 Fiscal Year 2014

Identity Theft Performance Measures

	<u>FY 2010</u>	<u>FY 2011</u>	<u>FY 2012</u>	<u>FY 2013</u>	<u>FY 2014</u>
Investigation Initiations	224	276	898	1,492	1,063
Prosecution Recommended	147	218	544	1,257	970
Indictments	94	165	494	1,050	896
Sentenced	45	80	223	438	748
Avg. Months to Serve	41	44	48	38	43

In FY 2014, IRS field agents conducted 250 Bank Secrecy Act compliance visits to money services businesses nationwide (29 states and Puerto Rico). The highest percentage of the visits occurred in the states of Florida and Georgia, which are known high-risk areas for refund fraud and ID theft. This "sweep" was part of a comprehensive ID theft strategy focused on preventing, detecting, and resolving ID theft cases. These compliance visits help ensure check-cashing facilities are not, knowingly or unknowingly, facilitating refund fraud and ID theft. In addition, the IRS had more than 900 check-cashing operations under examination across the country and looked for indicators of ID theft as part of its examination efforts.

♦ **Objective 3: Build and maintain public trust by anticipating and addressing the tax-exempt sector's need for a clear understanding of its tax-law responsibilities**

The IRS uses Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, to determine whether applicants qualify for recognition as an exempt organization pursuant to IRC section 501(c)(3), which allows them to receive tax-exempt charitable contributions. The IRS introduced a new, shorter application form, Form 1023-EZ, to help small charities apply for 501(c)(3) tax-exempt status more easily. The new Form 1023-EZ is only three pages long, far less lengthy compared to the standard 26-page Form 1023. Most small organizations with gross receipts of \$50,000 or less and assets of \$250,000 or less, including as many as 70 percent of all applicants, qualify to use the new streamlined form. The change will allow the IRS to speed the approval process for smaller groups and free up resources to review applications from larger, more complex organizations while reducing the application backlog. The new EZ form must be filed online, and the form's instructions include an eligibility checklist that organizations must complete before filing the form. Of the 23,854 applications for tax exempt status received since the Form 1023-EZ was introduced, 40% were Form 1023-EZ applications.

In FY 2014, of the 74,579 total applications received, 55,374 (74%) came in on Form 1023. In an effort to make the application for tax-exempt status easier for the taxpayer, the IRS created *i1023*, an interactive guide to Form 1023, which was released to the public on October 1, 2013. The interactive guide assists applicants and ensures more accurate and complete applications through features such as embedded, interactive pop-up information boxes that permitted applicants to access IRS educational resources and guidance on what information was needed for a complete 501(c)(3) application for tax-exempt status. In addition, the guide provided applicants with a checklist to track the required documentation and sample questions an applicant might be asked before a determination can be made. The interactive guide reduced taxpayer burden, improved the quality and consistency of

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

applications, and resulted in increased efficiency and reduced processing times in reviewing applications.

◆ **Objective 4: Identify trends, detect high-risk areas of noncompliance and prioritize enforcement approaches by applying research and advanced analytics**

In FY 2014, identifying the highest compliance risks among the taxpayer base and working issues effectively and efficiently were key priorities. Schedule UTP (Uncertain Tax Positions) requests information about tax positions related to the U.S. federal income tax liabilities of certain corporations and is used to help identify compliance risks. For tax year (TY) 2012, the filing requirement was expanded to include 133 new taxpayers with asset levels between \$50-100 million. Many of the UTP returns for the 2012 tax year were received in late 2013, with calendar year tax returns being filed in September 2013 and processed in late 2013 and into 2014.

In FY 2014, highlights of Schedule UTP included:

- Taxpayers reporting UTPs numbered 2,333 in TY 2012.
- Repeat filers accounted for 78% in TY 2012.
- The percentage of public companies filing Schedule UTP was 57% in TY 2012.
- Prepared education and outreach letters for late TY 2011 filers and for early TY 2012 filers.
- Sent education and outreach letters that provided guidance on how to prepare compliant Concise Descriptions of tax positions, for TY 2011, to 140 taxpayers with non-compliant Schedule UTP disclosures.
- Issued 168 TY 2012 letters to taxpayers that filed non-compliant Schedule UTP Concise Descriptions for the first time.
- Issued 278 TY 2012 letters to taxpayers who received education and outreach letters for one prior tax year (either TY 2010 or TY 2011) advising them that subsequent filings will be subject to additional scrutiny and review.
- Issued 16 TY 2012 letters to taxpayers who received outreach letters relating to non-compliant Concise Descriptions of tax positions for both TY 2010 and TY 2011.

To ensure compliance and enhance enforcement presence in the return preparer community, the IRS implemented Operation Electronic Filing Identification Number (EFIN), which utilizes real-time data to aid Scheme Development Centers (SDC) in identifying EFINs that transmit false ID theft returns. Operation EFIN identified fraudulent EFIN filings and ID theft tax returns. In FY 2014, 52 investigations were initiated as a result of the operation, and 160 EFINs were suspended or revoked due to ID theft.

The IRS Scheme Development Centers (SDC) identified 1,538 Questionable Refund Program (QRP) schemes, comprising 306,017 individual tax returns with more than \$1.5 billion in potentially fraudulent refund claims. QRP schemes utilize genuine identities

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

for the purpose of preparing and filing fictitious tax returns that claim false income and deductions to generate fraudulent claims for refund.

In FY 2014, the IRS:

- Initiated 1,027 QRP Criminal Investigations.
- Completed 1,181 QRP Criminal Investigations.
- Secured 843 QRP convictions, which equated to a 97.1% QRP conviction rate.
- Obtained an 89.3% QRP publicity rate on adjudicated investigations.

In FY 2014, IRS revised the selection criteria for examinations based upon improved data analytics. Returns delivered to field examiners included issue discussion papers to ensure examiners were aware of the technical issues present on the return. Employee expertise in Subchapter K tax law (Partnership taxation/Taxing a partnership business entity) and Tax Equity and Fiscal Responsibility Act (TEFRA) procedures have been strengthened through delivery of training, workshops, and job aids. Examiners were provided additional resources through expanded access to technical specialists and online resources. A number of improvements were made to TEFRA administrative forms and check sheets, increasing efficiencies in processing and reducing revisions.

Partnership filings have grown at a rate of 6.2% each tax year since 2010, while Subchapter C corporations have declined 5.7% over the same time period. The complexity of partnerships grew as more entities had a structure that involved tiered ownership, special allocations, and thousands of investors. For example, about 31% of partnerships were part of multi-tiered networks in tax year 2011. The IRS developed a strategy that included actions that improved workload identification, issue identification, technical support, and TEFRA administrative procedures.

The IRS Compliance Management Operations (CMO) group provided new mechanisms that identified and delivered high-quality, productive returns to the field, including returns that might not have been selected for examination using past methods. Additionally, the IRS demonstrated capability in incorporating modeling and other data analysis that enhanced business rules for case selection.

In addition, FY 2014 was a test year for sending out a "bundled" case, which is an enterprise case where there are related taxpayers. The test marked the first time that Compliance Management and Collaboration was tested on delivery of these cases to the field. The IRS closed 756 of the 1,238 cases selected for examination by the Compliance Management Teams.

◆ **Objective 5: Address noncompliance by improving data, information and knowledge sharing with tax community and government partners**

In FY 2014, IRS representatives participated in at least 454 outreach events (with a total audience of over 23,400) to promote compliance through publicity and education. Approximately 41% of those events provided audiences with information about general

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

fraud; 17% covered money laundering and the Bank Secrecy Act; 18% were identity theft related; and 9% provided education about the IRS' mission and accomplishments.

Identity theft continued to be one of the main areas of investigative concentration. To combat this growing problem, the IRS partnered with the Department of Justice's Interagency Working Group to address systemic issues related to identity theft.

The IRS also engaged with Federal and state agencies in order to exchange data and to implement aggressive actions to address identity theft and refund fraud. For 26 of the 41 states in which a state income tax is levied, the IRS secured Criminal Investigations (CI) Memorandums of Understanding, which establish reciprocal information sharing opportunities and cooperative compliance efforts between the IRS and certain states. The IRS is working with 2 additional states with income tax, as well as New York City, to secure additional agreements.

In an effort to increase collaboration with states on identity theft, fraudulent refunds, and the transmission of leads from the states to the IRS, the IRS established a centralized approach for working with members of the States' Suspicious Filer Group and automated referrals of suspicious filer information to the IRS. The IRS received 23 files from 10 states for 11,000 suspicious filers. This resulted in 2,100 questionable returns to stop over \$8.5 million in refunds.

The IRS also worked with the Federation of Tax Administrators, which consists of all the 41 states in which a state income tax is levied, to identify states with data sources of information on identity theft and refund schemes. The IRS also collaborated with Federal, state, and local agencies on best practices for authentication and identity protection.

The IRS continued to ensure the timely implementation of Affordable Care Act (ACA) tax provisions by engaging impacted stakeholders and performing outreach activities. The IRS worked with Federal and state agencies on the requirements and procedures for safeguarding Federal tax information used in the Exchange market (IRC 6103 (l)(21): *Disclosure of Return Information to Carry Out Eligibility Requirements for Health Insurance Affordability Programs*). Additionally, the IRS collaborated with HHS on outreach and IT deployment related to insurance market reforms and the health insurance exchange system. The IRS also issued 33 items of published guidance on ACA provisions, including final regulations on information reporting of Minimum Essential Coverage, Information Reporting by Applicable Large Employers, Shared Responsibility for Employers regarding health care coverage, and final rules establishing the Basic Health Program. The IRS launched the Income and Family Size Verification (IFSV) process in time for the Marketplace Open Enrollment in October 2013 (IRS ACA Release 3.0) and the Insurer Provider Fee in March 2014 (IRS ACA Release 4.1).

During FY 2014, the IRS prepared marketplace-related tax provisions for the ACA that will impact the 2015 filing season. The IRS continued implementation of ACA provisions which included industry fees and other provisions involving net investment income tax and medical device manufacturer excise tax. The IRS also continued preparation for the premium tax credit and individual responsibility payment on Forms 1040 and for information returns from employers, insurers, and marketplaces (IRS ACA Releases 5.0 and 6.0) for filing season 2015, as well as for post-filing compliance.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

The IRS has educated external partners on their responsibilities for accurately reporting Form 1099-K since the form's inception in TY 2011. For TY 2012, which is filed in 2013 and under Information Reporting and Document Matching (IRDM) in 2014, approximately 2,300 payers filed 9.5 million Forms 1099-K (*Payment Card and Third Party Network Transactions*) with the gross amount totaling over \$5.3 trillion. As compared to TY 2011, the number of 1099-K records increased 6.5% and the gross amount increased 8.4%. Several compliance treatments were underway using Form 1099-K data to pursue underreporting utilizing different adjustment methods. For example, typical Automated Underreporter (AUR) notices focus on Information Return (IR) discrepancies only (e.g., the 1099-K matched against gross receipts) while other newly developed notices focus on both IR and cash underreporting. As part of the IRDM program initiative, Securities Basis Reporting (IRC section 6045(g)) enhances the processing of the existing Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions*, within compliance work streams.

♦ **Objective 6: Improve compliance and reduce the risk of fraud through strong partnerships with the tax professional community**

The IRS strives to develop and maintain strong partnerships with return preparers while working diligently to improve compliance and reduce the risk of fraud. In FY 2014, IRS employees visited over 3,000 return preparers nationally to provide education and promote compliance. The visits focused on Earned Income Tax Credit (EITC) due diligence requirements, Preparer Tax Identification Number (PTIN) requirements, Schedule C (Form 1040) preparation, and the consequences of preparing inaccurate returns. The IRS also addressed egregious preparers through a variety of methods including Program Action Cases, IRC Sections 6700/6701 investigations, and civil penalties. The percentage of resolved IRS contacts with return preparers who have not fulfilled their personal income tax obligations was more than 86% of the 3,707 cases found in FY 2014. The IRS secured 53 injunctions, both permanent and preliminary, against questionable preparers in FY 2014.

The IRS Return Preparer Program (RPP) promoted compliance in the return preparer community through education, outreach, and coordinated cross-functional publicity.

In FY 2014, the RPP:

- Initiated 305 criminal investigations.
- Completed 348 criminal investigations.
- Secured 193 convictions with a 96.0% conviction rate.
- Achieved a 94.5% publicity rate on adjudicated cases.
- Held seven RPP-related outreach events for tax and accounting practitioners, the general public, and the media.

The IRS continued to support the RPP by administering the EITC Return Preparer Program. The objective of the program was to increase the accuracy of EITC returns by focusing efforts on EITC return preparers not exercising due diligence prior to and during the filing season.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

In FY 2014, highlights of the IRS EITC Return Preparer Program included:

- 411 pre-filing season due diligence visits were completed with over \$22 million in proposed penalties and an 84% penalty rate.
- 96 "Knock and Talk" visits were successfully completed with identified at-risk return preparers.
- Nearly 17,000 pre-filing season compliance and educational letters were sent.
- 296 real-time due diligence visits were completed with over \$3.5 million in proposed penalties and an 80% penalty rate.
- 3,000 filing season letters were mailed and 2,000 calls made.

In January 2014, almost 800 30-day letters, known as a Letter 1125, were mailed to EITC return preparers who failed to attach the Form 8867, *Paid Preparer's Earned Income Credit Checklist*, to TY 2012 returns after receiving a warning letter for failure to attach the form to TY 2011 returns. Letter 1125 is an examination notice explaining why the IRS proposes a tax return preparer penalty and it provides the preparer an opportunity to agree or disagree with the assessment within 30 days of the date on the letter.

The IRS Office of Professional Responsibility (IRS-OPR) is responsible for the oversight of tax practitioner interaction with tax administration and has been delegated authority for matters related to practitioner conduct with exclusive responsibility for discipline, including disciplinary proceedings and sanctions under Treasury Department Circular No. 230, *Regulations Governing Practice before the Internal Revenue Service*. In FY 2014, IRS-OPR focused on the proper analysis and interpretation of Circular 230 provisions as applied to specific practitioner misconduct, and on ensuring adherence to principles of due process throughout the disciplinary process. In FY 2014, 278 disciplinary or corrective actions were finalized including 9 practitioner disbarments and 64 suspensions. IRS-OPR entered into 17 Deferred Disciplinary Agreements (DDAs) and issued 188 reprimands and/or soft notices.

In FY 2014, four disciplinary proceedings were heard before Administrative Law Judges (ALJ). Circular 230 requires an ALJ to render a disciplinary decision in contested cases. For the first time, the IRS arranged for the responsible IRS-OPR Attorney-Advisor on a disciplinary case to attend the administrative hearing and assist General Legal Services (GLS) as "second-chair" during the proceedings.

Strategic Goal 2 Missed Opportunities

The mission of the IRS is to provide America's taxpayers top-quality service; however, budget cuts undermined the IRS' ability to fully realize all of its goals in enforcing tax laws and helping taxpayers understand their tax responsibilities. Certain important programs, such as identity theft prevention initiatives, were not fully maximized due to budget shortfalls. In an effort to continue to provide excellent service to the taxpayer and general population, the IRS was forced to allocate its scarce resources to tasks that required immediate funding. The outcome of such decisions led to reductions in vital fraud prevention and detection programs; decreases in training opportunities for taxpayers and IRS employees; reduced enforcement actions; and

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

understaffed IRS units. The IRS needs to be supplied with appropriate, timely resources in order to continue providing quality tax enforcement and education to America's taxpayers.

Identity Theft

Outreach is one of the primary methods through which the IRS educates the general population about filing requirements, latest tax-related refund crimes, legal actions, ways to protect taxpayer identity, and steps to follow if taxpayer identity is compromised. As a result of budget constraints, outreach was limited and the IRS decreased the number of identity theft refund and fraud presentations made available to stakeholders and the general population.

Budget constraints prevented the IRS from hosting annual live seminars for the Questionable Refund Program/Return Preparer Program (QRP/RPP) and ID theft coordinators in preparation for the 2014 filing season. In lieu of live seminars, a condensed online class was offered. The online classes provided limited topics, almost no classroom interaction, and a lessened ability to learn from the real life experiences of special agents. As a result, some of the coordinators, especially those that were new to the position, were not able to expand their knowledge of the legal options available, cultivate nationwide agency relationships, or gain tools needed for a full understanding of how to successfully combat identity theft and refund fraud.

The IRS need for additional resources to combat stolen identity refund fraud increased in FY 2014 due to escalated ID theft incidents, which spurred nationwide compliance visits including 250 visits to money services businesses in relation to the Bank Secrecy Act and 3,000 visits to return preparers. Coordinators assigned to critical ID protection roles needed to be fully equipped and educated on the latest legal actions, processes, and tools required for working investigations quickly and efficiently. With additional funding the IRS would have been able to conduct several more training events such as live ID Theft and QRP/RPP training for key personnel. This training would have included information on new fraud trends as well as legal and enforcement options necessary to combat refund fraud crimes.

Each of the IRS Scheme Development Centers (SDCs) played a vital role in identifying EFINs transmitting false identity theft returns, prompting 52 investigations and suspending or revoking 160 EFINs due to identity theft in FY 2014. However, that role was compromised when budgetary constraints prevented hiring and training additional staff. With additional funding of approximately \$3.76 million and 29 FTE, the IRS would have filled vacant positions and been able to bolster employee retention. The additional staff would have aided in further development of potential schemes and assisted in identification of new schemes.

The IRS used the Business Scheme Tracking and Referral System (BSTARS System) to store business return information verified as fraudulent filings and to track filings for potential criminal investigation. Additional funding would have allowed the IRS to modernize the BSTARS system to eliminate manual data entry and improve data gathering.

Several other initiatives designed to prevent stolen identity refund fraud were hampered by an insufficient budget.

- With an additional \$63.8 million and 622 FTE, the IRS could have:
 - Expanded the Identity Protection Specialized Unit (IPSU) and the Taxpayer Protection Program (TPP), allowing the IRS to answer 64,000 more identity theft-

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

related telephone calls in FY 2014, as well as adjust 50,000 more tax accounts affected by identity theft, prevent 88,000 identity theft returns from posting, and protect \$500 million in revenue.

- Reduced the backlog of identity theft cases.
- Expanded the Identity Theft Clearinghouse to better process and analyze identity theft leads and to work more collaboratively on tax cases with multi-agency task forces.
- With an additional \$16.6 million and 61 FTE, the IRS could have:
 - Enhanced system capabilities for early detection and flagging of refund claims at high risk of identity-related fraud, which would have protected \$780 million annually in revenue.
 - Provided IT and programming resources to more quickly acquire data from Social Security Administration Forms W-2, *Wage and Tax Statement*, and Form W-3, *Transmittal of Wage and Tax Statement*, which would speed the processing of legitimate refunds and the verification of wages and withholding on suspicious returns.
 - Increased the capacity of the Integrated Automated Technology program, which develops tools that enhance productivity through automated processing of certain taxpayer accounts, to develop three additional new software programs per year.

Enforcement

Compliance is one of the most challenging problems facing the IRS. Reduced enforcement resources resulted in nominal e-file monitoring and fewer enforcement actions. With fewer resources to monitor return preparers' e-filing requirements, potentially abusive return preparers were allowed to continue e-filing tax returns. Return Preparer investigations decreased from 176 in FY 2013 to 151 in FY 2014. Since investigations can lead to referrals to the Department of Justice for potential enjoinder, the number of preparers prohibited from preparing returns to prevent further tax harm to the Government decreased from 64 in FY 2013 to 53 in FY 2014.

The IRS would have benefited from increased funding for expanding audit coverage to prevent, detect, and address noncompliance, while promoting the likelihood of voluntary compliance. In FY 2014, the IRS performed over 1.4 million individual and high income audits and over 62,000 audits of businesses both large and small. Additional funding could have further expanded correspondence examinations of refundable credits and allowed greater field examination coverage across high-risk segments of the taxpayer population.

The IRS was unable to expand the Automated Collection System (ACS) program to better address taxpayers with balance due accounts. With an additional 121 FTE and \$11.8 million to support the increase in ACS closures, the IRS could have:

- Increased revenue by approximately \$78 million in FY 2014, \$140 million in FY 2015 and \$175 million in FY 2016.
- Closed additional cases in ACS where the taxpayer was delinquent in payment.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

Also, the IRS was unable to fund the ACS plan to automate Installment Agreement acceptance and input directly to the ACS database which would have saved call contact time and helped ensure contact case resolution.

The IRS could not expand the Withholding Compliance (WHC) program, which automates the process of correcting Federal income tax withholding and preventing future delinquent returns. In FY 2014, the WHC program enrolled approximately 234,000 taxpayers and protected \$574.5 million in revenue. Expansion of the program by adding 50 FTE and \$4.9 million could have:

- Increased revenue by over \$11 million in FY 2014, \$20 million in FY 2015 and \$25 million in FY 2016.
- Added 250,000 taxpayers to the WHC program and encouraged voluntary compliance.

Budget shortfalls prevented the IRS from expanding the Predictive Dialer (PD) program to the Compliance Services Collection Operation. With an additional 50 FTE and \$4.9 million the program was expected to:

- Implement additional PD campaigns, which would have initiated early contact with taxpayers helping them resolve their account issues.
- Increase projected revenue by over \$11 million in FY 2014, \$20 million in FY 2015 and \$25 million in FY 2016.

The IRS strives to expand pre-refund treatment options during return processing to ensure revenue protection and timely delivery of correct refunds. The IRS wanted to hire additional business analysts to enable the Return Review Program to develop and implement new ID theft algorithms. Existing algorithms protected \$3.7 billion in revenue. The implementation of a new and more sophisticated identity theft algorithm developed by the IRS in FY 2014 could have added one million selections at a 30% false positive rate to existing processing year 2014 Taxpayer Protection Program (TPP) filters, representing 400,000 - 500,000 more calls to TPP annually with an estimated revenue protection of \$3 billion.

The IRS has been unable to properly address transfer pricing compliance risk due, in part, to inadequate resources and funding allocated to transfer pricing compliance efforts. The Transfer Pricing Practice (TPP) currently employs only 57 technical employees. With this level of staffing, TPP is only able to participate in fewer than half of transfer pricing issues that may have a potential adjustment of \$100 million or more.

With additional funding, the IRS could have:

- Expanded the current staffing of transfer pricing professionals in the TPP and thus have the capability to more adequately staff and examine significant pricing issues.
- Participated in more issues exceeding \$100 million.
- Increased significant expertise in topics such as economic, engineering, valuation, marketing, industry and intellectual property law.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

- Brought desperately needed expertise to a number of significant intangible property transfer pricing issues with an estimated tax impact of \$2 billion or more.

The ongoing budget environment negatively impacted the IRS regulatory and enforcement presence in the Tax Exempt and Government Entities (TE/GE) arena. The FY 2014 year-end examination staffing was 10% less than the FY 2012 level and the IRS completed 21% fewer audits. If TE/GE had been able to replace two-thirds of the attrition that took place in the last two fiscal years, the FY 2014 exam closures would have decreased by 19% and projections for FY 2015 would be better.

In addition, due to delayed hiring, the IRS had to reallocate resources from the exempt organization enforcement program to address the backlog of applications for tax-exempt status resulting in a nearly 6% reduction in projected exempt organization examination closures from what was planned. More specifically, due to this reallocation of resources, enforcement of the Form 990 series of returns (e.g. Form 990, *Return of Organization Exempt from Income Tax*; Form 990-EZ, *Short Form Return of Organization Exempt from Income Tax*) was reduced by nearly 30% from the planned levels.

Lack of information technology funding prevented planned revision or implementation of some forms including Form 8027 and Form 8922. Revised Form 8027, *Employer's Annual Information Return of Tip Income and Allocated Tips*, for filing year 2014, processing year 2015 would have increased tip reporting compliance. Similarly, Form 8922, *Third-Party Sick Pay Recap*, would have replaced the third-party sick pay recaps no longer provided by the Social Security Administration (SSA). As a result, manually driven workarounds are being pursued to prevent issuance of approximately 25,000 erroneous Combined Annual Wage Reporting (CAWR) notices in FY 2016.

Limited IT resources diminished the ability of the IRS to plan, track, and allocate resources with regard to partnership return compliance. Budget constraints for technological improvements also forced the IRS to continue using less effective case selection of flow-through returns for examination and resulted in a diminished ability to determine return linkages to key cases. This created additional work in the campus Tax Equity and Fiscal Responsibility Act (TEFRA) unit by forcing them to order and manually review returns to obtain correct information and determine appropriate actions on partnership cases. Enforcement of partnership return compliance would have been improved if there was sufficient funding to:

- Implement process improvements to enhance case selection and reconciliation.
- Expand partnership activity codes based on asset size in conjunction with the number of partners and type of partners, which would properly capture the complexity of partnership returns and allow more effective workload management.
- Increase staffing for front line compliance positions by 337 FTE, which would have resulted in over 1,700 additional partnership audits.
- Replace the Partnership Control System, which would have made Examination more efficient in processing TEFRA and Non-TEFRA Pass-Through Entity Returns.

The IRS sought to expand and establish new compliance programs to handle reporting on merchant payment card and third-party reimbursements that emerged from the Housing and

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

Economic Recovery Act of 2008, as well as reporting on security sales that stemmed from the Emergency Economic Stabilization Act of 2008. Analysis of payment card information can significantly reduce the tax gap by enhancing identification of businesses at high risk of underreporting gross receipts. With an additional \$50.3 million and 536 FTE, the IRS would have been able to more successfully enforce taxes owed on merchant card payments and third party network transactions by enhancing document analysis; correspondence, field, and nonfiler examinations; fraud and criminal investigations; and requisite information systems. The funding would have also produced additional enforcement revenue of \$152.4 million in FY 2014.

The Criminal Investigation division currently utilizes a limited virtual environment for processing digital evidence that houses a number of cases monitored by the IRS' e-Crimes Lab. The virtual machines permit more efficient analysis and sanitation of electronic data and allow for remote support within a secure workspace. With additional FTE, the IRS could have expanded the virtual environment to all CI agents nationwide, providing a unified platform for computer forensic analysis across the IRS.

The IRS would like to have enhanced the software platforms for the Content Management and Collaboration (CMC) system and the Issue Management System (IMS). Enhancements would have had a positive, material impact on improving the efficiency and effectiveness of the examination process and on robust risk management programs such as Compliance Management Operations, Lean Six Sigma, International Business Compliance, and Global High Wealth.

Hiring and Training

The Regional On-the-Job-Instructors (ROJI) and the IRS Re-employed Annuitant (REA) programs support IRS hiring and course development/delivery initiatives. Both of these programs were eliminated due to budget constraints. The loss of these programs had a direct impact on maintaining up-to-date training resources, the IRS Re-Engineering Exam Process, and the New Hire program. Lack of funding had a heavy impact on course development and instructional delivery especially in developing virtual courses.

Due to hiring freezes and restricted budgets, business units across the IRS were unable to dedicate enough resources to fully leverage web and SharePoint technology capabilities that would have enabled IRS employees to further optimize the delivery of services to taxpayers and stakeholders. Specifically in areas such as SharePoint Services, IRWeb/Intranet Publishing, IRS.gov Publishing, Web Design Services, Email integration (in collaboration with Business Systems Planning for secure email with taxpayers, and IT for organization mailboxes and distribution lists). IT was unable to provide adequate user support and training beyond the bare basics for SharePoint, a powerful collaboration tool. Also, the IRS will not be able to support the user demands as SharePoint gains momentum.

Strategic Goal 2 Performance Measures

The IRS met 88% (15 of 17) of its enforcement performance measure targets in FY 2014 compared to 71% (12 of 17) in FY 2013.

INTERNAL REVENUE SERVICE
 Management's Discussion & Analysis
 Fiscal Year 2014

Strategic Goal 2: Effectively enforce the law to ensure compliance with tax responsibilities and combat fraud

Performance Measure	FY 2014	
	Target	Actual
Examination Coverage – Individual	0.8%	0.9%
Field Examination National Quality Review Score	89.6%	88.4%
Office Examination National Quality Review Score	90.2%	90.6%
Examination Quality – Large Business	90.0%	83.0%
Examination Coverage – Business (assets >\$10M)	4.2%	4.3%
Examination Efficiency – Individual (1040)	133	138
Automated Underreporter (AUR) Efficiency	1,931	1,935
Automated Underreporter (AUR) Coverage	2.5%	2.6%
Collection Coverage – Units	42.7%	45.9%
Collection Efficiency – Units	2,007	2,051
Field Collection National Quality Review Score	81.0%	81.6%
Automated Collection System (ACS) Accuracy	94.0%	95.2%
Criminal Investigations Completed	4,440	4,606
Number of Convictions	2,450	3,110
Conviction Rate	92.0%	93.4%
Conviction Efficiency Rate (\$)	\$280,000	\$231,103
TE/GE Determination Case Closures	71,219	136,746

Shortfall Explanations

Field Exam National Quality Review Score: A decline in the weakest quality attribute (Time Span) for this performance measure has contributed to a decline in overall quality performance, with year-end performance falling slightly short of target. The leading error in this attribute is failure to meet closing action timeframes. Area Directors have quality action plans and their FY 2014 and FY 2015 Performance Management Review System quality commitments focus on reducing those leading errors. Educational efforts, customized to address the leading errors within the weaker attributes, are ongoing at the area and territory level.

Examination Quality – Large Business: The 83.0 percent was a result of lower scores in quality standards for Planning, Inspection, and Workpapers and Reports. Actions currently underway to improve this score include direct feedback to revenue agents, outreach presenting the Quality Standards and ways to affect case quality improvement, quarterly CENTRA sessions to highlight and discuss actions for areas of improvement, and one-on-one report outs to industry analysts in each industry.

Focus Area: Enterprise Risk Management

In May 2013, in response to concerns about operational challenges, the Secretary of the U.S. Department of the Treasury requested that the IRS assess options for improving future operations. Part of the IRS' response was to create a robust Enterprise Risk Management (ERM) Program and to establish the position of Chief Risk Officer (CRO) with responsibilities for the ERM program within the Office of the Commissioner.

ERM supports the identification and assessment of risks, and provides senior management with the information necessary to make sound decisions, with risk being one of the core elements of the decision-making framework. ERM enables management to effectively deal with uncertainty and associated risk and opportunity, enhancing the capacity to deliver on the IRS mission.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

Further, ERM supports the ability to strike an optimal balance between operational, financial and legal considerations and related risks (including reputational risk), improving management's ability to effectively and efficiently deploy resources in pursuit of the IRS' objectives. The IRS ERM Program objectives include the following:

- Align risk appetite and strategy;
- Identify and manage cross-enterprise risks;
- Enhance enterprise risk response decisions;
- Reduce operational surprises;
- Identify opportunities;
- Inform resource deployment;
- Support a risk-aware culture; and,
- Provide transparency to stakeholders.

Leveraging the *Committee of Sponsoring Organizations of the Treadway Commission's (COSO) Enterprise Risk Management – Integrated Framework*, the IRS is designing and implementing ERM through a phased approach. In particular, this approach includes: 1) Enterprise level initiatives focusing on key ERM program components and top risks facing the IRS; and, 2) Operational level initiatives supporting specific functions or processes with risk management techniques and special projects.

The ERM Program is led by the Chief Risk Officer, supported by a small ERM Program Team and embedded ERM Liaisons from each organization. ERM Liaisons include senior officials that serve as champions for risk management and support their unit leadership in identifying, assessing, and managing risk. In addition, an integrated ERM governance structure provides a dedicated forum for senior executive IRS officials to obtain transparency into and openly discuss the most significant risks facing the IRS and other enterprise risk management elements.

In addition to designing and implementing an ERM governance model and operating model, the ERM Program has also completed the following:

- Established an enterprise risk identification and assessment process;
- Developed an enterprise risk reporting capability;
- Trained approximately 300 executives on ERM;
- Developed the IRS' first enterprise risk register;
- Executed a high-level enterprise risk assessment to serve as a baseline starting point for the organization; and,
- Supported numerous operational level special projects and provided risk management advice.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

The IRS is dedicated to establishing a robust ERM program. While significant progress has been made this year with key fundamental building blocks for our program, this is still a work in progress and the IRS will continue to learn from and adapt in designing and implementing ERM in the upcoming years.

SYSTEMS CONTROLS AND LEGAL COMPLIANCE

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

Federal Managers' Financial Integrity Act (FMFIA)

The IRS provides qualified assurance that the systems of management control objectives, in accordance with the internal control requirements of the Federal Managers' Financial Integrity Act (FMFIA), the Federal Financial Management Improvement Act (FFMIA), the Office of Management and Budget (OMB) Circular A-123, the Government Charge Card Abuse Prevention Act of 2012, and the Reports Consolidation Act of 2000, were achieved during FY 2014. Furthermore, the IRS is operating in accordance with the procedures and standards prescribed by the Comptroller General and OMB guidelines.

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

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

The qualified assurance is based on the fact that the IRS has a material weakness in internal control over financial reporting and the financial management systems do not substantially comply with FFMIA. Specifically, this assurance is provided relative to FMFIA Sections 2 and 4.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

Federal Financial Management Improvement Act (FFMIA)

To address the Unpaid Tax Assessment Material Weakness, the Customer Account Data Engine 2 (CADE 2) Transition State 2 (TS2) initiative deployed two incremental Penalty & Interest (P&I) Common Code base releases to eliminate the differences in programming platforms that caused inconsistent balance due amounts issued on taxpayer notices during FY 2014. The application now calculates with more consistency the penalty and interest on individual and business accounts for taxes not received by the due date, resulting in more accurate notices and better service in helping taxpayers meet their tax obligations. Other actions that have been taken include:

- The IRS CADE 2 team mapped financial requirements for ten business areas that will address the financial material weakness.
- A controlled launch was conducted on CADE 2 resulting in validation of new historical data that will be used for further analysis.

The IRS also developed a CADE 2 TS2 Release Plan on September 30, 2014, that includes high-level milestones to leverage the CADE 2 data and make changes to the IRS financial systems (Custodial Detail Database and Redesign Revenue Accounting Control System) to improve the accuracy of the financial classifications and downgrade the UA material weakness related to individual taxpayer accounts, including a new projected closure date of November 30, 2020. New planned actions and target dates for implementing the improvements will be added to the UA material weakness action plan

USAspending.gov

In accordance with the requirements of the OMB Memorandum, *Improving Data Quality for USAspending.gov*, IRS provides assurance that its internal controls over the underlying spending reported on USAspending.gov, and in relation to the IRS financial statements, are effective. Specifically, on a quarterly basis, IRS performed a sample analysis to determine the accuracy of the data to comply with the OMB memorandum and validated USAspending.gov prime Federal award financial data with data maintained in the IRS financial system. Based on the results of our analysis, IRS records on USAspending.gov are 99.9 percent accurate for contracts and 98.9 percent accurate for grants.

Government Charge Card Abuse Prevention Act of 2012

In accordance with the requirements of the Government Charge Card Abuse Prevention Act of 2012, the IRS provides assurance that its internal control over the use of government charge cards was effective. Specifically, the IRS complied with the Department of Treasury Charge Card Management Plan and provided agency-wide purchase card guidance for the proper use of government charge cards. The IRS monitors charge card activity to validate that the appropriate policies and procedures are being followed and ensures that corrective actions have been taken to mitigate the risk of fraud and inappropriate charge card practices.

Reports Consolidation Act of 2000

In accordance with the Reports Consolidation Act of 2000, the IRS provides assurance that the IRS Critical Performance Measures are reliable. Internal Revenue Manual 1.5.1, *Managing*

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

Statistics in a Balanced Measurement System, The IRS Balanced Performance Measurement System, provides a detailed template that documents each measure's definition, formula, reliability, and reporting frequency. These controls verify that performance data is consistently and accurately collected over time.

Continuity of Operations (COOP)

The IRS enhanced its disaster recovery program by incorporating critical business processes and system infrastructure into Information System Contingency Plans and ensuring that each plan has a documented Business Impact Analysis. The IRS validated that each Information System Contingency Plan for all IRS FISMA master inventory systems contained keystroke recovery procedures for each asset and ensured that each plan was updated and tested annually. The IRS conducted 286 exercises and tests to determine that the plans were current and executable, back up data was readily available and readable, and Critical Infrastructure Protection systems could be recovered within their defined Recovery Time Objective. To mitigate the highest risk and promote cost effectiveness, the IRS prioritized the systems' infrastructure single points of failure to identify the most beneficial remediation investments that reinforced the downgrade of the disaster recovery area of the Information Security significant deficiency.

Limitations of Financial Statements

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

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

IRS management is responsible for establishing and maintaining adequate internal control over financial reporting, which includes safeguarding of assets and compliance with applicable laws and regulations. The IRS conducted the required evaluation of the effectiveness of its internal control over financial reporting in accordance with OMB Circular A-123, *Management's Responsibility for Internal Control*, including for the first time, collaborating with the Centers for Medicare and Medicaid Services (CMS) as they pertain to Advance Premium Tax Credit (APTC) and Cost Sharing Reduction (CSR) payment amounts in connection with the IRS financial reporting requirements for these amounts. Based on the results of this evaluation, the IRS provides qualified assurance that its internal controls were operating effectively as of September 30, 2014 based on the existing material weakness on unpaid tax assessments affecting the internal control over financial reporting.

The FY 2014 OMB Circular A-123 testing included the following activities:

- Tested internal control sets for the 18 transaction processes identified by the Department of the Treasury that are material to its Consolidated Financial Statements. The tests included 9 administrative processes covering material portions of the \$11.3 billion in annual administrative transactions, 5 information system processes, and

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

4 custodial processes covering material portions of the over \$3.0 trillion in tax revenue receipts through September 30, 2014. The transactions included additional testing for custodial activity related to tax refunds and cash reconciliation.

- Tested the compensating procedures used to produce the annually audited financial statements.
- Performed supplemental testing of the FY 2014 transactions during the fourth quarter to verify that controls remained effective throughout the year.
- Conducted a self-assessment of the IRS internal control environment using an Abbreviated Internal Control Evaluation Checklist authored by GAO.
- Reviewed IRS compliance with applicable laws and regulatory requirements regarding financial reporting and internal control, including compliance with FFMA, FMFIA, FISMA, and the Chief Financial Officers Act.
- Made measurable progress towards eliminating noncompliance under the Improper Payments Elimination and Recovery Improvement Act of 2012 (IPERIA) and Executive Order (EO) 13520. Noncompliance results from not achieving an error rate of less than ten percent.
- Reviewed CMS documented testing of internal controls related to certifying and making APTC and CSR payments and performed independent evaluations of these controls.
- Reviewed CMS representation letter indicating there were no material changes to the control environment around the processes executed in support of the APTC and CSR payment amounts during the period July 1, 2014, through September 30, 2014. Specifically, CMS management represented that:
 - Internal controls in place at CMS for the period January 1, 2014, through June 30, 2014, were still in place for the requested period with no material changes in the control environment
 - No internal control gaps were identified during the period July 1, 2014, through September 30, 2014.

CMS management is not aware of any fraud, non-compliance with laws and regulations, and did not have any uncorrected misstatements affecting IRS's financial statements.

INTERNAL REVENUE SERVICE
 Management's Discussion & Analysis
 Fiscal Year 2014

Federal Information Security Management Act (FISMA)

In accordance with FISMA requirements, the IRS maintained an agency-wide information security program and provided a comprehensive framework for validating the effectiveness of information security controls over resources that support IRS business operations and goals. Specifically, the IRS inventory of FISMA reportable systems is compliant with security requirements from OMB, NIST, the Department of the Treasury, and IRS internal policies. These systems completed annual security control testing, participated in required security authorization and assessment activities, and timely addressed required Plans of Actions and Milestones (POA&Ms) for identified weaknesses. Additionally, the IRS exceeded all FY 2014 FISMA goals, with the exception of POA&M items which reached 84 percent of the 90 percent goal.

Actions	Status
Security Assessment and Authorization of Systems	100%
Security Authorization	100%
Specialized Training	99.8%
Annual Awareness Training	98.9%
Contractor Systems Reviews	100%
Annual Security Controls Testing	100%
Information Systems Contingency Plan Testing	100%
Privacy Impact Assessment	100%
System of Record Notice	100%

Progress Made on Significant Deficiency

The IRS organizations worked diligently to continue to enhance IT security which is currently identified as a significant deficiency. IRS has implemented a strategy and a well-defined assessment process that documents with verifiable results the effectiveness of internal controls for the financial systems that impact the financial statements. The process supports IRS's overall internal control framework and provides assurance that the likelihood of a material weakness reoccurring is low in the Information Technology (IT) environment. In FY 2014, the following activities were completed:

- Complied with Federal Information Security Management Act (FISMA), Office of Management and Budget (OMB), National Institute of Standards and Technology (NIST), Department of the Treasury, and IRS security requirements and met the 90 percent compliance metric.
- Performed self-assessments to ensure policies, procedures, processes, metrics, training, testing, and controls were in place to protect the IRS' infrastructure and data.
- Reviewed and evaluated the security monitoring controls for IT systems owned or operated by external entities to provide assurance that their systems' security management programs were adequately documented.
- Addressed potential risks to IRS financial systems.
- Tested and validated prior year GAO recommendations to prevent premature closure and attain a high closure rate.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

Major Management Challenges and High-Risk Areas

GAO and TIGTA identified several Management Challenges and High-Risk Areas facing the IRS. The following are the high risk area identified by GAO in its 2013 High Risk Series Update, the management and performance challenges identified by GAO in the December 12, 2013 *Financial Audit: IRS's Fiscal Years 2013 and 2012 Financial Statements*, and the management and performance challenges identified by TIGTA in its November 8, 2013, memorandum titled *Management and Performance Challenges Facing the Internal Revenue Service for Fiscal Year 2014*.

GAO High Risk Areas for IRS

- Enforcement of Tax Laws

GAO Management Challenges

1. Preventing and Detecting Improper Refunds from Identity Theft
2. Safeguarding Taxpayer Receipts and Associated Information

1. PREVENTING AND DETECTING IMPROPER REFUNDS FROM IDENTITY THEFT

Summary of Major Issues: The IRS must respond to challenges created by the large number of identity theft-based refund claims it receives by recognizing and mitigating fraudulent claims and minimizing burden on the victims of identity theft.

Actions Taken:

- Worked to combat phishing, vishing, and malware sites to protect taxpayer information and maintain public confidence. IRS shut down 302 schemes related to "Get Your Refund" and 419 vishing incidents.
- Provided specialized outreach and education campaigns to help taxpayers avoid ID theft. Social media outreach included YouTube videos, Tumblr posts, Twitter tweets, and information on the IRS Facebook page
- Stopped more than 54,000 fraudulent prisoner returns with associated refunds of more than \$2 billion. In addition, the IRS implemented new pre-refund filters through the Automated Questionable Credit program to address questionable claims, protecting or assessing more than \$109 million.
- Continued the External Leads program collaboration efforts with software developers, banks, and other industries to determine how to better partner to address ID theft and prevent federal monies from reaching the hands of identity thieves. The External Leads program recovered more than \$514 million in FY 2014.
- Implemented Operation Electronic Filing Identification Number (EFIN), which utilizes real-time data to aid Scheme Development Centers (SDC) in identifying EFINs that transmit false ID theft returns. In FY 2014, 52 investigations were initiated as a result of the operation, and 160 EFINs were suspended or revoked due to ID theft
- Ensured IRS compliance with OMB-issued Memorandum 07-16 (Safeguarding Against and Responding to the Breach of Personally Identifiable Information), which mandates that all federal agencies take necessary actions to eliminate or reduce the unnecessary use of SSNs.
 - Utilized innovative 2D barcode technology to mask the SSN on outgoing IRS notices while creating processing efficiencies on the subsequent correspondence replies. To

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

- date, the 2D barcode technology has masked the SSN on 80 IRS notices totaling 50 million pieces of correspondence annually
- Removed or masked the SSN on 116 IRS forms (internal and external use)

2. SAFEGUARDING TAXPAYER RECEIPTS AND ASSOCIATED INFORMATION

Summary of Major Issues: Safeguard the large volume of sensitive hard copy taxpayer information, payment receipts, and related information.

Actions Taken:

- Randomly reviewed contract couriers and found no instances of unlocked vehicles or other violations
- Completed a thorough background check and security clearance authorizing "staff-like access" to IRS buildings for all contract couriers.
- Issued an IRS-wide memorandum to reinforce existing policies and procedures for IT assets assuring that:
 - Records are timely and accurately recorded
 - Approval is obtained prior to the disposal of assets and only approved by those properly authorized to do so
 - Hard drives of disposal assets are wiped clean of sensitive information prior to disposition
 - Non-IRS building management and cleaning staffs are not given cipher lock codes to access IRS space
- Moved the records management program to the Privacy organization to provide opportunities to reduce the volume of electronic and paper records and reduce privacy risks and operating costs

Actions Planned or Underway for FY 2015 and Beyond:

- Complete revisions to policies and procedures on Information Protection and Security Awareness Training Requirements, to require additional contractors to receive security training.
- Continue tracking and monitoring compliance of Security Awareness Training on behalf of Cybersecurity.
- Work with Vendors and Contracting Officer's Representatives to ensure they understand their role in ensuring that contractors are properly trained to have access to systems, facilities, and information.

TIGTA Management Challenges

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

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

The IRS is addressing these issues through its existing program activities. Measures of these program activities serve to show progress in addressing the management challenges and high-risk areas. Summarized below are the major management and performance challenges facing the IRS and information on the actions taken in fiscal year 2014 and planned for fiscal year 2015 and beyond.

1. SECURITY FOR TAXPAYER DATA AND IRS EMPLOYEES

Summary of Major Issues: Promote measures for appropriate physical security and protection of financial, personal, and other information.

Actions Taken:

- Issued approximately 1.2 million Identity Protection Personal Identification Numbers (IP PINs) to taxpayers with identity theft markers on their accounts.
- Launched an online application process so that taxpayers who were victimized by identity theft can retrieve their lost or misplaced IP PINs.
- Created an IP PIN eAuthentication service for taxpayers from high-risk identity theft areas to use an Electronic Filing PIN (EFP) as an option to request an IP PIN.
- Added the two-dimensional (2D) barcode to four installment agreement notices affecting an estimated 33 million notices annually. The 2D barcode provides IRS with information needed to process the notice and mask the full display of the SSN in the body of the notice by exposing only the last four digits of the SSN.
- Embedded the taxpayer SSN and other processing data in the 2D barcode on installment payment notices.
- Issued a memorandum to all business functions emphasizing the new Internal Revenue Manual 1.4.30, *Monitoring Internal Control Planned Corrective Actions*, which strengthens existing policies and procedures on internal controls, to ensure that all adhere to the requirements governing the internal control process for the JAMES.
- Closed four enterprise-wide IT security vulnerabilities related to auditing, penetration testing, security of shared services, and procurements of Commercial-Off-The-Shelf (COTS) products.
- Completed all of the Computer Security Plan corrective actions resulting in the closure of the plan and significant improvements to our IT security posture.
- Developed a detailed corrective action plan to address 23 specific actions to address newly identified control weaknesses over key financial and tax processing systems.
- Worked with the appropriate business units and the Department of Treasury to reopen seven previously closed corrective actions to establish new corrective actions that fulfill the original audit recommendations; the new corrective actions will remain open until fully implemented.
- Initiated appropriate outreach to ensure that frontline employees are aware of current Potentially Dangerous Taxpayer (PDT) and Caution Upon Contact (CAU) designation processes as well as any changes that are made to the process in the future.

Actions Planned or Underway for FY 2015 and Beyond:

- Establish clear policies and procedures to assure service contracts have the appropriate security provisions included in the related solicitation and contract, and that associated contractor personnel have appropriate interim access approval or final background investigation prior to beginning work on the contract.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

- Continue to mask social security numbers (SSNs) on notices by adding the 2D barcode to 35 individual non-payment notices and 23 Automated Collection System notices.
- Develop a long-term strategy to expand eAuthentication to reduce identity theft and refund fraud.
- Increase the success rate of IP PIN requests and replacements by reducing address mismatch.
- Enhance authentication to use the Individual/Information Returns Transaction File (IRTF) and the Masterfile address of record to enable mailing of opt-in notices.
- Revise IRS notice CP01A, *We've Assigned You an Identity Protection Personal Identification Number*, to explain the effect IP PINS have on recipient tax return processing, and will include information relating to the use of IP PINS for dependents, secondary filers, and taxpayers without a filing requirement.

2. IMPLEMENTING THE AFFORDABLE CARE ACT AND OTHER TAX LAW CHANGES

Summary of Major Issues: Implement new tax provisions, including tax-related health care provisions of the Patient Protection and Affordable Care Act, and the American Recovery and Reinvestment Act (Recovery Act)

Affordable Care Act

Actions Taken:

- Placed the following Individual Shared Responsibility Payment (ISRP) (IRC 5000A) materials on IRS.gov:
 - ISRP and ISRP Questions & Answers (Q&As) page.
 - Electronic publications.
 - Health care tax tips.
 - Videos.
- Developed or revised 157 Marketplace and 330 non-Marketplace products including: Web content in both English and Spanish on IRS.gov, Q&As, presentations, Talking Points, e-News items, articles, health care tax tips, electronic flyers and brochures, and training materials.
- Conducted over 180 outreach events, reaching over 70,000 participants from over 100 organizations.
- Created a series of releases to organize IT work needed to deliver ACA Services and placed ACA Release 3.0 into production, which delivered capabilities to support Health Insurance Marketplaces.
- Completed 100% of the pre- and post-refund Small Business Health Care Tax Credit (45R) sampled examinations to determine level of compliance.
- Responded to requests to calculate the Advance Premium Tax Credit (APTC) and to verify income and family size with the following results:
 - Income and Family Size Verification (IFSV) - responded to 53,652,280 requests.
 - Advance Premium Tax Credit calculation - responded to 17,205,299 requests.
 - Integrated operations activities, including proactive, end-to-end monitoring and incident management activities into the enterprise process.
 - Responded to IFSV requests on average in 162 milliseconds exceeding the five-second target 99.94% of the time.
 - Responded to APTC requests on average in 19 milliseconds, exceeding the five-second target 99.98% of the time.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

- Issued 33 pieces of published guidance on ACA provisions.
- Coordinated IT business requirements to support 2015 IRS implementation of market place provisions.
- Delivered six employee training modules and provided "ACA acronym awareness" training to customer-facing managers and employees.
- Implemented programming modifications so that variables in the Coverage Data Repository are consistent with those in the Individual Master File.
- Collaborated with federal partners and the National Taxpayer Advocate on more than a dozen implementation communications products.

Actions Planned or Underway for FY 2015 and Beyond:

- Create additional Individual Shared Responsibility Payment materials:
 - IRS.gov Updates.
 - Additional Health Care Tax Tips.
 - Tax Forms and Instructions.
 - Customer Service assistance and account services.
- Consider alternative strategies for identifying noncompliant medical device manufacturers. IRS may issue notices to potential non-filers if there appears to be a benefit to future tax administration.
- Require agencies to submit an initial independent security assessment and signed system security authorization.
- Complete Brand Prescription Drug revisions of Form 8947 and its instructions for clarity to reduce taxpayer burden.
- Implement compliance checks before, during, and after Premium Tax Credit processing.
- Collaborate with other government agencies to develop and deliver shared messages, customer assistance tools, and training materials on tax and non-tax provisions for individuals and employers.
- Communicate impacts of the Marketplace Provisions for individuals, employers, and insurers, in an effort to ensure compliance when filing 2014 tax returns.
- Expand outreach resources to provide education and assistance in advance of the 2015 Filing Season.
- Gear-up for the 2015 filing season:
 - Prepare IT systems to integrate the administration and reconciliation of the Premium Tax Credit into the individual tax filing process.
 - Receive Exchange Periodic Data (EPD) from the Marketplaces.
 - Receive Information reports (1095s).
 - Perform third-party data checks to enhance fraud prevention.
 - Modify numerous tax administration systems.
 - Upgrade Infrastructure.

Other Tax Law Changes

Actions Taken:

- Developed and implemented a prototype model for filing season 2014 that identified and froze Form 1120 corporate tax filings that claimed a fraudulent Fuel Tax Credit (FTC), which resulted in the Frivolous Return Program selecting 168 fraudulent Form 1120 returns and protecting \$7,994,209 in revenue.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

- Completed the American Tax Relief Act (ATRA) Section 209 action plan which provides a roadmap to implement this new law.
 - Invited all state Governors, the Federal Bureau of Prisons (FBOP) and the District of Columbia, as well as the Departments of Correction (DOC) in each state to collaborate with the IRS in efforts to deter tax fraud by inmates and prisoners.
 - Established contacts for the FBOP and 50 state DOCs.
 - Held conferences with the FBOP and 26 state DOCs.
 - Signed an agreement with the Mississippi DOC to exchange data
- Sent letters to all 50 states and the Federal Bureau of Prisons (FBOP) correctional agencies which explained the new ATRA legislation and requested they sign a Memoranda of Understanding (MOU). The MOU would allow the IRS to disclose return and return information of inmates who filed or facilitated the filing of false or fraudulent returns.
- Closed over 3,900 of the 4,000 pilot cases involving information reporting on merchant payment cards. For fiscal year 2014, 30,000 Merchant Card cases, with no Schedule C, were selected and distributed for screening and notices were issued. Over 10,700 cases were closed with assessments.
- Issued Notice 2014-19, which provides guidance (including the retroactive application) of the decision in *United States v. Windsor* on qualified retirement plans under section 401(a) of the Internal Revenue Code.
- Posted frequently asked questions (FAQs) on IRS.gov providing additional information regarding the application of the *United States v. Windsor* decision on qualified retirement plans.
- Issued Notice 2014-37, which amplifies Notice 2014-19 by providing further guidance with respect to mid-year amendments made to safe harbor 401(k) and 401(m) employee plans.
- Revised employee plan guidance to reflect the issuance of the *United States v. Windsor* decision.

Actions Planned or Underway for FY 2015 and Beyond:

- Continue to negotiate agreements with state Departments of Correction (DOC) to exchange information.
- Collaborate with the Departments of Corrections (DOC) that have signed agreements to establish Safeguard Security Reports (SSR) to ensure data security and exchange data on inmates who file false refunds through the DOCs so that they can use it to bring administrative fraud or similar charges against inmates.
- Develop additional models and filters to identify business filings claiming fraudulent Notice to Shareholder for Long Term Capital Gains and withholding claims that are either unsubstantiated or supported by fake or fraudulent information documents.
- Analyze additional business filings for other types of fraudulent refundable credits, such as the Accelerated Research Credit.
- Complete the Security Cost Basis Pilot selecting TY 2013 security cases with Schedule D and cost basis.
- Improve the selection of Merchant Card Cases for TY 2013 and future years using the results from TY 2011 and TY 2012 Merchant Card cases.
- Implement a strategic communication plan to provide information to taxpayers and partners about the Individual Shared Responsibility Payment and the Premium Tax Credit.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

3. TAX COMPLIANCE INITIATIVES

Summary of Major Issues: Improve compliance and fairness in the application of the tax laws.

Businesses and Individuals

Actions Taken:

- Provided Virtual Small Business Tax Workshops (VSBTW) to organizations that represent small business owners for use in direct and leveraged outreach that explained key tax elements in starting and maintaining a compliant small business.
- Established partnerships with over 150 new small business industry organizations to increase business owner compliance and to encourage owners to educate employees to bring them into compliance.
- Completed translation of the VSBTW into Spanish and Chinese to broaden outreach to emerging customers.
- Developed a preparer strategy to identify preparers that file egregious ITIN returns including preparer Client Analysis Referrals based on an evaluation of prior client examinations.
 - Selected approximately 5,700 referrals for examination.
 - Closed 3,615 preparer cases with a 2.2% no change rate.
- Added new screening criteria when it was discovered that ITIN filers were filing amended returns to increase dependents and claiming additional Child Tax Credits.
 - Selected 1,862 cases for examination, and closed 1,533 with a disallowance rate of 98% on cases closed.

Actions Planned or Underway for FY 2015 and Beyond:

- Expand efforts to reach emerging small business segments, stressing the use of technology and partnerships at the national and local level to reach stakeholders.
- Develop a preparer compliance strategy to enhance compliance activity by using historical data to determine the best approach in dealing with ITIN preparers who appear to file non-compliant tax returns.
- Explore the development of performance measures for the Delinquent Return Refund Hold Program, with implementation dependent on the availability of resources and the usefulness of the measures as a predictive tool in determining the effectiveness of the program.

Tax-Exempt Entities

Actions Taken:

- Identified three gaps within the Exempt Organizations, Examination program and completed 29 of the 45 action plan items to address the gaps:
 - Lack of formal procedures for ordering batches of cases for examination projects.
 - Staff who classified delinquent returns could potentially examine the cases they classified.
 - Examiners who conducted a compliance check could potentially also be assigned to classify the return when received.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

- Initiated the Unrelated Business Income (UBI) compliance project, examined a statistical sample of 100 exempt organizations; closed 54 examinations, which included 163 returns, and identified and analyzed the results for trends.
- Included the definition of "primary activity" in the joint 2013-2014 priority guidance plan with Treasury and released a Notice of Proposed Rulemaking (NPRM) that provided guidance to tax-exempt social welfare organizations on political activities that will not be considered to promote social welfare.
- Collaborated with the National Taxpayer Advocate (NTA) to develop, publish, and post new guidance for stakeholders and customers:
 - Developed new guidance on foster care payments, which now excludes qualified foster care payments from the gross income of a foster care provider.
 - Published Revenue Procedure (Rev. Proc.) 2014-11, which outlines procedures for taxpayers seeking reinstatement after automatic revocation for failure to file required annual returns or notices for three consecutive years.
 - Posted Notice 2014-7 to the IRS website to notify customers that qualified Medicaid waiver payments to care providers who are related or unrelated to the eligible individual are excludable from gross income.
- Completed two pilots to streamline the determination application case process by applying the Lean Six Sigma (LSS) methodology. All Exempt Organization determination agents were trained on the LSS methodology and streamlined processing was implemented on all determination cases.
- Updated IRS.gov and an educational site, StayExempt.IRS.gov, to include newly issued Form 1023-EZ, *Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*. The new application and an announcement about the release were issued to stakeholders.
- Initiated a review of the employee plans determination letter process using the Lean Six Sigma (LSS) method that identifies inefficiencies in case processing as well as other needed improvements to the overall program to alleviate the current backlog, reduce processing times, and reduce the possibility of unpredictable surges in application receipts. The review resulted in:
 - Conducting an opportunity assessment which identified over 100 potential improvement opportunities.
 - Forming two employee-led project teams to pursue the improvement opportunities identified during the opportunity assessment.
 - Developing a process solution to reduce case processing time by at least 50% over historical averages.
 - Developing a program guidance solution to limit applications to plans with the greatest compliance risk.
- Completed risk assessments, stakeholder analyses, and other LSS project tools to evaluate and prioritize improvement opportunities for the determination letter process for employee retirement plans. The result was the development and implementation of a pilot to reduce bottlenecks and improve processing efficiencies to reduce case processing time.
- Developed a training course, *Identification of Possible Political Campaign Intervention Activity*, including official training materials and breakout interactions among participants, which included:
 - Guidance for specialists on how to process requests for tax-exempt status involving potentially significant political campaign intervention.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

- Guidance to offer optional, expedited processing for section 501(c)(4) organizations whose applications indicated that the organizations may be involved in political campaign intervention or in providing private benefit to a political party.
- Guidance on processing applications of section 501(c)(3) organizations whose applications indicated that they may be involved in political campaign intervention.
- Reduced the inventory of section 501(c)(4) applications, including the group of 145 cases in the "priority backlog," of which 134 cases, or 92%, have been closed. Of those closed, 102 cases were approved and 43 organizations took advantage of the optional, expedited processing.
- Completed 92% of the 330 examinations of retirement plans detected through an advanced data mining application which compared past audit analytics to current return information in the Risk Modeling II project.

Actions Planned or Underway for FY 2015 and Beyond:

- Complete the remaining action plan items to address gaps in the Exempt Organizations (EO) Examination program by documenting processes related to the development of EO examinations' project cases, work plan, and the identification and process of working emerging issues.
- Analyze examination results in the Risk Modeling II project of Employee Plans to determine the effectiveness of the selection methodology once examinations are complete.
- Initiate a pre- and post-determination compliance process that will select a statistically valid sample of Form 1023-EZ filings for review to mitigate potential compliance risks created by the new form.
- Implement recommendations developed through a Lean Six Sigma (LSS) review of Employee Plans Determinations processing.
- Initiate a LSS review of the process for calculating and administering the Direct Pay Bonds (DPB) payment program.
- Implement a knowledge management strategy to further employee development through sharing and transferring skills, to enhance collaboration, and to ensure correct and consistent positions are in use.
- Implement a data and information strategy resulting from recommendations received from the TE/GE data strategy team to improve risk identification, program management, resource allocation, and service delivery.

Tax Return Preparers

Actions Taken:

- Assessed the effectiveness of three different types of preparer-level treatments for 3,750 Schedule C preparers with car and truck expenses. The treatments moved preparer behavior in a positive direction and resulted in a measurable difference in prepared client returns and consisted of:
 - An educational visit to the preparer to discuss issues found on returns.
 - A letter reminding the preparer of their due diligence requirements when preparing returns and warning that they and their clients might be subject to audit.
 - A letter with the same message regarding due diligence, and recommending continuing education regarding the specific issue.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

Actions Planned or Underway for FY 2015 and Beyond:

- Expand testing to learn which segments of the preparer population respond to soft touches and which require the more stringent treatment of a face-to-face visit.

4. MODERNIZATION

Summary of Major Issues: Improve taxpayer service and efficiency of operations

Actions Taken:

- Integrated testing of the Customer Account Data Engine 2 (CADE 2) Database Implementation into the Annual Filing Season test, successfully integrating CADE 2 into filing season operations. Successes included:
 - Initializing the CADE 2 database into production during the first two weeks of January for Filing Season 2014, balancing without discrepancy.
 - Beginning daily update processing in production two weeks ahead of schedule.
 - Validating system performance and data quality against the Individual Master File throughout the filing season.
- Distributed data to 16 systems from the CADE 2 database, which allowed more than 50,000 IRS customer service representatives and business users to view taxpayer account data on the new CADE 2 database.
- Completed all close out activities for CADE 2 Transition State 1.5 and officially closed action after it demonstrated sustainable system performance, data assurance maturity, and operational and organizational readiness.
- Completed the implementation of two incremental CADE 2 Transition State 2, Penalty & Interest (P&I) Common Code base releases to eliminate the differences in programming platforms that caused inconsistent balance due amounts issued on taxpayer notices. The application now calculates, with more consistency, the penalty and interest on individual and business accounts by the due date.
- Enhanced the Affordable Care Act eAuthentication capabilities to provide multiple levels of assurance and flexibility for the non-tax filing requirement and Spanish-speaking population.
- Provided standards for a benchmarking data center performance and purchased and installed equipment at the Martinsburg and Memphis Computing Centers.
- Developed a timeline to support the Detroit Computing Center's infrastructure and equipment relocation plan.
- Updated the CADE2 data validation plan to reflect the frequency and process of manually validating data not fed to downstream systems.

Actions Planned or Underway for FY 2015 and Beyond:

- Re-write core tax processing applications using modern programming languages and tools to better accommodate changes in tax laws and more fully populate the new database so that downstream applications can access data on the CADE 2 database and it becomes the authoritative data source for all individual taxpayers' accounts.
- Incorporate ACA requirements into the eAuthentication Release 3.
- Provide the capability to handle business entities for e-authorization.
- Continue to implement benchmarking performance standards within the Martinsburg and Memphis Computing Centers.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

- Complete migration of systems out of the Detroit Computing Center and implement a data backup infrastructure at the gaining sites to ensure capacity is allocated for the Detroit systems.

5. FRAUDULENT CLAIMS AND IMPROPER PAYMENTS

Summary of Major Issues: Effective use of taxpayer funds

Refundable Credits

Actions Taken:

- Analyzed the 2013 Automated Questionable Credit (AQC) case results which showed that cases with multiple issues were being pulled into the filtered case selection. These types of cases are accounts where the refundable and non-refundable portions of the American Opportunity Tax Credit (AOTC) are in question. Multiple issue cases change the tax, the non-refundable credit, the refundable portion of the credit and other refundable and non-refundable credits, such as Child tax credit and Additional Child Tax Credit. Results were:
 - Updated the AOTC non-compliant filters to include cases where only the refundable portion of the credit is in question.
 - Implemented a process to run all AOTC non-compliant filter selections against current year Information Return Processing data to identify Forms 1098T, *Tuition Statement*, which had been filed by accredited higher education institutions, which resulted in returns with valid AOTC credits refunds being released without delay.
 - Revised the referral process for fraud returns without a refundable credit claimed.
- Sent 1,000 education notices to high risk preparers who prepared AOTC claims in error.
- Increased the AOTC cases worked in the Automated Underreporter Program, for returns without an associated Form 1098-T, *Tuition Statement*, by 18,000 cases (82,000 in FY 2013 to 100,000 in FY 2014).
- Built upon a successful FY 2013 EITC Return Preparer Strategy in its FY 2014 strategy to address paid preparers' due diligence in preparing EITC returns. For FY 2014, new treatments tested to determine optimal effectiveness included expanded phone calls, updated and expanded letters addressing specific areas of EITC noncompliance, and compliance emails.
 - Conducted Pre-filing season activities including 431 due diligence audits completed with an 84% penalty rate and over \$22 million in proposed due diligence penalties, 96 Knock and Talk educational visits, 16,832 letters sent, 490 phone calls made on undeliverable mail, 19,571 post-refund client audits started, and 207 emails.
 - Conducted filing season activities including 296 real-time due diligence audits completed with an 81% penalty rate and over \$3.5 million in proposed due diligence penalties, 21 Knock and Talk Visit follow-up due diligence audits completed with a 75% penalty rate, almost 13,000 pre-refund client audits started, 2,006 outbound calls completed, and 2,272 follow up letters mailed.
 - The FY 2014 EITC Return Preparer Strategy protected over \$550 million, including revenue generated and reduction in improper claims (including EITC and Child Tax Credit) and had a total program value of over \$1.9 billion over its first three years of operation.
- Sent 6,667 letters (Warning to EITC Return Preparers – Missing Form 8867) and 1,642 e-file alerts to preparers who submitted one or more TY 2013 returns claiming EITC without the required Form 8867 attached.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

Actions Planned or Underway for FY 2015 and Beyond:

- Conduct further analytics to evaluate persistence over time in preparer due diligence improvement from various treatments in its EITC Preparer Strategy that addresses paid preparer's influence on EITC improper payments.
- Conduct further analysis of the National Research Program data on EITC to determine any new insights on improper payments.
- Report annually on new supplemental measures that capture key compliance efforts that address EITC improper payments.
- Develop operational metrics for Premium Tax Credits for Filing Season 2015. These metrics will help assess risk level and allow us to complete the risk scoring model for the credit as required by the Improper Payments Elimination and Recovery Act (IPERA).

Fraudulent Payments

Actions Taken:

- Implemented a pilot process to reduce labor intensive research and created coding requirements for false information documents.
 - Mailed 1,097 letters to the home address of the individuals listed as business owners of suspected fabricated entities; 21 percent responded and 15 percent were undeliverable.
 - Communicated new requirements and established an internal Entity Fabrication SharePoint Site to facilitate information sharing.
- Utilized a variety of research tools and processes to analyze and mark Employer Identification Numbers (EINs) selected by filters, such as:
 - Used markers to update the Electronic Fraud Detection System and protect refunds on returns using false information documents.
 - Marked information documents submitted by Fabricated Entities as fraudulent and fabricated EINs that were sent to Verification were marked as false to stop refunds.
- Completed Phase 1 of the Entity Fabrication (EF) Pilot.
 - Analyzed Master File data and developed filters for detection of employers that have a high likelihood of being a fabricated entity. Entity fabrication occurs when Employee Identification Numbers are acquired for the purpose of submitting falsified W-2s to the Social Security Administration and filing fraudulent tax returns with the intent of receiving unwarranted refunds.
 - Identified entities that will have their mode of contact updated to "suspicious" in the Electronic Fraud Detection System; all income documents issued by the entity will be marked as fraudulent on Information Returns.
 - Developed and submitted legislative proposals for supplemental authority that would provide for correctable error authority, similar to math error authority, in situations when information provided by taxpayers does not match the information contained in government databases. The IRS also requested acceleration of the filing dates of information returns to make the information available to the IRS earlier.

Actions Planned or Underway for FY 2015 and Beyond:

- Assess pilot results on the process to reduce labor intensive research and make changes as appropriate.
- Develop a method for sharing falsified information documents with the Social Security Administration.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

- Determine if the Mode of Contact (MOC) to contact the employer to verify the wages and withholding of employees can be updated systemically instead of manually.
- Modify filters based on research and responses from the Entity Fabrication Pilot and streamline the process by issuing letters systemically instead of manually.

Contract and Other Payments

Actions Taken:

- Completed phases one and two of the Treasury-wide Workforce Planning Pilot which included establishing strategic direction and conducting risk assessments of the Acquisition/Contract Specialist workforce.
- Required that all contract specialists and Federal Acquisition Certification for Contracting Officer's Representatives (FAC-COR) certified employees enter training and certification data in the Federal Acquisition Institute Training Application System (FAITAS) to enable more accurate data collection on employee certifications.
- Ensured all contract specialists and FAC-CORs take mandatory continuous learning requirements to address competency and skills gaps, as prescribed by the Department of the Treasury Acquisition Career Management Handbook.
- Implemented a quality review process, which requires all IRS contract specialists and non-contract specialist warrant holders be verified quarterly.

Actions Planned or Underway for FY 2015 and Beyond:

- Complete phases three and four of the Treasury Workforce Planning Pilot which instructs Acquisition/Contract Specialists to:
 - Conduct an ongoing analysis of the workforce to describe its current state.
 - Project the human resources needed to achieve the agency's program performance goals and objectives.
 - Identify potential shortfalls.
 - Create, monitor, and measure an action plan.

6. PROVIDING QUALITY TAXPAYER SERVICE OPERATIONS

Summary of Major Issues: Improve taxpayer service

Actions Taken:

- Implemented several initiatives for the 2014 filing season that leveraged automated self-service applications available to taxpayers through IRS.gov. These applications gave taxpayers the ability to use online options for needs such as obtaining transcripts, determining the status of their refunds, and researching tax questions.
- Implemented Virtual Service Delivery (VSD) technology as a permanent part of campus operations:
 - Installed VSD equipment in many campus operations locations and in taxpayer-facing IRS locations across the United States.
 - Developed Interim VSD technology guidance.
 - Developed training materials and trained employees on the use of VSD technology.
 - Held six virtual Appeals' hearings with taxpayers represented by Low Income Tax Clinics.
- Leveraged partners to provide taxpayers expanded access via alternative filing methods.
 - Conducted a train-the-trainer class for call center managers who participated in the United Way Worldwide MyFree Taxes Helpline.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

- Increased MyFreeTaxes toll-free assistor locations from five in 2013 to seven in 2014.
- Conducted refresher training for IRS tax consultants on the utilization and set up of Virtual Volunteer Income Tax Assistance (VITA).
- Surveyed more than 1,600 Facilitated Self Assistance (FSA) and more than 200 Virtual VITA taxpayers on their experience with using these alternative filing methods.
 - Of the more than 1,600 FSA respondents, 92% were satisfied with their experience, 87% were confident in the accuracy of their return, and 98% are willing to use FSA in the future.
 - Of the more than 200 Virtual VITA respondents, 97% of Virtual VITA clients were satisfied with their experience, 93% were confident in the accuracy of their return and 96% are willing to use Virtual VITA in the future.
- Prepared more than 169,000 returns using the FSA model which is a 106% increase over FY 2013.
- Prepared more than 17,000 returns using the Virtual VITA model.
- Leveraged the Department of Education to send 4.9 million e-mails to Free Application for Federal Student Aid parents and students that qualified for free tax return preparation services through VITA, also marketing FSA and Virtual VITA.
- Expanded the number of VSD sites from 34 locations in FY 2013 to 39 locations in FY 2014 by repurposing five support sites to taxpayer facing sites which reduced the number of TACs providing face-to-face assistor support from 38 TACs in 2013 to 33 TACs in 2014.
- Increased taxpayer VSD contacts by 7.5% (over 22,000 in FY 2013 vs. nearly 24,000 in FY 2014).

Actions Planned or Underway for FY 2015 and Beyond:

- Conduct outreach efforts to market the availability of Virtual Service Delivery technology in the nine taxpayer-facing locations and the benefits of its use by taxpayers and/or representatives.
- Leverage partner resources to prepare Amended and Prior Year returns by using Virtual VITA for directing taxpayers to sites offering year round tax return preparation.
- Analyze options to expand VSD to taxpayer-facing and support site locations.

7. HUMAN CAPITAL

Summary of Major Issues: Enable the IRS to achieve its mission

Actions Taken:

- Developed and completed servicewide training for executives, managers, and employees to support the Back to Basics training and incorporated the training in the IRS core values portion of the onboarding process, as well as the annual ethics briefings.

Actions Planned or Underway for FY 2015 and Beyond:

- Realign the compliance operations within the Small Business/Self-Employed and Wage & Investment divisions with the intent of reducing redundancies, improving taxpayer services and better identifying emerging compliance issues. As part of the work on the concept of operations for the new Collection organization, the Automated Collection System (ACS) program will be reviewed to determine whether the Collection responsibilities and authorities currently assigned to ACS employees need to be enhanced.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

- Develop, publish, and issue an Employee Recognition Handbook.

8. GLOBALIZATION

Summary of Major Issues: Increase the outreach efforts to foreign governments on cross-border transactions

Actions Taken:

- Conducted a feasibility study on embedding IRS investigative analysts at the Department of the Treasury's Office of Terrorist Financing and Financial Crimes (TFFC) and determined to assign IRS Tax Law Specialists to another U.S. Government working group dedicated to identifying terrorist financing.
- Presented a counterterrorism program and current IRS initiatives to the Department of the Treasury's Working Group on Terrorist Financing (TFWG), which resulted in the TFWG committing to implement a government-wide strategic plan to identify, investigate, sanction, and/or prosecute 501(c) tax exempt entities that are knowingly facilitating the financing of terrorist activity.
- Collaborated with the Department of Treasury's working group on Terrorist Financing (TFWG), and the Canada Revenue Agency to discuss Canada's process for detecting, examining, sanctioning and/or revoking the tax exempt status of Canadian non-profit organizations suspected of illicit terrorist financing.
- Enhanced the case management system by creating and implementing special purpose codes to facilitate the identification of new and existing investigations that meet the definition of third-party money launderers.
- Initiated ten criminal investigations with a third-party money laundering component.
- Conducted meetings with Homeland Security to combine efforts in identifying new money laundering schemes and cases.
- Deployed the Foreign Account Tax Compliance Act (FATCA) Foreign Financial Registration website for both internal and external stakeholder access, resulting in over 103,000 financial institutions around the world registering and receiving a Global Intermediary Identification Number (GIIN).
- Conducted FATCA data safeguarding reviews of Model 1A IGA (Intergovernmental Agreement) countries to ensure that appropriate safeguards and infrastructure are in place and an appropriate culture of care exists to maintain confidentiality of exchanged information.
- Developed a data safeguards workbook for completion by both the U.S. and FATCA partner jurisdictions prior to the reciprocal exchange of information. Forty-three countries have completed the workbook and 26 safeguard reviews have been conducted.
- Initiated the International Compliance Management Model (ICMM) Integrated Project and completed high-level business requirements for the first deployment of ICMM, which focused on receipt, processing, validation, management and storage of incoming FATCA data, and creation of notifications to send to the filer.

Actions Planned or Underway for FY 2015 and Beyond:

- Establish an initiative throughout the IRS to further improve the Fraud Referral Program and examinations of 501(c) entities to identify terrorism financing schemes and to refer to criminal investigations.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

- Create reports using the new case management coding system on third-party money laundering cases that can be provided to the Treasury Executive Office of Asset Forfeiture in order to help identify case methodologies.
- Develop a formal International Collection training plan that uses cross functional subject matter experts to develop and teach international specific courses.
- Explore ideas with Homeland Security on developing projects to target money laundering.
- Add additional capability to the Foreign Account Tax Compliance Act (FATCA) registration website.
- Revise the Form 1099-S, *Proceeds From Real Estate Transactions*, to include information that is necessary to identify transactions subject to the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) along with the pertinent buyer identifying information that would allow the IRS to effectively enforce compliance with the current law.
- Deploy additional International Compliance Management Model (ICMM) functionality to fully process and manage data and provide back end reporting capabilities, and gather business requirements for ICMM Release 2 for preparation of outgoing files for reciprocal exchange.
- Conduct International Data Exchange Service (IDES) testing with foreign partners to enable them to complete work on their own projects to conduct FATCA third-party reporting, and reciprocal exchanges in conjunction with the ICMM project.
- Deploy Release 2 of the FATCA registration to provide the financial institution (FI) sponsoring entity the ability to add all their sponsored entities and their FI type.
- Deploy Release 3 of the FATCA registration that will add the Qualified Intermediary application and supporting documents and the Financial Institution certification process.

9. TAXPAYER PROTECTION AND RIGHTS

Summary of Major Issues: Apply the tax laws fairly

Actions Taken:

- Engaged federal and state agencies to exchange data through the Criminal Investigation Memorandum of Understanding (MOU) that implemented aggressive actions to address identity theft and refund fraud. Secured 23 CI MOUs that established reciprocal information sharing opportunities and cooperative compliance efforts between the IRS and states.
- Created a data exchange MOU with the Federal Bureau of Prisons to allow for disclosures of returns and return information to states' Departments of Correction and the Federal Bureau of Prisons for fraudulent returns filed by inmates.
- Piloted the State Suspicious Filers Group to share fraudulent refund information that resulted in eight states submitting over 5,000 suspicious filers. Stopped fraudulent refunds of over \$3.3 million associated with these referrals.
- Established effective processes to handle the large volume of complaints made against paid tax preparers. Through increased staffing, enhanced processes, including using a centralized database to manage complaints, written guidance, and trained Return Preparer Office employees, the inventory backlog was reduced significantly.

Actions Planned or Underway for FY 2015 and Beyond:

- Update IRM 1.5.3, *Manager's Self-Certification and the Independent Review Process*, to instruct Section 1204 managers to review and update employees' HR Connect profiles as part of the Quarterly Certification process; Guidance is currently being provided to the Section 1204 program managers as part of the quarterly certification process until the IRM updates are published.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

- Collaborate with Federal, state and local agencies on best practices for authentication and identity protection.
- Expand participation by the state departments of corrections to deter inmate tax fraud by signing agreements to exchange information.

10. ACHIEVING PROGRAM EFFICIENCIES AND COST SAVINGS

Summary of Major Issues: Use resources to focus on producing the best value for stakeholders

Actions Taken:

- Implemented procedures to improve tracking and reconciliation of Form NA-13001, *Notice of Eligibility for Disposal*, issued to the Area Records Managers (ARMs) for records with upcoming disposal dates.
- Collaborated with all enforcement divisions to identify and update 13 cost-based performance measures for enforcement activities, such as the marginal cost per enforcement program and cost per full-time equivalent (FTE) for correspondence and field examination.
 - Updated the Notice performance measure to incorporate direct costs and revenues for four categories of balance due notices, and conducted a cost analysis on the FTE associated with the Notices, which resulted in arriving at the cost per notice.
 - Developed a methodology to allocate notices costs to the various sources of assessment.
- Completed the development of the cost of collection processes by activity and developed baseline measures.
- Provided the average (cost by series, grade and year) of employees handling cases in the examination and appeals stages for the marginal revenue/cost model.
- Provided the average cost of collection activities (notice, ACS, field Collection, etc.), that was applied to any audit that went through one of those activities.
- Provided IRS-wide access to cost/benefit analyses by publishing cost-based performance measures reports on the CFO IRWeb.
- Established and provided the structure and foundational elements necessary for an effective Enterprise Risk Management (ERM) program.
- Completed a review of 355 examination programs and compliance initiative projects and found that the IRS maintains sound internal controls throughout its examination programs. The risk of partiality in the programs was very low based on the documentary evidence of business rules, procedures, criteria, and internal controls reviewed.
- Created an Access Database to house original and corrected prisoner files from the states, which made correcting the files and reviewing them much easier and faster than in past years.
- Used new software capabilities to research missing prisoner information to ensure the accuracy of prisoner social security number (SSN) records for the 2013 and 2014 prisoner file. The result was identifying approximately 25,000 missing SSNs.
- Formed a team to develop a Servicewide strategy for increasing the volume of electronic returns filed by business taxpayers.

Actions Planned or Underway for FY 2015 and Beyond:

- Ensure established procedures, or approved alternative procedures, are followed when certifying invoiced record storage charges for payment.

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

- Develop an enterprise-wide repeatable method to manage and track the deployment of licenses that can be uniformly used by all organizational entities responsible for managing licenses.
- Expand availability and use of decision-making information, including information on at least one new area, in particular Return on Investment (ROI) data, to ensure IRS is spending its resources where it will get the maximum return.
- Expand the use of timekeeping data in cost analysis and oversee cost accounting and performance metrics for all IRS programs.
- Develop a project plan that will define the key deliverables for using timekeeping data.
- Educate IRS personnel on how the timekeeping data could be used to identify programs and activities.
- Complete the revenue/cost model for the non-filer and Earned Income Tax Credit (EITC) programs.
- Provide additional training and communications for continued deployment of the Enterprise Risk Management program and support integration of risk management practices into day-to-day operational activities.
- Enhance and roll out the Return Review Program (RRP) system to facilitate faster and more accurate data exchanges with our state and federal prison partners and internal users.
- Develop a Technology Road Map to use the Social Security Administration's Prisoner Update Processing System Data to improve IRS prisoner data.
- Developing a communications outreach plan to promote e-filing for business returns during the 2015 Filing Season.

FINANCIAL HIGHLIGHTS

Revenue and Refund Trend Information

FY 2014 revenue receipts collected by IRS increased to \$3.1 trillion from \$2.9 trillion in FY 2013. Federal tax revenues are collected through six major classifications: individual income and FICA/SECA, corporate income, excise taxes, estate and gift taxes, railroad retirement, and federal unemployment taxes.

FY 2014 tax refund and outlays activity totaled \$374 billion, representing an increase of almost 3% from FY 2013. Federal tax refunds include refunds of tax overpayments, payments for interest, and disbursements for refundable tax credits such as Earned Income Tax Credit and the Additional Child Tax Credit.

Excise Tax Trust Fund

The Quarterly Federal Excise Tax Return, Form 720, reports taxpayer liability for excise taxes. Taxpayers make periodic deposits in advance of filing the return. These deposits are classified as Federal Excise Tax. After the IRS receives and processes the returns, the IRS certifies amounts for several trust

	Liability Quarter Ended	
	December 2011 – September 2012	December 2012 – September 2013
Airport & Airway Trust Fund	\$12,524,925,643	\$12,867,499,487
Black Lung Disability Trust Fund	\$588,614,775	\$570,661,246
Highway Trust Fund	\$38,478,876,037	\$38,340,971,476
Total	\$51,592,416,455	\$51,779,132,209

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

funds. Amounts reported on the Statement of Custodial Activity are for fiscal year collections (October 1 through September 30). Because Form 720 reporting requirements are completed after receipt of most of the deposits, the certification amounts will not match the amounts collected in the fiscal year. The table shows revised receipts certified to the Airport and Airway Trust Fund, Black Lung Disability Trust Fund, and the Highway Trust Fund for the eight liability quarters from December 2011 through September 2013. The Department of the Treasury prepares the warrants and allocations to the trust funds.

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

The unpaid assessment balance includes amounts owed by taxpayers who file returns without sufficient payment as well as amounts assessed through the IRS enforcement programs. As reflected in the supplemental information to the IRS FY 2014 Financial Statements, the unpaid assessment balance was \$380 billion as of September 30, 2014, and \$205 billion (54%) of this balance consists of interest and penalties. Furthermore, the total outstanding balance of IRS unpaid assessments is largely uncollectible because it is composed mostly of compliance assessments and write-offs. Under federal accounting standards, unpaid assessments require taxpayer or court agreement to be considered federal taxes receivable. Assessments not agreed to by taxpayers or the courts are considered compliance assessments and are not considered federal taxes receivable. Assessments considered to have no future collection potential are called write-offs. The following provides detail on unpaid assessments:

- Taxes receivable represent \$156 billion (41%) of unpaid assessments and decreased \$3 billion (2%) from \$159 billion as of September 30, 2014. About \$116 billion (74%) of this balance is estimated to be uncollectible due primarily because of the economic situations of the taxpayers. Except generally for bankruptcy situations, the IRS may continue collection actions for 10 years after the assessment. About \$40 billion (26%) of taxes receivable is estimated to be collectible.
- Compliance assessments of \$86 billion represent amounts that have not been agreed to by either the taxpayer or a court. These assessments result primarily from various IRS enforcement programs promoting voluntary compliance.
- Write-off amounts of \$138 billion include amounts owed by defunct corporations with no assets and failed financial institutions. The remaining amounts are owed by taxpayers with extreme economic and/or financial hardships, deceased taxpayers, and taxpayers who are insolvent due to bankruptcy.

The Integrated Financial System (IFS)

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

In addition, IFS provides the core processes of General Ledger, Accounts Payable, Accounts Receivable, Budget Execution, Cost Accounting, Administrative Tax and Travel Accounting, Cost Allocations, some tax processing functionality for Health Coverage Tax Credit (HCTC) payments, Budget Formulation, Labor Forecasting and Budget Execution decision support.

INTERNAL REVENUE SERVICE
 Management's Discussion & Analysis
 Fiscal Year 2014

Appendix A

Performance Measures Descriptions

Strategic Foundation: Invest in our workforce and the foundational capabilities necessary to achieve our mission and deliver high performance for taxpayers and stakeholders	
Percent of BSM Projects within +/- 10% Cost Variance	The percentage of BSM projects that are within the +/-10% threshold for cost. The cost variance is measured from the initial cost estimate versus current cost estimate.
Percent of BSM Projects within +/- 10% Schedule Variance	The percentage of BSM projects that are within the +/-10% threshold for schedule. The schedule variance is measured from the initial schedule estimate to the current schedule estimate.
Goal 1: Deliver high quality and timely service to reduce taxpayer burden and encourage voluntary compliance	
Customer Service Representative (CSR) Level of Service	The number of toll free callers that either speak to a Customer Service Representative or receive informational messages divided by the total number of attempted calls.
Customer Contacts Resolved per Staff Year	The number of Customer Contacts resolved in relation to staff years expended.
Customer Accuracy – Tax Law Phones	The percentage of correct answers given by a live assistor on Toll-free tax law inquiries.
Customer Accuracy – Customer Accounts (Phones)	The percentage of correct answers given by a live assistor on Toll-free account inquiries.
Timeliness of Critical Individual Filing Season Tax Products to the Public	The percentage of critical individual filing season tax products (tax forms, schedules, instructions, publications, tax packages, and certain notices required by a large number of filers to prepare a complete and accurate tax return) available to the public in a timely fashion.
Timeliness of Critical TE/GE & Business Tax Products to the Public	Percentage of critical other tax products, paper and electronic, available to the public in a timely fashion.
Percent Individual Returns Processed Electronically	The percentage of electronically filed individual tax returns divided by the total individual returns filed.
Percent Business Returns Processed Electronically	The percentage of electronically filed business tax returns divided by the total business returns filed.
Refund Timeliness – Individual (Paper)	The percentage of refunds resulting from processing Individual Master File paper returns issued within 40 days or less.
Taxpayer Self Assistance Rate	The percentage of taxpayer assistance requests resolved using self-assisted automated services.
Goal 2: Effectively enforce the law to ensure compliance with tax responsibilities and combat fraud	
Examination Coverage – Individual (1040)	The sum of all individual 1040 returns closed by Small Business/Self Employed (SB/SE), Wage & Investment (W&I), Tax Exempt and Government Entities (TE/GE), and Large Business and International (LB&I) (Field Exam and Correspondence Exam programs) divided by the total individual return filings for the prior calendar year.
Field Exam Nat'l Quality Review Score	The score awarded to a reviewed field examination case by a Quality Reviewer using the National Quality Review System (NQRS) quality attributes.
Office Exam Nat'l Quality Review Score	The score awarded to a reviewed office examination case by a Quality Reviewer using the NQRS quality attributes.
Examination Quality – Large Business	Average of the scores of the Large Business Return (LBR) cases reviewed by LB&I Quality Measurement System (LQMS). Case scores are based on the percentage of elements passed within each of the four auditing standard.

INTERNAL REVENUE SERVICE
 Management's Discussion & Analysis
 Fiscal Year 2014

Appendix A

Performance Measures Descriptions (Continued)

Goal 2: Effectively enforce the law to ensure compliance with tax responsibilities and combat fraud (Continued)	
Examination Coverage – Business Assets >\$10 Million	The number of LB&I returns (C and S Corporations with assets over \$10 million and all partnerships) examined and closed by LB&I during the current fiscal year divided by the number of filings for the preceding calendar year.
Examination Efficiency – Individual (1040)	The sum of all individual 1040 returns closed by SB/SE, W&I, TE/GE, and LB&I (Field Exam and Correspondence Exam programs) divided by the total Full-Time Equivalent (FTE) expended in relation to those individual returns.
Automated Underreporter (AUR) Efficiency	The total number of W&I and SB/SE contact closures (a closure resulting from a case where IRS made contact) divided by the total FTE, including overtime.
Automated Underreporter (AUR) Coverage	A percentage representing the total number of W&I and SB/SE contact closures (a closure resulting from a case where SBSE and W&I made contact) divided by the total return filings for the prior year.
Collection Coverage – Units	The volume of collection work disposed compared to the volume of collection work available.
Collection Efficiency – Units	The volume of collection work disposed divided by total collection FTE.
Field Collection Nat'l Quality Review Score	The score awarded to a reviewed collection case by a Quality Reviewer using the NQRS quality attributes.
Automated Collection System (ACS) Accuracy	The percent of taxpayers who receive the correct answer to their ACS question.
Criminal Investigations Completed	The total number of subject criminal investigations completed during the fiscal year, including those that resulted in prosecution recommendations to the Department of Justice as well as those discontinued due to a lack of prosecution potential.
Number of Convictions	The number of criminal convictions.
Conviction Rate	The percent of adjudicated criminal cases that result in convictions.
Conviction Efficiency Rate (\$)	The cost of Criminal Investigation's (CI) program divided by the number of convictions.
TE/GE Determination Case Closures	The number of cases closed in the Employee Plans or Exempt Organizations Determination programs, regardless of type of case or type of closing.

Management's Discussion and Analysis

INTERNAL REVENUE SERVICE
Management's Discussion & Analysis
Fiscal Year 2014

Appendix B

Performance Measurement Data

	2011	2012	2013	2014	
				Target	Actual
Strategic Foundation: Invest in our workforce and the foundational capabilities necessary to achieve our mission and deliver high performance for taxpayers and stakeholders					
Percent of BSM Projects within +/- 10% Cost Variance ¹	71.4%	50.0%	0%	90.0%	66.7%
Percent of BSM Projects within +/- 10% Schedule Variance ¹	100.0%	90.0%	83.3%	90%	100.0%
Goal 1: Deliver high quality and timely service to reduce taxpayer burden and encourage voluntary compliance					
Customer Service Representative (CSR) Level of Service ²	70.1%	67.6%	60.5%	61.0%	64.4%
Customer Contacts Resolved per Staff Year	12,419	16,320	20,767	22,750	21,018
Customer Accuracy – Tax Law Phones	93.4%	93.2%	95.7%	93.0%	95.0%
Customer Accuracy – Customer Accounts (Phones)	96.0%	95.6%	96.0%	95.0%	96.2%
Timeliness of Critical Filing Season Tax Products to the Public	96.3%	97.2%	58.9%	95.0%	99.1%
Timeliness of Critical TE/GE and Business Tax Products to the Public	96.4%	94.5%	83.6%	95.0%	98.7%
Percent Individual Returns Processed Electronically	76.9%	80.5%	82.5%	84.1%	84.1%
Percent Business Returns Processed Electronically	31.8%	36.7%	40.2%	44.7%	43.1%
Refund Timeliness – Individual (Paper)	99.4%	99.7%	99.0%	97.0%	98.7%
Taxpayer Self Assistance Rate	70.1%	78.5%	83.3%	85.0%	84.7%
Goal 2: Effectively enforce the law to ensure compliance with tax responsibilities and combat fraud					
Examination Coverage – Individual	1.1%	1.0%	1.0%	0.8%	0.9%
Field Examination National Quality Review Score	85.8%	87.4%	89.2%	89.6%	88.4%
Office Examination National Quality Review Score	90.4%	91.3%	90.3%	90.2%	90.6%
Examination Quality – Large Business ³			92.0%	90.0%	83.0%
Examination Coverage – Business (assets >\$10M)	6.2%	6.2%	5.6%	4.2%	4.3%
Examination Efficiency – Individual (1040)	139	142	142	133	138
Automated Underreporter (AUR) Efficiency	2,007	2,041	2,025	1,931	1,935
Automated Underreporter (AUR) Coverage	3.3%	3.2%	2.8%	2.5%	2.6%
Collection Coverage – Units	50.0%	48.1%	47.0%	42.7%	45.9%
Collection Efficiency – Units	1,952	1,997	2,057	2,007	2,051
Field Collection National Quality Review Score	80.3%	80.4%	81.4%	81.0%	81.6%
Automated Collection System (ACS) Accuracy	94.9%	94.7%	94.4%	94.0%	95.2%
Criminal Investigations Completed	4,697	4,937	5,557	4,440	4,606
Number of Convictions	2,350	2,634	3,311	2,450	3,110
Conviction Rate	92.7%	93.0%	93.1%	92.0%	93.4%
Conviction Efficiency Rate (\$)	\$310,029	\$270,511	\$211,048	\$280,000	\$231,103
TE/GE Determination Case Closures	91,205	87,000	65,877	71,219	136,746

¹ Starting in FY 2015, the measure will include all major investments (BSM and non-BSM).

² Beginning in FY 2013, targets include an increase in base user fees. Does not reflect impact of the Opportunity, Growth and Security Initiative proposed in the FY 2015 President's Budget.

³ As a result of program changes that occurred in the Large Business and International (LB&I) organization, starting in FY 2013, a new Examination Quality - Large Business measure replaced the two previous LB&I quality measures; Examination Quality - Industry and Coordinated Industry.

Financial Statements

Principal Financial Statements

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

The IRS principal financial statements for fiscal years 2014 and 2013 are as follows:

- The **Balance Sheet** presents the assets, liabilities, and net position.
- The **Statement of Net Cost** presents the net cost of operations by program. It includes the gross costs less any exchange revenue earned from activities.
- The **Statement of Changes in Net Position** presents the change in net position resulting from the net cost of operations, budgetary financing sources other than exchange revenues, and other financing sources.
- The **Statement of Budgetary Resources** presents the budgetary resources; the status of those resources; the change in obligated balances during the year; and the budgetary authority and agency outlays. Additional detail by major budget accounts is available in the Required Supplementary Information section.
- The **Statement of Custodial Activity** presents the sources and disposition of non-exchange federal tax revenues collected and refunds disbursed.

Financial Statements

Internal Revenue Service
Balance Sheet
As of September 30, 2014 and 2013

(In Millions)

	2014	2013
Assets		
Intragovernmental		
Fund balance with Treasury (Note 2)	\$ 2,370	\$ 2,251
Due from Treasury (Note 6)	4,722	2,910
Other assets (Note 3)	26	33
Total intragovernmental	7,118	5,194
Cash and other monetary assets (Notes 4, 6)	392	491
Federal taxes receivable, net (Notes 5, 6)	40,000	35,000
General property and equipment, net (Note 7)	1,648	1,464
Other assets (Note 3)	16	16
Total assets	\$ 49,174	\$ 42,165
Liabilities		
Intragovernmental		
Due to Treasury (Note 5)	\$ 40,000	\$ 35,000
Other liabilities (Note 8)	168	160
Total intragovernmental	40,168	35,160
Federal tax refunds payable	4,722	2,910
Other liabilities (Note 8)	1,797	1,898
Total liabilities	46,687	39,968
Net position		
Unexpended appropriations	1,493	1,402
Cumulative results of operations	994	795
Total net position	2,487	2,197
Total liabilities and net position	\$ 49,174	\$ 42,165

The accompanying notes are an integral part of these statements.

Financial Statements

Internal Revenue Service
Statement of Net Cost
For the Years Ended September 30, 2014 and 2013

(In Millions)

	2014	2013
Program		
Taxpayer Assistance and Education		
Gross cost	\$ 608	\$ 607
Earned revenue	(2)	(1)
Net cost of program	<u>606</u>	<u>606</u>
Filing and Account Services		
Gross cost	3,828	3,829
Earned revenue	(95)	(113)
Net cost of program	<u>3,733</u>	<u>3,716</u>
Compliance		
Gross cost	8,031	8,196
Earned revenue	(397)	(384)
Net cost of program	<u>7,634</u>	<u>7,812</u>
Administration of Tax Credit Programs		
Gross cost	164	169
Earned revenue	-	-
Net cost of program	<u>164</u>	<u>169</u>
Net cost of operations (Note 11)	<u>\$ 12,137</u>	<u>\$ 12,303</u>

The accompanying notes are an integral part of these statements.

Financial Statements

**Internal Revenue Service
Statement of Changes in Net Position
For the Years Ended September 30, 2014 and 2013**

(In Millions)

	2014		2013	
	Cumulative Results of Operations	Unexpended Appropriations	Cumulative Results of Operations	Unexpended Appropriations
Beginning balances	\$ 795	\$ 1,402	\$ 643	\$ 1,490
Budgetary financing sources				
Appropriations received		11,291		11,819
Transfers in/out without reimbursement	30		16	
Other adjustments		(86)		(692)
Appropriations used	11,114	(11,114)	11,215	(11,215)
Other financing sources				
Imputed financing	1,233		1,272	
Transfers in/out without reimbursement	(10)		-	
Transfers to general fund	(31)		(48)	
Total financing sources	<u>12,336</u>	<u>91</u>	<u>12,455</u>	<u>(88)</u>
Net cost of operations	<u>(12,137)</u>		<u>(12,303)</u>	
Net change	<u>199</u>	<u>91</u>	<u>152</u>	<u>(88)</u>
Ending balances	<u>\$ 994</u>	<u>\$ 1,493</u>	<u>\$ 795</u>	<u>\$ 1,402</u>

The accompanying notes are an integral part of these statements.

Financial Statements

Internal Revenue Service
Statement of Budgetary Resources
For the Years Ended September 30, 2014 and 2013

(In Millions)

	2014	2013
Budgetary resources		
Unobligated balance, brought forward, October 1	\$ 994	\$ 983
Recoveries of prior year unpaid obligations	115	137
Other changes in unobligated balance	(86)	(72)
Unobligated balance from prior year budget authority, net	1,023	1,048
Appropriations (discretionary and mandatory)	11,657	11,555
Spending authority from offsetting collections (discretionary and mandatory)	154	121
Total budgetary resources	\$ 12,834	\$ 12,724
Status of budgetary resources		
Obligations incurred (Note 12)	\$ 11,746	\$ 11,730
Unobligated balance, end of year:		
Apportioned	648	635
Exempt from apportionment	8	7
Unapportioned	432	352
Total unobligated balance, end of year	1,088	994
Total budgetary resources	\$ 12,834	\$ 12,724
Change in obligated balance		
Unpaid obligations, brought forward, October 1 (gross)	\$ 1,296	\$ 1,673
Obligations incurred	11,746	11,730
Outlays (gross)	(11,598)	(11,970)
Recoveries of prior year unpaid obligations	(115)	(137)
Unpaid obligations, end of year (gross)	1,329	1,296
Uncollected payments, federal sources, brought forward, October 1	(31)	(42)
Change in uncollected customer payments from federal sources	(7)	11
Uncollected payments, federal sources, end of year	(38)	(31)
Memorandum (non-add) entries:		
Obligated balance, start of year	1,265	1,631
Obligated balance, end of year	\$ 1,291	\$ 1,265
Budget authority and outlays, net		
Budget authority, gross (discretionary and mandatory)	\$ 11,811	\$ 11,676
Actual offsetting collections (discretionary and mandatory)	(147)	(132)
Change in uncollected customer payments from federal sources (discretionary)	(7)	11
Budget authority, net (discretionary and mandatory)	\$ 11,657	\$ 11,555
Outlays, gross (discretionary and mandatory)	\$ 11,598	\$ 11,970
Actual offsetting collections (discretionary and mandatory)	(147)	(132)
Outlays, net (discretionary and mandatory)	11,451	11,838
Distributed offsetting receipts	(323)	(333)
Agency outlays, net (discretionary and mandatory)	\$ 11,128	\$ 11,505

The accompanying notes are an integral part of these statements.

Internal Revenue Service
Statement of Custodial Activity
For the Years Ended September 30, 2014 and 2013

(In Billions)

	<u>2014</u>	<u>2013</u>
Revenue activity		
Collections of federal tax revenue (Note 13)		
Individual income, FICA/SECA, and other	\$ 2,605	\$ 2,449
Corporate income	353	312
Excise	71	61
Estate and gift	20	20
Railroad retirement	6	5
Federal unemployment	9	8
Total collections of federal tax revenue	3,064	2,855
Increase/(Decrease) in federal taxes receivable, net	5	(4)
Total federal tax revenue	\$ 3,069	\$ 2,851
Distribution of federal tax revenue to Treasury	\$ 3,064	\$ 2,855
Increase/(Decrease) in amount due to Treasury	5	(4)
Total disposition of federal tax revenue	3,069	2,851
Net federal revenue activity	\$ -	\$ -
Federal tax refund and outlay activities		
Total refunds of federal taxes and outlays (Note 14)	\$ 374	\$ 364
Appropriations used for refund of federal taxes and outlays	(374)	(364)
Net federal tax refund and outlay activities	\$ -	\$ -

The accompanying notes are an integral part of these statements.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2014 and 2013

Note 1. Summary of Significant Accounting Policies

A. Reporting Entity

The Internal Revenue Service (IRS), a bureau of the United States (U.S.) Department of the Treasury (Treasury), celebrated its 150-year anniversary in 2012. The IRS originated in 1862, when Congress established the Office of the Commissioner of the Internal Revenue. The IRS administers the nation's tax laws and annually collects over 90 percent of the revenues funding the Federal Government. Numerous organizational divisions and major programs within the IRS contribute to this achievement.

Operating Divisions

The IRS has four operating divisions:

- Wage and Investment provides customer support, submission processing, and compliance activities with respect to individuals with wage and investment income;
- Small Business and Self-Employed administers compliance activities for small businesses, self-employed individuals, and others with income from sources other than wages;
- Tax Exempt and Government Entities oversees and assists employee plans, tax exempt organizations, and government entities in complying with tax laws and regulations; and
- Large Business and International serves corporations, subchapter S corporations, and partnerships with assets greater than \$10 million on complicated issues involving tax law and accounting principles, and conducts business in an expanding global environment.

Functional Divisions

Five functional divisions within the IRS provide enforcement services supporting both internal and external operations:

- Appeals
- Criminal Investigation
- Communications & Liaison
- Taxpayer Advocate Service
- Office of Chief Counsel

The National Taxpayer Advocate reports directly to Congress and the IRS Chief Counsel reports to the Secretary of the Treasury.

Support Divisions

Nine support divisions provide shared services support to all of the IRS organizations:

- Information Technology
- Agency-Wide Shared Services
- Stewardship
- Wage & Investment - Stewardship
- Executive Leadership and Direction
- Privacy, Governmental Liaison and Disclosure
- Human Capital Office
- Human Capital Office Corporate Programs
- Chief Financial Officer

Major Programs

The IRS has four major programs (further discussed in Note 1.J., Program Costs):

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

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2014 and 2013

B. Basis of Accounting and Presentation

The financial statements have been prepared from the accounting records of the IRS in conformity with accounting principles generally accepted in the U.S. and in accordance with the Office of Management and Budget (OMB) Circular No. A-136, *Financial Reporting Requirements*. Accounting principles generally accepted for federal entities are the standards prescribed by the Federal Accounting Standards Advisory Board, which is the official body for setting accounting standards of the Federal Government.

These comparative financial statements and related notes consist of the Balance Sheet, the Statement of Net Cost, the Statement of Changes in Net Position, the Statement of Budgetary Resources, and the Statement of Custodial Activity.

The accounting structure of federal agencies is designed to reflect both accrual and budgetary accounting transactions. Under the accrual method of accounting, revenues are recognized when earned and expenses are recognized when incurred, without regard to receipt or payment of cash. Budgetary accounting facilitates compliance with legal constraints and controls over the use of federal funds. The Statement of Custodial Activity is presented on the modified cash basis of accounting. Under this method, cash collections and transfers to Treasury are reported on a cash basis. The collections and transfers to Treasury are adjusted on the face of the statement for the net change in taxes receivable, producing modified cash basis balances.

Certain assets, liabilities, earned revenues, and costs have been classified as intragovernmental throughout the financial statements and notes. Intragovernmental is defined as transactions made between two reporting entities within the Federal Government.

C. Fund Balance with Treasury

The fund balance with Treasury is the aggregate of funds in the accounts of the IRS, primarily appropriated funds, from which the IRS is authorized to make expenditures and pay liabilities.

The status of fund balance with Treasury represents amounts obligated and unobligated. The obligated balances not yet disbursed represent the unpaid funds with budgetary obligations. Unobligated balances, available represent amounts in unexpired appropriations as of the end of the current fiscal year. Unobligated balances become available when apportioned by the OMB. Unobligated balances, unavailable represent amounts in expired appropriations and amounts not apportioned for obligation as of the end of the current fiscal year.

D. Other Assets

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

Advances to the public represent cash outlays for criminal investigations and employee travel. In fiscal year (FY) 2013, advances to government agencies were funds paid to the Treasury Working Capital Fund (WCF). Centralized services funded through the WCF consisted of telecommunication

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2014 and 2013

services, payroll processing, security, and employee programs. On October 1, 2013, the WCF advances were transferred into the Treasury Franchise Fund (TFF) to pay for shared service programs on a reimbursable, fee-for-service basis.

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

E. Cash and Other Monetary Assets

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

F. Federal Taxes Receivable, Net and Due to Treasury

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

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

Compliance assessments are unpaid assessments for which neither the taxpayer nor a court has affirmed the taxpayer owes to the Federal Government. Examples include assessments resulting from an IRS audit or examination in which the taxpayer does not agree with the results. Write-offs consist of unpaid assessments for which the IRS does not expect further collections due to factors such as taxpayers' bankruptcy, insolvency, or death. Compliance assessments and write-offs are not reported on the balance sheet. Statutory provisions require the accounts to be maintained until the statute for collection expires.

Tax Assessments

Under the Internal Revenue Code (26 USC) Section 6201, the Secretary of the Treasury is authorized and required to make inquiries, determinations, and assessments of all taxes imposed and accruing under any internal revenue law, which have not been duly paid including interest, additions to the tax, and assessable penalties. The Secretary has delegated this authority to the Commissioner of the IRS. Unpaid assessments result from taxpayers filing returns without sufficient payments and from the enforcement programs of the IRS, such as examination, under-reporter, substitute for return, and combined annual wage reporting.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2014 and 2013

Abatements

Section 6404 of the Internal Revenue Code (26 USC) authorizes the Commissioner of the IRS to abate certain paid or unpaid portions of assessed taxes, interest, and penalties. Abatements occur for a number of reasons and are a standard part of the tax administration process.

Abatements may be allowed for qualifying corporations claiming net operating losses that create a credit when carried back and applied against a prior year's tax liability. Additionally, abatements can correct previous assessments from enforcement programs, eliminate taxes discharged in bankruptcy, reduce or eliminate taxes encompassed in offers-in-compromise, eliminate penalty assessments for reasonable cause, eliminate contested assessments caused by mathematical or clerical errors, and eliminate assessments contested after the liability has been satisfied. Abatements may result in claims for refunds or reductions of the unpaid assessed amounts.

G. General Property and Equipment

General property and equipment is recorded at historical cost. It consists of tangible assets and software. The IRS depreciates property and equipment on a straight line basis over its estimated useful life. Except for leases meeting the 75 percent useful life and/or 90 percent of net present value (NPV) criteria, the IRS records a half-year of depreciation in the first year and the final year for all property and equipment. The IRS depreciates leases meeting the 75 percent useful life and/or 90 percent of NPV criteria over the life of the leases, with no use of a half-year convention. Disposals are recorded when deemed material.

The IRS capitalization policy for property and equipment by asset class and threshold:

Asset Class	Capitalization Threshold
ADP equipment	Capitalized regardless of acquisition cost. However, mainframe and server components and related commercial off the shelf software purchased separately are only capitalized when the bulk cost is \$50 thousand or greater.
Non-ADP equipment	Assets with bulk cost of \$50 thousand or greater
Furniture	Capitalized regardless of acquisition cost
Investigative equipment	Assets with bulk cost of \$50 thousand or greater
Vehicles	Capitalized regardless of acquisition cost
Major systems	Projects with costs of \$20 million or greater
Internal Use Software	Major business systems modernization projects with an estimated cost of \$10 million per year or \$50 million over the life cycle.
Leasehold Improvements	Improvements with bulk cost of \$50 thousand or greater
Assets under capital lease	Assets with bulk cost of \$50 thousand or greater

Major systems was a category for large-scale computer systems prior to Statement of Federal Financial Accounting Standards (SFFAS) No. 10, *Accounting for Internal Use Software*.

Internal Use Software captures the costs of major Business Systems Modernization (BSM) projects in accordance with SFFAS No. 10. It encompasses software design, development, and testing of projects adding significant new functionality and long-term benefits. Costs for developing internal use

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2014 and 2013

software are accumulated in work in process until final acceptance and testing are successfully completed. When the software is completed and placed into service, the costs are transferred to amortizable property.

H. Federal Tax Refunds Payable and Due from Treasury

Federal tax refunds payable is comprised of measurable and legally payable amounts due to taxpayers under established refund processes of the IRS. It is a fully funded liability offset by a corresponding asset due from Treasury. The IRS records an amount due from Treasury to designate approved funding to pay year-end tax refund liabilities to taxpayers.

I. Financing Sources and Revenues

Appropriations Received

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

Appropriations

The major budget accounts are:

- Taxpayer Services
- Enforcement
- Operations Support
- Other

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

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

Operations Support funds the indirect costs of all programs. Activities include executive planning and direction; shared service support for facilities, rent, utilities, and security; procurement; printing; postage; headquarters' activities such as strategic planning, finance, and human resources; research and statistics of income; and information systems, data processing, and telecommunication.

The IRS administers various tax provisions in the *Patient Protection and Affordable Care Act of 2010* (PPACA). The administrative costs are funded in the three major budget accounts: Taxpayer Services, Enforcement and Operations Support.

Other primarily consists of the BSM appropriation, which provides resources for the planning and capital asset acquisition of information technology to modernize the business systems. Additionally, BSM is obligated pursuant to an expenditure plan submitted to Congress.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2014 and 2013

Exchange Revenues

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

Imputed Financing Sources

Other financing sources include imputed financing sources to offset the imputed costs recognized for goods or services received from other federal agencies without reimbursement from the IRS. The imputed costs are pension and other benefit costs administered by the Office of Personnel Management (OPM), costs of processing payments and collections by the Bureau of Fiscal Service, costs of providing training by the Federal Law Enforcement Training Center, and legal judgments paid by the Treasury Judgment Fund.

J. Program Costs

Taxpayer Assistance and Education provides services to assist taxpayers with tax return preparation. Primary activities include tax law interpretations, developing and disseminating tax forms and publications, researching customer needs and establishing partnerships with stakeholder groups, and taxpayer advocacy. In addition, these programs continue to emphasize taxpayer education, outreach and enhancing pre-filing taxpayer support through electronic media. Earned revenues include reimbursable revenues from services provided to other federal agencies.

Filing and Account Services provides resources and support services to taxpayers in filing returns or paying taxes, and for the issuance of refunds and maintenance of taxpayer accounts. Program activities include providing assistance, education and compliance services to taxpayers through telephone, correspondence and electronic means to resolve account and notice inquiries. Earned revenues include user fees from photocopies, U.S. Residency Certification and Income Verification Express Service, and reimbursable revenues from services provided to other federal agencies.

Compliance administers compliance activities after a return is filed to identify and correct possible errors or underpayments. This program includes examination and collection programs, which ensure proper payment and tax reporting; criminal investigation programs to uncover violations of internal revenue tax laws and other financial crimes; the development and printing of published IRS guidance materials; and support of taxpayers for pre-filing agreements, determination letters, and advance pricing agreements. It also includes specialty program examinations, international collections, and international examinations. Earned revenues are primarily from user fees for installment agreements, letter rulings and determinations, offers-in-compromise, enrollment programs and return preparer registrations, and reimbursable revenues from services provided to other federal agencies.

Administration of Tax Credit Programs primarily administers the EITC program, which works closely with internal and external stakeholders through expanded customer service and public outreach, enforcement, and research efforts to increase the number of eligible taxpayers who claim the EITC and to reduce the number of EITC claims paid in error. The EITC payments actually refunded to individuals or credited against tax liabilities are not included in program costs. This program also includes a portion of the costs related to administering the Health Coverage Tax Credit (HCTC). The HCTC program activities focus on providing staff, training, and direct support to administer the health

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2014 and 2013

insurance tax credit portion of the *Trade Adjustment Assistance Reform Act of 2002*. These costs do not encompass payments made to health insurance carriers on behalf of participants or tax credits refunded to qualifying individuals. In FY 2012, HCTC program activity costs were consolidated under Filing and Account Services except for costs related to HCTC obligations made prior to FY 2012, which are still reported here. The consolidation was made in advance of the program's termination effective January 1, 2014.

K. Custodial Activity

Non-exchange Revenues

The IRS collects custodial non-exchange revenues for taxes levied against taxpayers for: individual and corporate income, Federal Insurance Contributions Act (FICA) and Self-Employment Contribution Act (SECA), excise, estate, gift, railroad retirement, and federal unemployment taxes. These collections are not available to the IRS for obligation or expenditure and are recognized as custodial revenues when collected. The sources of federal tax revenue and their distribution to the general fund of the Treasury are reported on the Statement of Custodial Activity.

Permanent Indefinite Appropriations

The IRS was granted permanent and indefinite budgetary authority through legislation to disburse tax refund principal and related interest as they become due. The permanent and indefinite appropriations are not subject to budgetary ceilings set by Congress during the annual appropriation process.

Refunds due to taxpayers are reported as federal tax refunds payable on the Balance Sheet. The IRS records an offsetting asset, due from Treasury, to reflect the year-end budget authority to pay this liability.

Disbursements for tax refunds and related interest, reported on the Statement of Custodial Activity, are offset by appropriations used for refunds. Disbursements for refunds are not a cost to the IRS, but rather a cost to the Federal Government as a whole.

L. Funds from Dedicated Collections

In accordance with SFFAS No. 43, *Funds from Dedicated Collections: Amending Statement of Federal Financial Accounting Standards 27, Identifying and Reporting Earmarked Funds*, Funds from Dedicated Collections are financed by specifically identified revenues, which remain available over time. These specifically identified revenues are required by statute to be used for designated activities, benefits or purposes and must be accounted for separately from the Federal Government's general revenues.

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

The Private Collection Agent Program (20X5510) was established under the *American Jobs Creation Act of 2004*. In March 2009, the IRS Commissioner announced the program would not renew the contracts with the private debt collection agencies. Unobligated funds from prior collections of delinquent federal tax liabilities were retained by the IRS to fund adjustments to prior enforcement activity obligations.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2014 and 2013

M. Allocation Transfers

The IRS is a party to allocation transfers with other federal agencies as both a transferring (parent) entity and a receiving (child) entity. Allocation transfers are legal delegations by one department of its authority to obligate budget authority and outlay funds to another department. A separate fund account (allocation account) is created in the U.S. Treasury as a subset of the parent fund account for tracking and reporting purposes. All allocation transfers of balances are credited to this account, and subsequent obligations and outlays incurred by the child entity are charged to this allocation account as they execute the delegated activity on behalf of the parent. Financial activity related to these allocation transfers is reported in the financial statements of the parent entity, from which the underlying legislative authority, appropriations, and budget apportionments are derived. The IRS allocates funds, as the parent, to the Department of Health and Human Services (HHS). Additionally, the IRS receives allocation transfers, as the child, from the Department of Transportation's Federal Highway Administration and HHS.

N. Fiduciary Activities

Fiduciary activities are the collection or receipt, and the management, protection, accounting, investment and disposition by the Federal Government of cash or other assets in which non-federal individuals or entities have an ownership interest the Federal Government must uphold.

The IRS fiduciary activities include the net collections for a taxable year from U.S. military and federal employees working in the U.S. territories of the Northern Mariana Islands, the U.S. Virgin Islands, Guam, and American Samoa. These fiduciary assets are not assets of the IRS.

O. Employee Compensation and Benefits

Accrued Annual, Sick, and Other Leave

Annual and compensatory leave is expensed with an offsetting liability as it is earned, and the liability is reduced as leave is taken. Each year, the IRS adjusts the balance in the accrued annual leave liability account to reflect current pay rates. To the extent current or prior year appropriations are not available to fund annual and compensatory leave earned but not taken, funding is obtained from future financing sources. Sick leave and other types of non-vested leave are expensed as taken.

Federal Employees Compensation Act

The Federal Employees Compensation Act (FECA) provides income and medical cost protection to covered federal civilian employees injured on the job, to employees who have incurred work-related occupational diseases, and to beneficiaries of employees whose deaths were attributed to job-related injuries or occupational diseases. The FECA program is administered by the Department of Labor (DOL), which pays valid claims and subsequently seeks reimbursement for claims paid. Accrued FECA liability represents amounts due to the DOL for claims paid on behalf of the IRS. Actuarial FECA liability represents the liability for future workers' compensation benefits, which includes the expected liability for death, disability, medical, and miscellaneous costs for approved cases. The DOL estimates the liability for future payments as a result of past events.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2014 and 2013

Employee Pension Benefits

The IRS recognizes the full costs of its employees' pension benefits. The liabilities associated with these costs are reported by the OPM, who administers the plans. Eligibility of employees to participate in the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS) is based on their hire date with the Federal Government, and the IRS contributes a percentage of an employee's basic pay toward the employee's retirement plan. The FERS contribution rates have been revised over the past two years.

EMPLOYEE PENSION BENEFIT CONTRIBUTION RATES			
	Category	Employee	Agency
CSRS Rates	Regular	7.0%	7.0%
	Law Enforcement Officers	7.5%	7.5%
FERS Rates	Regular	0.8%	11.9%
	Hired prior to January 1, 2013	Law Enforcement Officers	1.3%
FERS – Revised Annuity Rate	Regular	3.1%	9.6%
	Hired January 1, 2013 - December 31, 2013	Law Enforcement Officers	3.6%
FERS – Further Revised Annuity Rate	Regular	4.4%	9.6%
	Hired January 1, 2014 or later	Law Enforcement Officers	4.9%

Employees covered by either CSRS or FERS are also eligible to contribute to the Thrift Savings Plan (TSP), a defined contribution plan. A TSP account is automatically established for employees participating in FERS, and the IRS makes a mandatory contribution to this plan equal to one percent of an employee's compensation. Additionally, the IRS matches up to four percent of the compensation for FERS-eligible employees contributing to their TSP. No TSP matching contributions are made for employees participating in the CSRS.

Employee Health and Life Insurance Benefits

Employees are eligible to participate in the Federal Employees Health Benefit Program (FEHB) and Federal Employees Group Life Insurance Program (FEGLI). The FEHB offers a wide variety of group plans and coverage. The coverage is available to employees, retirees, and their eligible family members. The cost for each plan varies and is shared between the IRS and the employee. Employees participating in the FEGLI program can obtain basic term life insurance, with the employee paying two-thirds of the cost and the IRS paying one-third. Additional coverage is optional, to be paid fully by the employee. The basic life coverage may continue into retirement if certain requirements are met. The IRS recognizes the full cost of providing these benefits.

P. Use of Estimates

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

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2014 and 2013

Note 2. Fund Balance with Treasury

<u>(In Millions)</u>	<u>2014</u>	<u>2013</u>
General funds	\$ 2,088	\$ 1,919
Special funds	275	324
Revolving funds	7	7
Other funds	-	1
Fund balance with Treasury	<u>\$ 2,370</u>	<u>\$ 2,251</u>

<u>(In Millions)</u>	<u>2014</u>	<u>2013</u>
Unobligated balances:		
Available	\$ 656	\$ 641
Unavailable	432	352
Obligated balance not yet disbursed	1,291	1,265
Non-budgetary FBWT	<u>(9)</u>	<u>(7)</u>
Status of fund balance with Treasury	<u>\$ 2,370</u>	<u>\$ 2,251</u>

Note 3. Other Assets

<u>(In Millions)</u>	<u>2014</u>		<u>2013</u>	
	<u>Intra- governmental</u>	<u>With the Public</u>	<u>Intra- governmental</u>	<u>With the Public</u>
Accounts receivable, net	\$ 26	\$ 9	\$ 18	\$ 9
Advances	-	7	15	6
Forfeited property held for sale	-	-	-	1
Other assets	<u>\$ 26</u>	<u>\$ 16</u>	<u>\$ 33</u>	<u>\$ 16</u>

Note 4. Cash and Other Monetary Assets

<u>(In Millions)</u>	<u>2014</u>	<u>2013</u>
Imprest fund	\$ 7	\$ 7
Other monetary assets	<u>385</u>	<u>484</u>
Cash and other monetary assets	<u>\$ 392</u>	<u>\$ 491</u>

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2014 and 2013

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

<u>(In Billions)</u>	<u>2014</u>	<u>2013</u>
Federal taxes receivable	\$ 156	\$ 159
Allowance for uncollectible taxes receivable	(116)	(124)
Federal taxes receivable, net and due to Treasury	\$ 40	\$ 35

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

Note 6. Non-entity Assets

<u>(In Millions)</u>	<u>2014</u>		<u>2013</u>	
	<u>Intra- governmental</u>	<u>With the Public</u>	<u>Intra- governmental</u>	<u>With the Public</u>
Due from Treasury	\$ 4,722	\$ -	\$ 2,910	\$ -
Federal taxes receivable, net	-	40,000	-	35,000
Other monetary assets	-	385	-	484
Non-entity assets	\$ 4,722	\$ 40,385	\$ 2,910	\$ 35,484

Non-entity assets are not available for use by the IRS. Federal taxes receivable are collected for the U.S. Government, but the IRS does not have the authority to spend them.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2014 and 2013

Note 7. General Property and Equipment, Net

<u>(In Millions)</u>	<u>Useful Life (Years)</u>	<u>Cost</u>	<u>Accumulated Depreciation</u>	<u>2014 Net Book Value</u>	<u>2013 Net Book Value</u>
ADP assets	3 to 7	\$ 1,345	\$ (919)	\$ 426	\$ 452
Internal use software	2 to 15	1,580	(864)	716	460
Leasehold improvements	10	261	(123)	138	141
Major systems	7	221	(221)	-	-
Internal use software - work in process		260	-	260	292
Vehicles	5	4	(3)	1	8
Furniture and non-ADP equipment	8 to 10	160	(64)	96	105
Assets under capital lease	7	17	(6)	11	6
Investigative equipment	10	5	(5)	-	-
Property and equipment		\$ 3,853	\$ (2,205)	\$ 1,648	\$ 1,464

The Cost column represents the historical cost of property and equipment, net of disposals. The cost basis for FY 2014 and FY 2013 is \$3,853 million and \$3,572 million, respectively. Accumulated depreciation for FY 2014 and FY 2013 is \$2,205 million and \$2,108 million, respectively.

The IRS has 17 internal use software projects, including deployed and work in process:

- Account Management Services (AMS) provides the applications to monitor and interface with taxpayers, issue enhanced notices, and deliver improved customer support and functionality.
- Customer Account Data Engine 2 (CADE 2) is leveraging existing systems and new development to implement a single data-centric solution, which provides daily processing of individual taxpayer accounts and establishes a solid data foundation for the future. CADE 2 replaced current Customer Account Data Engine (CADE) in FY 2012.
- Customer Communications is a customer service telephone system.
- Custodial Detail Database (CDDB), the subsidiary ledger for Redesign Revenue and Accounting System (RRACS), provides the functionality needed for custodial financial management and reporting.
- E-Services is a system of web-based products and services for tax practitioners and the public.
- Enterprise Systems Management (ESM) is an infrastructure system allowing remote monitoring and network management.
- Foreign Account Tax Compliance Act (FATCA) is being developed to enable foreign financial institutions to report information to the IRS about financial accounts held by U.S. taxpayers or foreign entities in which U.S. taxpayers hold a substantial ownership interest.
- Information Reporting and Document Matching (IRDM) is a business document matching program designed to increase voluntary compliance and accurate reporting of income through the use of third party information reporting data.
- Integrated Financial System (IFS) is the IRS administrative financial system.
- Integrated Procurement System (IPS) is the re-engineered procurement system meeting current enterprise architecture and security standards.
- Internet Refund Fact of Filing allows taxpayers to review the status of their refund.
- Knowledge Incident/Problem Service Asset Management (KISAM) is the IRS' asset and problem management system.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2014 and 2013

The IRS has 17 internal use software projects, continued:

- Modernized e-file (MeF) is an electronic filing system for tax returns.
- *Patient Protection and Affordable Care Act* (PPACA) is the development and implementation of systems to support IRS' tax administration responsibilities associated with the PPACA.
- RRACS adds enhancements to financial reporting of taxpayer receipts and adds traceability between summary records and the detailed subsidiary ledger (CDDB).
- Return Review Program (RRP) is an automated system designed to maximize fraud detection at the time tax returns are filed.
- Security and Technology Infrastructure Release (STIR) is the infrastructure for information technology security.

Deployed Internal Use Software

<u>(In Millions)</u>	<u>Cost</u>	<u>Accumulated Depreciation</u>	<u>2014 Net Book Value</u>	<u>2013 Net Book Value</u>
MeF	\$ 381	\$ (260)	\$ 121	\$ 116
CADE 2	259	(92)	167	203
PPACA	231	(12)	219	-
IFS	167	(152)	15	19
E-Services	141	(141)	-	-
AMS	78	(29)	49	54
STIR	76	(76)	-	-
RRP	66	(5)	61	-
IRDM	59	(16)	43	50
FATCA	30	(2)	28	-
Customer Communications	25	(25)	-	-
ESM	16	(16)	-	-
Internet Refund Fact of Filing	15	(15)	-	-
CDDB	8	(7)	1	2
IPS	8	(2)	6	8
KISAM	6	(3)	3	4
RRACS	7	(4)	3	4
Other	7	(7)	-	-
Deployed internal use software	\$ 1,580	\$ (864)	\$ 716	\$ 460

Work in Process Internal Use Software

<u>(In Millions)</u>	<u>2014</u>	<u>2013</u>
PPACA	\$ 225	\$ 182
RRP	15	65
FATCA	20	21
MeF	-	24
Work in process internal use software	\$ 260	\$ 292

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2014 and 2013

Note 8. Liabilities

Other Liabilities

(In Millions)	2014		
	Current	Non-Current	Total
Intragovernmental:			
Accrued payroll and benefits	\$ 52	\$ -	\$ 52
Accrued FECA liability	44	51	95
Accrued expense	14	-	14
Capital lease vehicle liability	2	5	7
Other liabilities	\$ 112	\$ 56	\$ 168
With the Public:			
Accrued annual leave	\$ 502	\$ -	\$ 502
Actuarial FECA liability	-	489	489
Accrued payroll and benefits	173	-	173
Accrued expenses	240	-	240
Liability for deposit funds, clearing accounts and custodial liabilities	385	-	385
Energy savings performance liability	1	7	8
Other liabilities	\$ 1,301	\$ 496	\$ 1,797
2013			
(In Millions)	Current	Non-Current	Total
Intragovernmental:			
Accrued payroll and benefits	\$ 47	\$ -	\$ 47
Accrued FECA liability	45	54	99
Accrued expenses	14	-	14
Other liabilities	\$ 106	\$ 54	\$ 160
With the Public:			
Accrued annual leave	\$ 510	\$ -	\$ 510
Actuarial FECA liability	-	495	495
Accrued payroll and benefits	151	-	151
Accrued expenses	246	-	246
Liability for deposit funds, clearing accounts and custodial liabilities	484	-	484
Accounts payable	12	-	12
Other liabilities	\$ 1,403	\$ 495	\$ 1,898

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2014 and 2013

Liabilities Not Covered by Budgetary Resources

<u>(In Millions)</u>	2014		2013	
	<u>Intra-governmental</u>	<u>With the Public</u>	<u>Intra-governmental</u>	<u>With the Public</u>
Accrued annual leave	\$ -	\$ 502	\$ -	\$ 510
Actuarial FECA liability	-	489	-	495
Accrued FECA liability	95	-	99	-
Capital lease vehicle liability	7	-	-	-
Energy savings performance liability	-	8	-	-
Liabilities not covered by budgetary resources	\$ 102	\$ 999	\$ 99	\$ 1,005

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

Note 9. Leases

Capital Leases

The IRS leases ADP telecommunications equipment for toll free call centers, and currently has a two-year lease and two seven-year leases.

The remaining liability on the two-year lease was paid in FY 2012, and title for the equipment remains with the vendor. The payments for the leased equipment under the seven-year leases were made at the beginning of the leases. There are no future payments due for the equipment under the seven-year leases.

Additionally, the IRS has a lease with the General Services Administration (GSA) for vehicles used for enforcement. The vehicles are being leased over a period of three to five years. Future minimum payments due are as follows:

<u>(In Millions)</u>	<u>Lease Payment</u>
<u>Fiscal Year</u>	
2015	\$ 2
2016	2
2017	2
2018	1
2019	-
After 2019	-
Total future lease payments	\$ 7

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2014 and 2013

Operating Leases

<u>(In Millions)</u>	
<u>Fiscal Year</u>	<u>Lease Payment</u>
2015	\$ 12
2016	12
2017	10
2018	6
2019	1
After 2019	-
Total future lease payments	\$ 41

The IRS leases office space from commercial entities under five-year non-cancelable operating leases. Future lease payments under non-cancelable leases of office spaces are presented above.

Additionally, the IRS has annual operating leases with the GSA for office space and vehicles, and with commercial entities for equipment and software licenses. These leases may be canceled or renewed on an annual basis at the option of the IRS. They do not impose binding commitments on the IRS for future rental payments on leases with terms longer than one year.

Note 10. Commitments and Contingencies

The IRS is a party to legal actions whose outcome, if unfavorable, could materially affect the financial statements. As of September 30, 2014 and 2013, there were no estimated contingent liabilities arising from these actions.

Management has determined it is probable two of these proceedings will result in a loss. As of September 30, 2014, the potential losses for these cases cannot be estimated. For some of the legal actions to which the IRS is a party, management and legal counsel cannot determine the likelihood of an unfavorable outcome nor can any related loss be reasonably estimated. The IRS does not accrue for possible losses related to cases where the potential loss cannot be estimated or the likelihood of an unfavorable outcome is less than probable. As of September 30, 2014 and 2013, there were seven cases and ten cases, respectively, for which management and legal counsel are unable to determine the likelihood of an unfavorable outcome or establish a range of potential losses. Additionally, for some of the legal actions, management and legal counsel have determined the likelihood of an unfavorable outcome is remote.

As of September 30, 2014 and 2013, the IRS does not have contractual commitments for payments on obligations related to canceled appropriations or contractual arrangements for which the IRS has not recognized liabilities for goods and services provided.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2014 and 2013

Note 11. Cost and Earned Revenue by Programs

(In Millions)	2014				
	Taxpayer Assistance and Education	Filing and Account Services	Compliance	Administration of Tax Credit Programs	Total
Intragovernmental gross cost	\$ 151	\$ 1,674	\$ 2,479	\$ 43	\$ 4,347
Gross costs with the public	457	2,154	5,552	121	8,284
Program costs	608	3,828	8,031	164	12,631
Intragovernmental earned revenue	(2)	(44)	(50)	-	(96)
Earned revenue from the public	-	(51)	(347)	-	(398)
Program revenues	(2)	(95)	(397)	-	(494)
Net cost of operations	\$ 606	\$ 3,733	\$ 7,634	\$ 164	\$ 12,137

(In Millions)	2013				
	Taxpayer Assistance and Education	Filing and Account Services	Compliance	Administration of Tax Credit Programs	Total
Intragovernmental gross cost	\$ 150	\$ 1,699	\$ 2,516	\$ 43	\$ 4,408
Gross costs with the public	457	2,130	5,680	126	8,393
Program costs	607	3,829	8,196	169	12,801
Intragovernmental earned revenue	(1)	(50)	(44)	-	(95)
Earned revenue from the public	-	(63)	(340)	-	(403)
Program revenues	(1)	(113)	(384)	-	(498)
Net cost of operations	\$ 606	\$ 3,716	\$ 7,812	\$ 169	\$ 12,303

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2014 and 2013

Note 12. Statement of Budgetary Resources (SBR)

Obligations Incurred

<u>(In Millions)</u>	<u>2014</u>	<u>2013</u>
Direct		
Category B	\$ 11,647	\$ 11,634
Exempt from apportionment	<u>1</u>	<u>1</u>
Total	11,648	11,635
Reimbursable		
Category B	<u>98</u>	<u>95</u>
Obligations Incurred	<u>\$ 11,746</u>	<u>\$ 11,730</u>

Category B apportionments distribute budgetary resources by activities or programs and are restricted by purpose for which obligations can be incurred.

Explanation of Differences Between the FY 2013 SBR and the FY 2015 President's Budget

<u>(In Millions)</u>	<u>Budgetary Resources</u>	<u>Obligations Incurred</u>	<u>Distributed Offsetting Receipts</u>	<u>Net Outlays</u>
Statement of Budgetary Resources (SBR)	\$ 12,724	\$ 11,730	\$ 333	\$ 11,505
Included on SBR, not in President's Budget				
Expired funds	(336)	-	-	-
Distributed offsetting receipts	-	-	(333)	333
Allocation transfer from Treasury	(1)	-	-	-
Other	(1)	2	-	(3)
Included in President's Budget, not on SBR				
Tax credits and interest refunds to taxpayers	91,417	91,417	-	91,406
Payments to informants	<u>53</u>	<u>53</u>	<u>-</u>	<u>54</u>
Budget of the United States Government	<u>\$ 103,856</u>	<u>\$ 103,202</u>	<u>\$ -</u>	<u>\$ 103,295</u>

The FY 2016 Budget of the United States Government (President's Budget) presenting the actual amounts for the year ended September 30, 2014 has not been published as of the issue date of these financial statements. The FY 2016 President's Budget is scheduled for publication in February 2015. A reconciliation of the FY 2013 column on the SBR to the actual amounts for FY 2013 in the FY 2015 President's Budget for budgetary resources, obligations incurred, distributed offsetting receipts, and net outlays is presented above.

The President's Budget includes \$91.5 billion in appropriations for tax credits and interest refunds, and payments to informants. The majority of the appropriations represent budgetary resources and outlays of payments to taxpayers for credits exceeding the taxpayer's income tax liability, including EITC, Child Tax Credit, and Making Work Pay Credit.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2014 and 2013

Undelivered Orders at the End of Period

Undelivered orders are the value of goods and services ordered and obligated, but not yet received. This amount includes any prepaid or advanced orders for which delivery or performance has not yet occurred. Undelivered orders were \$855 million and \$847 million for the periods ended September 30, 2014 and 2013, respectively.

Note 13. Collections of Federal Tax Revenue

(In Billions)	Tax Year				Collections Received FY 2014	Collections Received FY 2013
	2014	2013	2012	Prior Years		
Individual income, FICA/SECA, and other	\$ 1,692 *	\$ 864	\$ 24	\$ 25	\$ 2,605	\$ 2,449
Corporate income	253 **	88	1	11	353	312
Excise	55	16	-	-	71	61
Estate and gift	-	7	1	12	20	20
Railroad retirement	5	1	-	-	6	5
Federal unemployment	4	5	-	-	9	8
Collections of federal tax revenue	\$ 2,009	\$ 981	\$ 26	\$ 48	\$ 3,064	\$ 2,855

* Includes other collections of \$232 million.

** Includes tax year 2015 corporate income tax receipts of \$15 billion.

Note 14. Federal Tax Refund and Outlay Activities

(In Billions)	Tax Year				Refunds and Outlays FY 2014	Refunds and Outlays FY 2013
	2014	2013	2012	Prior Years		
Individual income, FICA/SECA, and other	\$ 14	\$ 291	\$ 24	\$ 7	\$ 336	\$ 321
Corporate income	5	11	7	13	36	41
Excise	-	1	-	-	1	1
Estate and gift	-	-	1	-	1	1
Federal tax refund and outlay activities	\$ 19	\$ 303	\$ 32	\$ 20	\$ 374	\$ 364

Refunds and outlays include payments for various refundable credits including EITC, child tax credit, the PPACA, and those enacted under the *American Recovery and Reinvestment Act of 2009*.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2014 and 2013

Note 15. Fiduciary Activities

<u>(In Millions)</u>	2014				
	<u>20X6737</u>	<u>20X6738</u>	<u>20X6740</u>	<u>20X6741</u>	<u>Total</u>
Fiduciary net assets, beginning of year	\$ -	\$ 33	\$ -	\$ -	\$ 33
Contributions	9	12	22	10	53
Disbursements to and on behalf of beneficiaries	(9)	(27)	(22)	(10)	(68)
Decrease in fiduciary net assets	-	(15)	-	-	(15)
Fiduciary net assets, end of year	<u>\$ -</u>	<u>\$ 18</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 18</u>
	2013				
<u>(In Millions)</u>	<u>20X6737</u>	<u>20X6738</u>	<u>20X6740</u>	<u>20X6741</u>	<u>Total</u>
Fiduciary net assets, beginning of year	\$ -	\$ 27	\$ -	\$ -	\$ 27
Contributions	10	13	18	8	49
Disbursements to and on behalf of beneficiaries	(10)	(7)	(18)	(8)	(43)
Increase in fiduciary net assets	-	6	-	-	6
Fiduciary net assets, end of year	<u>\$ -</u>	<u>\$ 33</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 33</u>

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

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

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

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

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

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2014 and 2013

Note 16. Reconciliation of Net Cost of Operations to Budget

<u>(In Millions)</u>	<u>2014</u>	<u>2013</u>
Resources used to finance activities:		
Obligations incurred	\$ 11,746	\$ 11,730
Spending authority from offsetting collections and recoveries	(269)	(258)
Distributed offsetting receipts	(323)	(333)
Transfers to General Fund	(31)	(48)
Imputed financing	1,233	1,272
Transfers in/out without reimbursement	(10)	-
	<u>12,346</u>	<u>12,363</u>
Resources that do not fund net cost of operations:		
Changes in goods, services and benefits ordered but not yet received or provided	(9)	105
Costs capitalized on the balance sheet	(130)	(170)
Budgetary offsetting collections and receipts	30	35
	<u>(109)</u>	<u>(30)</u>
Costs that do not require resources in current period:		
Depreciation and amortization	277	261
Increase (decrease) in unfunded liabilities	(13)	13
Revaluation of assets and liabilities	8	14
Other	(372)	(318)
	<u>(100)</u>	<u>(30)</u>
Net cost of operations	<u>\$ 12,137</u>	<u>\$ 12,303</u>

In accordance with the SFFAS No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, the budgetary resources obligated during the period for the programs and operations of the IRS must be reconciled to the net cost of operations. Budgetary accounting reports the obligations and outlays of financial resources to acquire or provide goods and services. The accrual basis of accounting reports the net cost of resources used.

Required Supplementary Information

INTERNAL REVENUE SERVICE
 Required Supplementary Information - Unaudited
 For the Years Ended September 30, 2014 and 2013

Schedule of Budgetary Resources by Major Budget Accounts

(In Millions)	2014				
	Taxpayer Services	Enforcement	Operations Support	Other	Total
Budgetary resources					
Unobligated balance, brought forward, October 1	\$ 65	\$ 104	\$ 325	\$ 500	\$ 994
Recoveries of prior year unpaid obligations	8	19	78	10	115
Other changes in unobligated balance	167	3	41	(297)	(86)
Unobligated balance from prior year budget authority, net	240	126	444	213	1,023
Appropriations (disc & mand)	2,157	4,955	3,987	558	11,657
Spending authority from offsetting collections (disc & mand)	40	67	46	1	154
Total budgetary resources	\$ 2,437	\$ 5,148	\$ 4,477	\$ 772	\$ 12,834
Status of budgetary resources					
Obligations incurred	\$ 2,377	\$ 5,013	\$ 4,109	\$ 247	\$ 11,746
Unobligated balance, end of year:					
Apportioned	12	47	180	409	648
Exempt from apportionment	-	-	-	8	8
Unapportioned	48	88	188	108	432
Total unobligated balance, end of year	60	135	368	525	1,089
Total budgetary resources	\$ 2,437	\$ 5,148	\$ 4,477	\$ 772	\$ 12,834
Change in obligated balance					
Unpaid obligations, brought forward, October 1 (gross)	\$ 101	\$ 233	\$ 862	\$ 100	\$ 1,296
Obligations incurred	2,377	5,013	4,109	247	11,746
Outlays (gross)	(2,352)	(4,937)	(4,053)	(256)	(11,598)
Recoveries of prior year unpaid obligations	(8)	(19)	(78)	(10)	(115)
Unpaid obligations, end of year (gross)	118	290	840	81	1,329
Uncollected payments, federal sources, brought forward, October 1	-	(31)	-	-	(31)
Change in uncollected customer payments from federal Sources	-	(7)	-	-	(7)
Uncollected payments, federal sources, end of year	-	(38)	-	-	(38)
Memorandum (non-add) entries:					
Obligated balance, start of year	101	202	862	100	1,265
Obligated balance, end of year	\$ 118	\$ 252	\$ 840	\$ 81	\$ 1,291
Budget authority and outlays, net					
Budget authority, gross (disc & mand)	\$ 2,197	\$ 5,022	\$ 4,033	\$ 559	\$ 11,811
Actual offsetting collections (disc & mand)	(40)	(60)	(46)	(1)	(147)
Change in uncollected customer payments from federal sources (disc)	-	(7)	-	-	(7)
Budget authority, net (disc & mand)	\$ 2,157	\$ 4,955	\$ 3,987	\$ 558	\$ 11,657
Outlays, gross (disc & mand)	\$ 2,352	\$ 4,937	\$ 4,053	\$ 256	\$ 11,598
Actual offsetting collections (disc & mand)	(40)	(60)	(46)	(1)	(147)
Outlays, net (disc & mand)	2,312	4,877	4,007	255	11,451
Distributed offsetting receipts	-	-	-	(323)	(323)
Agency outlays, net (disc & mand)	\$ 2,312	\$ 4,877	\$ 4,007	\$ (68)	\$ 11,128

INTERNAL REVENUE SERVICE
 Required Supplementary Information - Unaudited
 For the Years Ended September 30, 2014 and 2013

Schedule of Budgetary Resources by Major Budget Accounts

(In Millions)	2013				
	Taxpayer Services	Enforcement	Operations Support	Other	Total
Budgetary resources					
Unobligated balance, brought forward, October 1	\$ 62	\$ 85	\$ 356	\$ 480	\$ 983
Recoveries of prior year unpaid obligations	19	25	87	6	137
Other changes in unobligated balance	178	9	80	(339)	(72)
Unobligated balance from prior year budget authority, net	259	119	523	147	1,048
Appropriations (disc & mand)	2,136	4,949	3,859	611	11,555
Spending authority from offsetting collections (disc & mand)	42	50	27	2	121
Total budgetary resources	\$ 2,437	\$ 5,118	\$ 4,409	\$ 760	\$ 12,724
Status of budgetary resources					
Obligations incurred	\$ 2,372	\$ 5,014	\$ 4,084	\$ 260	\$ 11,730
Unobligated balance, end of year:					
Apportioned	16	30	138	451	635
Exempt from apportionment	-	-	-	7	7
Unapportioned	49	74	187	42	352
Total unobligated balance, end of year	65	104	325	500	994
Total budgetary resources	\$ 2,437	\$ 5,118	\$ 4,409	\$ 760	\$ 12,724
Change in obligated balance					
Unpaid obligations, brought forward, October 1 (gross)	\$ 204	\$ 448	\$ 886	\$ 135	\$ 1,673
Obligations incurred	2,372	5,014	4,084	260	11,730
Outlays (gross)	(2,456)	(5,204)	(4,021)	(289)	(11,970)
Recoveries of prior year unpaid obligations	(19)	(25)	(87)	(6)	(137)
Unpaid obligations, end of year (gross)	101	233	862	100	1,296
Uncollected payments, federal sources, brought forward, October 1	-	(34)	(8)	-	(42)
Change in uncollected customer payments from federal Sources	-	3	8	-	11
Uncollected payments, federal sources, end of year	-	(31)	-	-	(31)
Memorandum (non-add) entries:					
Obligated balance, start of year	204	414	878	135	1,631
Obligated balance, end of year	\$ 101	\$ 202	\$ 862	\$ 100	\$ 1,265
Budget authority and outlays, net					
Budget authority, gross (disc & mand)	\$ 2,178	\$ 4,999	\$ 3,886	\$ 613	\$ 11,676
Actual offsetting collections (disc & mand)	(42)	(53)	(35)	(2)	(132)
Change in uncollected customer payments from federal sources (disc)	-	3	8	-	11
Budget authority, net (disc & mand)	\$ 2,136	\$ 4,949	\$ 3,859	\$ 611	\$ 11,555
Outlays, gross (disc & mand)	\$ 2,456	\$ 5,204	\$ 4,021	\$ 289	\$ 11,970
Actual offsetting collections (disc & mand)	(42)	(53)	(35)	(2)	(132)
Outlays, net (disc & mand)	2,414	5,151	3,986	287	11,838
Distributed offsetting receipts	-	-	-	(333)	(333)
Agency outlays, net (disc & mand)	\$ 2,414	\$ 5,151	\$ 3,986	\$ (46)	\$ 11,505

INTERNAL REVENUE SERVICE

Required Supplementary Information - Unaudited

For the Years Ended September 30, 2014 and 2013

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), which may be paid for claims pending judicial review by the federal courts or, internally, by Appeals. In FY 2014, the total estimated payout (including principal and interest) for claims pending judicial review by the federal courts is \$3.1 billion and by Appeals is \$4.7 billion. In FY 2013, the total estimated payout (including principal and interest) for claims pending judicial review by the federal courts was \$0.8 billion and by Appeals was \$3.5 billion. To the extent judgments against the government in these cases prompt other similarly situated taxpayers to file similar refund claims, these amounts could become significantly greater.

Federal Taxes Receivable, Net

In accordance with the Statements of Federal Financial Accounting Standards No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, some unpaid assessments do not meet the criteria for financial statement recognition as discussed in Note 1.F., Federal Taxes Receivable, Net and Due to Treasury. Although compliance assessments and write-offs are not considered receivables under federal accounting standards, they represent legally enforceable claims of the IRS acting on behalf of the Federal Government. There is, however, a significant difference in the collection potential of these categories.

The components of the total unpaid assessments and derivation of net federal taxes receivable were as follows:

<u>(In Billions)</u>	<u>2014</u>	<u>2013</u>
Total unpaid assessments	\$ 380	\$ 374
Compliance assessments	(86)	(85)
Write-offs	<u>(138)</u>	<u>(130)</u>
Gross federal taxes receivables	156	159
Allowance for uncollectible taxes receivable	<u>(116)</u>	<u>(124)</u>
Federal taxes receivable, net	<u>\$ 40</u>	<u>\$ 35</u>

To eliminate double-counting, the compliance assessments reported above exclude trust fund recovery penalties assessed against officers and directors of businesses involved in the non-remittance of federal taxes withheld from their employees. These penalties totaled \$2 billion as of September 30, 2014 and September 30, 2013. The related unpaid assessments of those businesses are reported as taxes receivable or write-offs, but the IRS may also recover portions of those businesses' unpaid assessments from any and all individual officers and directors against whom a trust fund recovery penalty is assessed.

INTERNAL REVENUE SERVICE

Required Supplementary Information - Unaudited

For the Years Ended September 30, 2014 and 2013

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

Other Information

INTERNAL REVENUE SERVICE

Other Information - Unaudited

For the Years Ended September 30, 2014 and 2013

Schedule of Spending

The Schedule of Spending presented below is an overview of the fiscal year (FY) 2014 and 2013 resources of the IRS and how they were used. The schedule is presented to help the public better understand what money was provided to the IRS, how the IRS spent the money, and to whom the money was paid.

The data used to populate this schedule is the same underlying data used to populate the Statement of Budgetary Resources (SBR). The amounts shown below as "Total amounts agreed to be spent" agree with amounts shown as "Obligations, incurred" on the SBR.

The underlying data for this schedule also populates the information on USASPENDING.GOV, which was established to provide a single searchable website accessible to the public at no cost. USASPENDING.GOV receives and displays data pertaining to obligations incurred by the Agency, but there are known differences between the website and the SBR. Most notably, the website does not contain obligations incurred for individuals (e.g., payroll expenses) or for transactions less than \$25,000.

<u>(In Millions)</u>	<u>2014</u>	<u>2013</u>
What money is available to spend?		
Total resources	\$ 12,834	\$ 12,724
Less amount available but not agreed to be spent	(656)	(642)
Less amount not available to be spent	(432)	(352)
Total amounts agreed to be spent	\$ 11,746	\$ 11,730
How was the money spent/issued?		
Tax administration		
Personnel compensation	\$ 6,467	\$ 6,482
Personnel benefits	2,110	2,092
Rent, communications and utilities	993	1,021
Contracts	1,537	1,529
Other	639	606
Total amounts agreed to be spent	\$ 11,746	\$ 11,730
Who did the money go to?		
Federal	\$ 3,124	\$ 3,104
Non Federal	8,622	8,626
Total amounts agreed to be spent	\$ 11,746	\$ 11,730

INTERNAL REVENUE SERVICE

Other Information - Unaudited

For the Years Ended September 30, 2014 and 2013

Refundable Tax Credits and Other Outlays

To offer tax relief to targeted individuals and businesses, Congress has provided assistance in the form of tax credits. For the majority of tax credits, the economic benefit is limited to the taxpayer's tax liability. Credits limited in this manner are termed nonrefundable credits. Refundable credits, in contrast, are fully payable to the taxpayer, even if the credit exceeds the tax liability. These types of credits provide greater economic benefits because the taxpayer realizes the full benefit of the credit, regardless of the underlying tax liability.

The following overview summarizes the refundable credits the IRS administers and pays. The overview describes refundable credits in existence for many years, as well as those enacted as part of the *American Recovery and Reinvestment Act of 2009* (ARRA) and the *Patient Protection and Affordable Care Act of 2010* (PPACA).

Earned Income Tax Credit

The Earned Income Tax Credit (EITC) is a refundable tax credit for low to moderate income working individuals and families. Congress originally approved the tax credit legislation in 1975, in part, to offset the burden of social security taxes and to provide an incentive to work. To qualify, taxpayers must meet certain requirements and file a tax return, even if they did not have sufficient income to meet regular tax return filing requirements.

Additional Child Tax Credit

The Additional Child Tax Credit is a special credit for taxpayers who work, have earnings below an established ceiling, and have a qualifying child. The Child Tax Credit is limited to the taxpayer's tax liability and is a nonrefundable tax credit. However, certain individuals who receive less than the full amount of the Child Tax Credit may qualify for the "Additional" Child Tax Credit. Under this credit, subject to additional criteria, the taxpayer may receive the full credit amount even if such amount exceeds the taxpayer's tax liability. Consequently, the Additional Child Tax Credit is categorized as a refundable tax credit.

Health Care Tax Credit

The Health Care Tax Credit was established in 2002 to assist economically dislocated workers in acquiring or continuing critical health care coverage during periods of economic distress. Under this credit, participants can elect to take a portion of their premium as a credit on their tax return.

Alternatively, participants can elect to receive direct reimbursements should they have insufficient tax liability against which to apply the credit. This credit expired as of December 31, 2013.

Individual Alternative Minimum Tax (AMT) Credit

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

INTERNAL REVENUE SERVICE

Other Information - Unaudited

For the Years Ended September 30, 2014 and 2013

First-Time Home Buyer Credit

In 2008, Congress provided taxpayers with a refundable tax credit equivalent to an interest-free loan equal to ten percent of the purchase price of a home (up to \$7,500) by a first-time home buyer. The provision applied to homes purchased on or after April 9, 2008, and before July 1, 2009. Taxpayers receiving this tax credit are required to repay any amount received under this provision back to the government over 15 years in equal installments, or earlier if the home is sold. The credit phases out for taxpayers with adjusted gross income in excess of \$75,000 (\$150,000 in the case of a joint return).

The ARRA bill eliminated the repayment obligation for taxpayers who purchase homes after January 1, 2009, increased the maximum value of the credit to \$8,000, and removed the prohibition on financing by mortgage revenue bonds. Additionally, ARRA extended the availability of the credit for homes purchased before December 1, 2009. The ARRA provision retains the credit recapture if the house is sold within three years of purchase. This credit expired as of April 30, 2010, but was extended until April 30, 2011, for certain military and civilian federal personnel outside of the United States.

Corporate Alternative Minimum Tax (AMT) Credit

Section 168(k)(4) allows a taxpayer to elect to claim a refundable credit for certain unused research credits in lieu of the special depreciation allowance for eligible property.

American Opportunity Tax Credit

The American Opportunity Tax Credit modifies the existing Hope Credit. The credit was extended to apply for tax years through 2017 by the *American Taxpayer Relief Act of 2012*. This tax credit makes the Hope Credit available to a broader range of taxpayers including many with higher incomes and those who owe no tax. Additionally, it adds required course materials to the list of qualifying expenses and allows the credit to be claimed for four post-secondary education years instead of two. Many of those eligible will qualify for the maximum annual credit of \$2,500 per student.

Making Work Pay Credit

The Making Work Pay Credit was established in 2009. This is a refundable tax credit calculated at a rate of 6.2 percent of earned income, phasing out for taxpayers with adjusted gross income in excess of \$75,000 (\$150,000 for married couples filing jointly). Taxpayers receive this benefit through a reduction in the amount of income tax withheld from their paychecks or through claiming the credit on their tax returns. This credit expired as of December 31, 2010.

Build America and Recovery Zone Bonds (BAB)

BABs are a financing tool for state and local governments. The bonds, which allow a new direct federal payment subsidy, are taxable bonds issued by state and local governments to give them access to the conventional corporate debt markets. At the election of the state and local governments, the U.S. Department of Treasury (Treasury) will make a direct payment to the state or local governmental issuer in an amount equal to 35 percent of the interest payment on the Build America Bonds. This federal subsidy payment provides state and local governments lower net borrowing costs and allows them to reach more sources of borrowing than they can with more traditional tax-exempt or tax credit bonds.

INTERNAL REVENUE SERVICE

Other Information - Unaudited

For the Years Ended September 30, 2014 and 2013

Created by the ARRA, Recovery Zone Bonds are targeted to areas particularly affected by job losses and help local governments obtain financing for much needed economic development projects, such as public infrastructure development.

Qualified Zone Academy Bonds (QZAB) and Qualified School Construction Bonds (QSCB)

Congress created QZABs and QSCBs to help schools raise funds to help renovate and repair buildings, invest in equipment and current technology, develop more challenging curricula, and train teachers. The tax credit portion of these bonds depends on the issuance date of the bonds, the number of bonds outstanding, and their redemption.

Qualified Energy Conservation and New Clean Renewable Energy Bonds

Qualified Energy Conservation Bonds (QECB) may be issued by state, local, and tribal governments to finance qualified energy conservation projects. A minimum of 70 percent of a state's allocation must be used for governmental purposes, and the remainder may be used to finance private activity projects. QECBs were originally structured as tax credit bonds. However, the March 2010 *Hiring Incentives to Restore Employment (HIRE) Act* (H.R. 2847 (Sec. 301)) changed QECB from tax credit bonds to direct subsidy bonds similar to BABs. The QECB issuer pays the investor a taxable coupon and receives a rebate from Treasury.

New Clean Renewable Energy Bonds (CREBs) may be issued by public power utilities, electric cooperatives, government entities (states, cities, counties, territories, Indian tribal governments), and certain lenders to finance renewable energy projects. CREBs were originally structured as tax credit bonds. However, the March 2010 HIRE Act (H.R. 2847 (Sec. 301)) changed CREBs from tax credit bonds to direct subsidy bonds similar to BABs. The issuer pays the investor a taxable coupon and receives a rebate from Treasury.

COBRA Continuation Coverage for Unemployed Workers

To assist persons in maintaining health coverage for themselves and their families, ARRA provides a 65 percent subsidy for COBRA continuation premiums for up to nine months for workers who have been involuntarily terminated. Additionally, this subsidy applies to health care continuation coverage if required by states for small employers.

To qualify for premium assistance, a worker must have been involuntarily terminated between September 1, 2008 and December 31, 2009. The subsidy terminates upon an offer of any new employer-sponsored health care coverage or Medicare eligibility. Workers who were involuntarily terminated between September 1, 2008 and enactment, but failed to initially elect COBRA because it was unaffordable, were given an additional 60 days to elect COBRA and receive the subsidy. To ensure this assistance is targeted at workers who are most in need, participants must attest their same year income will not exceed \$125,000 for individuals and \$250,000 for families.

COBRA continuation coverage payments to workers are initially paid by the employer. The employer receives reimbursement either as a direct refund or through their payroll tax return where payments are taken as a credit against existing withholdings and payroll taxes. This credit expired as of August 30, 2011.

INTERNAL REVENUE SERVICE

Other Information - Unaudited

For the Years Ended September 30, 2014 and 2013

Adoption Tax Credit

Individuals qualify for the adoption tax credit if they have adopted a child and paid out-of-pocket expenses relating to the adoption. They may claim an adoption credit of up to \$12,970 (for tax year 2013) per eligible child. In tax year 2012, the credit changed from a refundable to a non-refundable credit. The credit is phased out based on the individual's modified adjusted gross income.

Small Business Health Insurance Tax Credit

Certain small employers will be eligible for a tax credit, provided they contribute a uniform percentage of at least 50 percent toward their employees' health insurance. For nonprofit (tax-exempt) organizations, the credit will be in the form of a reduction in income and Medicare tax the employer is required to withhold from employees' wages and the employer share of Medicare tax on employees' wages.

Therapeutic Discovery Grants

The Qualifying Therapeutic Discovery Project tax credit is provided under new Section 48D of the Internal Revenue Code (26 USC), enacted as part of the PPACA. The credit is a tax benefit targeted to certain therapeutic discovery projects. Such projects must show a reasonable potential to (1) achieve new therapies to treat unmet medical needs, (2) detect or treat chronic or acute diseases and conditions, (3) reduce the long-term growth of health care costs, or (4) significantly advance the goal of curing cancer.

Premium Tax Credit

Starting January 1, 2014, persons who purchase health insurance coverage through the Health Insurance Marketplace may be eligible for the premium tax credit. In general, a person is eligible for the credit if they (a) buy health insurance through the Marketplace, (b) are ineligible for coverage through an employer or government plan, (c) are within certain income limits, (d) do not file a Married Filing Separately tax return (unless they meet certain criteria that allow certain victims of domestic abuse to claim the premium tax credit using the Married Filing Separately filing status for the 2014 calendar year), and (e) cannot be claimed as a dependent by another person. Eligible individuals may elect to have some or all of their estimated credit paid in advance directly to their insurance company to lower the amount they must pay out-of-pocket for their monthly premiums or they may elect to receive all of the credit when they file their tax return. Each person who receives the benefit of a credit advance or who wishes to claim the credit must file an income tax return.

Cost Sharing Reduction

In addition to receiving a premium tax credit, a person who obtains a Silver health care insurance policy through a Marketplace may be able to secure lower costs on their deductibles, copayments and coinsurance costs depending upon their family size and family income. Unlike the premium tax credit, these subsidies are not considered to be tax credits and are not reported on the recipient's income tax return.

INTERNAL REVENUE SERVICE

Other Information - Unaudited

For the Years Ended September 30, 2014 and 2013

The following table summarizes refundable tax credits in excess of tax liabilities and other outlays paid in FY 2014 and FY 2013.

<u>(In Millions)</u>	<u>2014</u>	<u>2013</u>
Earned Income Tax Credit	\$ 60,087	\$ 57,513
Additional Child Tax Credit	21,490	21,608
Health Care Tax Credit	23	121
Individual Alternative Minimum Tax (AMT) Credit	66	169
First-Time Homebuyer Credit	-	17
Corporate Alternative Minimum Tax (AMT) Credit	39	190
American Opportunity Tax Credit	4,244	4,041
Making Work Pay Credit *	-	(11)
Build America and Recovery Zone Bonds	3,596	3,899
Qualified Zone Academy Bonds	54	51
Qualified School Construction Bonds	621	699
Qualified Energy Conservation Bonds	32	29
New Clean Renewable Energy Bonds	29	29
COBRA Credit	-	30
Adoption Tax Credit	58	143
Small Business Health Insurance Tax Credit	74	75
Therapeutic Discovery Grants	1	-
Premium Tax Credit	10,957	-
Cost Sharing Reduction	2,110	-
Refundable tax credits and other outlays	<u>\$ 103,481</u>	<u>\$ 88,603</u>

* Reflects net return of payments.

INTERNAL REVENUE SERVICE

Other Information - Unaudited

For the Years Ended September 30, 2014 and 2013

Social Security and Medicare Taxes

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

A portion of FICA benefits involves old-age, survivors, and disability payments. These benefits are funded by the social security tax, which is currently 6.2 percent of wages and tips up to \$117,000, and an employer matching amount of 6.2 percent, bringing the total rate to 12.4 percent for calendar year 2014. In calendar year 2013, the rate was 6.2 percent of wages and tips up to \$113,700 and an employer matching amount of 6.2 percent, bringing the total rate to 12.4 percent. These benefits are also funded by a self-employment tax of 12.4 percent and 12.4 percent on self-employment income up to \$117,000, and \$113,700 for calendar years 2014 and 2013, respectively. Remaining benefits under FICA pertain to hospital benefits (referred to as "Medicare") and are funded by a separate 1.45 percent tax on all wages and tips (there is no wage limit) and the employer matching contribution of 1.45 percent, bringing the total rate to 2.9 percent. Self-employed individuals pay a Medicare tax of 2.9 percent on all self-employment income. Beginning in 2013, an additional Medicare tax of 0.9 percent was collected on earned individual income of more than \$200,000 (\$250,000 for married couples filing jointly). Social security taxes collected by the IRS were estimated to be approximately \$743 billion and \$680 billion in FY 2014 and FY 2013, respectively. Medicare taxes collected by the IRS were estimated to be approximately \$225 billion and \$211 billion in FY 2014 and FY 2013, respectively. Social security taxes and Medicare taxes are included in the Individual income, FICA/SECA, and other financial statement line on the Statement of Custodial Activity.

Tax Gap and Tax Burden

Tax Gap

The tax gap is the difference between the amount of tax imposed by law and what taxpayers actually pay on time. The tax gap arises from the three types of noncompliance: not filing required tax returns on time or at all (the nonfiling gap), underreporting the correct amount of tax on timely filed returns (the underreporting gap), and not paying on time the full amount reported on timely filed returns (the underpayment gap). Of these three components, only the underpayment gap is observed; the nonfiling gap and the underreporting gap must be estimated. The tax gap, estimated to be about \$450 billion for tax year 2006 (the most recent estimate made), represents the net amount of noncompliance with the tax laws. Underreporting of tax liability accounts for 84 percent of the gap, with the remainder divided between nonfiling (6 percent) and underpaying (10 percent). Part of the estimate is based on data from a study of individual returns filed for tax year 2006. It does not include any taxes that should have been paid on income from illegal activities. Each instance of noncompliance by a taxpayer contributes to the tax gap, whether or not the IRS detects it, and whether or not the taxpayer is even aware of the noncompliance. Some of the tax gap arises from intentional (willful) noncompliance, and some of it arises from unintentional mistakes.

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

INTERNAL REVENUE SERVICE

Other Information - Unaudited

For the Years Ended September 30, 2014 and 2013

reported on the balance sheet of the IRS. The tax gap and the collection gap are related and overlapping concepts, but they have significant differences. The collection gap is a cumulative balance sheet concept for a particular point in time, while the tax gap is like an income statement item for a single year. Moreover, the tax gap estimates include all noncompliance, while the collection gap includes only amounts that have been assessed (a small portion of all noncompliance) and have not yet reached their statutory collection expiration date. Also, the tax gap includes only tax, while the collection gap includes tax, penalties, and interest.

Tax Burden

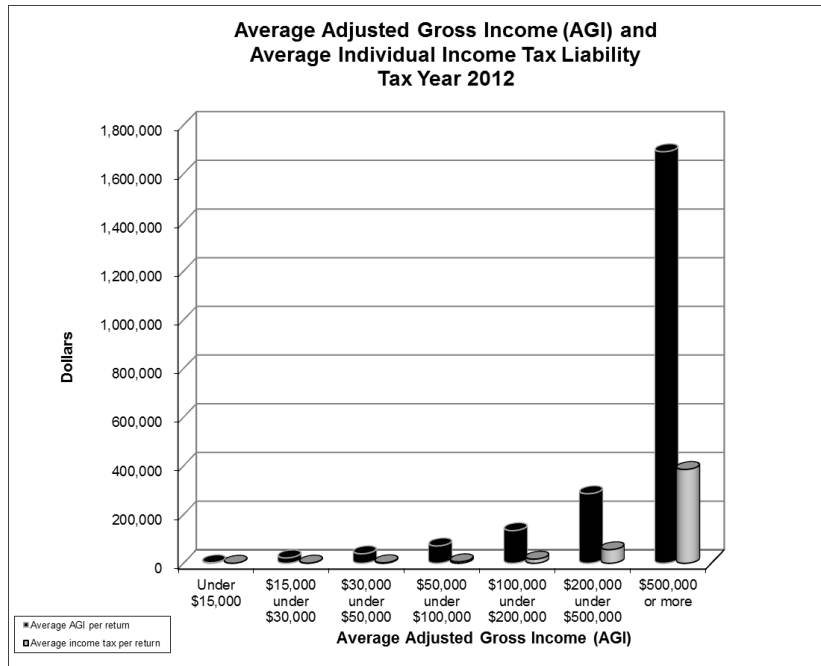
The Internal Revenue Code provides for progressive rates of tax, whereby higher incomes are generally subject to higher rates of tax. The following pages present in both graph and table format various income levels and their associated tax liabilities for individuals and corporations. This information is the most recent available for individuals (tax year 2012) and corporations (tax year 2011). The graphs and charts are representative of more detailed data and analyses available from the IRS Statistics of Income office.

For individuals, the information illustrates, in both percentage and dollar terms, the tax burden borne by varying levels of Adjusted Gross Income (AGI). The corporate information illustrates, for varying corporate asset categories, the tax burden borne by these entities as a percentage of taxable income.

Tax Expenditures

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

INTERNAL REVENUE SERVICE
 Other Information - Unaudited
 For the Years Ended September 30, 2014 and 2013



Adjusted gross income (AGI)	Number of taxable returns (in thousands)	AGI (in millions)	Total income tax (in millions)	Average AGI per return (in whole dollars)	Average income tax per return (in whole dollars)	Income tax as a percentage of AGI
Under \$15,000	37,096	82,510	2,290	2,224	62	2.8%
\$15,000 under \$30,000	30,519	670,097	18,787	21,957	616	2.8%
\$30,000 under \$50,000	25,325	989,413	54,739	39,069	2,161	5.5%
\$50,000 under \$100,000	31,089	2,215,015	192,091	71,248	6,179	8.7%
\$100,000 under \$200,000	15,647	2,100,003	265,391	134,211	16,961	12.6%
\$200,000 under \$500,000	4,154	1,186,751	231,596	285,689	55,753	19.5%
\$500,000 or more	1,098	1,856,342	423,133	1,690,658	385,367	22.8%
Totals	144,928	9,100,131	1,188,027			

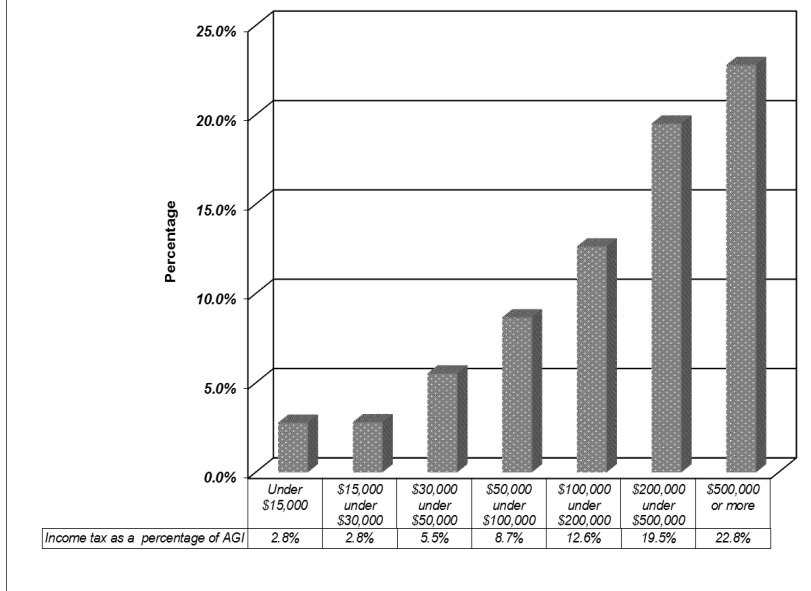
(All figures are estimates and based on samples provided by the Statistics of Income Office.)

INTERNAL REVENUE SERVICE

Other Information - Unaudited

For the Years Ended September 30, 2014 and 2013

**Individual Income Tax Liability as a Percentage of AGI
(as reported on tax returns)
Tax Year 2012**

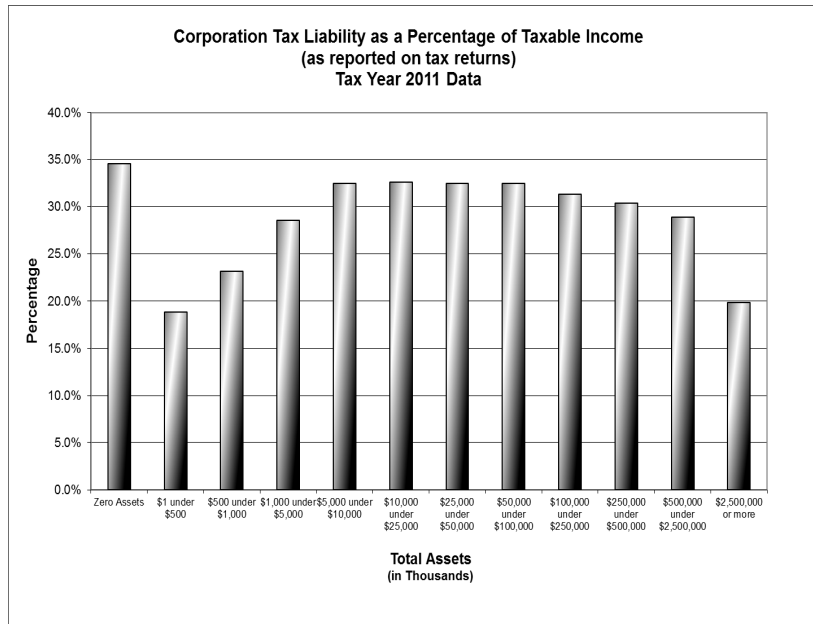


(All figures are estimates and based on samples provided by the Statistics of Income Office.)

INTERNAL REVENUE SERVICE

Other Information - Unaudited

For the Years Ended September 30, 2014 and 2013



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	14,156	4,889	34.5%
\$1 under \$500	6,264	1,181	18.9%
\$500 under \$1,000	3,243	752	23.2%
\$1,000 under \$5,000	10,715	3,061	28.6%
\$5,000 under \$10,000	6,834	2,217	32.4%
\$10,000 under \$25,000	10,493	3,417	32.6%
\$25,000 under \$50,000	10,425	3,385	32.5%
\$50,000 under \$100,000	12,413	4,029	32.5%
\$100,000 under \$250,000	23,342	7,308	31.3%
\$250,000 under \$500,000	26,194	7,945	30.3%
\$500,000 under \$2,500,000	109,134	31,542	28.9%
\$2,500,000 or more	761,180	151,168	19.9%
Totals	994,393	220,894	

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

Appendix I: Management's Report on Internal Control over Financial Reporting



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

November 10, 2014

Ms. Cheryl E. Clark
Director, Financial Management and Assurance
U.S. Government Accountability Office
441 G Street, NW, Room 5474
Washington, DC 20548

Dear Ms. Clark:

The Internal Revenue Service's (IRS) internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, the objectives of which are to provide reasonable assurance that: (1) transactions are properly recorded, processed and summarized to permit the preparation of financial statements in accordance with U.S. generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition; and (2) transactions are executed in accordance with laws governing the use of budget authority and with other applicable laws, regulations, contracts, and grant agreements that could have a direct and material effect on the financial statements.

IRS management is responsible for maintaining effective internal control over financial reporting, including the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error. IRS management evaluated the effectiveness of the IRS's internal control over financial reporting as of September 30, 2014, based on the criteria established under 31 U.S.C. 3512(c), (d) (commonly known as the Federal Managers' Financial Integrity Act).

Based on our evaluation, the IRS has one material weakness in its internal control over financial reporting, specifically unpaid tax assessments. The IRS's financial management systems do not substantially comply with the requirements of the Federal Financial Management Improvement Act. On this basis, management provides qualified assurance that as of September 30, 2014, the IRS's internal control over financial reporting was effective.

Handwritten signature of John A. Koskinen in black ink.

John A. Koskinen
Commissioner

November 10, 2014
Date

Handwritten signature of Robin L. Canady in black ink.

Robin L. Canady
Chief Financial Officer

November 10, 2014
Date

Appendix II: Comments from the Internal Revenue Service



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

November 5, 2014

Ms. Cheryl E. Clark
Director
Financial Management and Assurance
U.S. Government Accountability Office
441 G Street, NW, Room 5474
Washington, DC 20548

Dear Ms. Clark:

Thank you for the opportunity to comment on the draft report titled, *Financial Audit: IRS's Fiscal Years 2014 and 2013 Financial Statements*. We are pleased that the Internal Revenue Service (IRS) received an unmodified opinion on the combined financial statements for the 15th consecutive year. The unmodified opinion demonstrates that the IRS accurately accounts for approximately \$3.1 trillion in tax revenue receipts, \$374 billion in tax refunds, and \$11 billion in IRS appropriated funds.

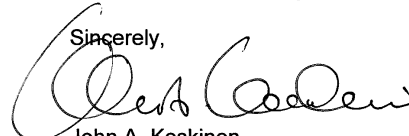
We are pleased the Government Accountability Office (GAO) recognized our progress in addressing a number of information technology security areas to include improving configuration and change controls in the mainframe environment, upgrading encryption across the network, and enabling a more secure communication environment for sensitive data.

The IRS also developed procedures and tested the effectiveness of internal controls over the accounting, reporting, and funding of the Premium Tax Credit as part of implementing the Affordable Care Act. This included, for the first time, collaborating with the Centers for Medicare and Medicaid Services to evaluate the internal controls that pertain to the Advance Premium Tax Credit and Cost Sharing Reduction payments that directly affect IRS financial reporting requirements. The IRS is dedicated to continuing to improve its financial management, internal controls, and information technology security posture.

2

I want to recognize the GAO's support throughout the audit. While challenges remain, the IRS has established its ability to consistently produce accurate and reliable financial statements. We have a solid management team dedicated to promoting the highest standard of financial management, and we continue to increase our focus on information security and internal controls. We look forward to working with the GAO in our efforts to continue to improve controls over financial reporting.

Sincerely,



John A. Koskinen

GAO's Mission

The Government Accountability Office, the audit, evaluation, and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's website (<http://www.gao.gov>). Each weekday afternoon, GAO posts on its website newly released reports, testimony, and correspondence. To have GAO e-mail you a list of newly posted products, go to <http://www.gao.gov> and select "E-mail Updates."

Order by Phone

The price of each GAO publication reflects GAO's actual cost of production and distribution and depends on the number of pages in the publication and whether the publication is printed in color or black and white. Pricing and ordering information is posted on GAO's website, <http://www.gao.gov/ordering.htm>.

Place orders by calling (202) 512-6000, toll free (866) 801-7077, or TDD (202) 512-2537.

Orders may be paid for using American Express, Discover Card, MasterCard, Visa, check, or money order. Call for additional information.

Connect with GAO

Connect with GAO on [Facebook](#), [Flickr](#), [Twitter](#), and [YouTube](#). Subscribe to our [RSS Feeds](#) or [E-mail Updates](#). Listen to our [Podcasts](#). Visit GAO on the web at www.gao.gov.

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Website: <http://www.gao.gov/fraudnet/fraudnet.htm>

E-mail: fraudnet@gao.gov

Automated answering system: (800) 424-5454 or (202) 512-7470

Congressional Relations

Katherine Siggerud, Managing Director, siggerudk@gao.gov, (202) 512-4400, U.S. Government Accountability Office, 441 G Street NW, Room 7125, Washington, DC 20548

Public Affairs

Chuck Young, Managing Director, youngc1@gao.gov, (202) 512-4800 U.S. Government Accountability Office, 441 G Street NW, Room 7149 Washington, DC 20548

