United States Government Accountability Office

Report to the Secretary of the Treasury

November 2016

FINANCIAL AUDIT

IRS's Fiscal Years 2016 and 2015 Financial Statements

Accessible Version

GAO-17-140

GAO Highlights

Highlights of GAO-17-140, a report to the Secretary of the Treasury

Why GAO Did This Study

In accordance with the authority conferred by the Chief Financial Officers Act of 1990, as amended, 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 stated that it is dedicated to continuing to improve its financial management, internal controls, and information security

View GAO-17-140. For more information, contact Cheryl E. Clark at (202) 512-3406 or clarkce@gao.gov

November 2016

FINANCIAL AUDIT

IRS's Fiscal Years 2016 and 2015 Financial Statements

What GAO Found

In GAO's opinion, the Internal Revenue Service's (IRS) fiscal years 2016 and 2015 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, 2016, because of a continuing material weakness in internal control over unpaid 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 2016.

The continuing material weakness in internal control over unpaid assessments was primarily caused by financial system limitations and other control deficiencies that rendered IRS's systems unable to properly distinguish between taxes receivable, compliance assessments, and write-offs, as necessary to determine reliable balances for financial reporting purposes. These deficiencies necessitated the use of a compensating estimation process to determine the amount of taxes receivable, the largest asset on IRS's balance sheet. Through this compensating process, IRS made over $9 billion in adjustments to the 2016 fiscal year-end gross taxes receivable balance produced by its financial systems. In response to GAO's recommendations from prior audits, IRS has taken actions over the years to address this material weakness, including developing a long-term corrective action plan. However, the plan does not include milestones or related completion dates for most of the actions, so it is unclear when IRS will fully address the issues that cause significant inaccuracies in the unpaid assessments information it maintains.

During fiscal year 2016, IRS continued to make progress in addressing deficiencies in internal control over its financial reporting systems. However, continuing and newly identified control deficiencies in IRS's information security placed IRS systems and data at risk. Collectively, these deficiencies represent a significant deficiency in IRS's internal control over financial reporting systems. Until IRS takes the necessary steps to address these deficiencies in controls, its financial reporting and taxpayer data will remain at increased risk of inappropriate and undetected use, modification, or disclosure.

In addition to its internal control deficiencies, IRS faces significant ongoing financial management challenges related to (1) safeguarding taxpayer receipts and associated information, (2) preventing and detecting fraudulent refunds based on identity theft, and (3) implementing the tax-related 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

Abbreviations

APTC	Advanced Premium Tax Credit
BHP	Basic Health Program
CFO	Chief Financial Officer
CMS	Centers for Medicare & Medicaid Services
CSR	Cost-Sharing Reduction
ESRP	Employer Shared Responsibility Payment
FASAB	Federal Accounting Standards Advisory Board
FMFIA	Federal Managers' Financial Integrity Act
HCERA	Health Care and Education Reconciliation Act of 2010
IDT	identity theft
IRS	Internal Revenue Service
PPACA	Patient Protection and Affordable Care Act
RSI	required supplementary information
SRP	Shared Responsibility Payment

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U.S. GOVERNMENT ACCOUNTABILITY OFFICE

441 G St. N.W.
Washington, DC 20548

November 10, 2016

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 2016 and 2015 financial statements of the Internal Revenue Service (IRS). Specifically, we found

- IRS's financial statements as of and for the fiscal years ended September 30, 2016, and 2015, 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, 2016, because of a continuing material weakness[1] in internal control over unpaid assessments; and
- no reportable noncompliance for fiscal year 2016 with provisions of applicable laws, regulations, contracts, and grant agreements we tested.

This report also provides a discussion of a continuing significant deficiency[2] in IRS's internal control over financial reporting systems that we believe merits the attention of those charged with governance of IRS. In addition, this report discusses ongoing financial management challenges that IRS faces related to (1) safeguarding taxpayer receipts and associated information, (2) preventing and detecting fraudulent refunds based on identity theft, and (3) implementing the tax-related provisions of the Patient Protection and Affordable Care Act.

[1]A 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.

[2]A 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.

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, 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

Cheryl E. Clark Director Financial Management and Assurance

Independent Auditor's Report

To the Commissioner of Internal Revenue

In our audits of the fiscal years 2016 and 2015 financial statements of the Internal Revenue Service (IRS), we found

- IRS's financial statements as of and for the fiscal years ended September 30, 2016, and 2015, 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, 2016; and
- no reportable noncompliance for fiscal year 2016 with 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 on internal control over financial reporting, which includes required supplementary information (RSI),[1] other information[2] included with the financial statements, and three significant financial management challenges confronting IRS related to safeguarding taxpayer receipts and associated information, preventing and detecting fraudulent refunds based on identity theft (IDT), and implementing the tax-related provisions of the Patient Protection and Affordable Care Act (PPACA);[3] (2) our report on IRS's compliance with laws, regulations, contracts, and grant agreements; and (3) IRS's comments.

[1]RSI consists of Management's Discussion and Analysis and the Required Supplementary Information section, which are included with the financial statements.

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

[3]Pub. 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.

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

In accordance with our authority conferred by the Chief Financial Officers (CFO) Act of 1990, as amended by the Government Management Reform Act of 1994, we have audited IRS's financial statements.[4] IRS's financial statements comprise the balance sheets as of September 30, 2016, and 2015; 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, 2016, 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

[4]See 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. 31 U.S.C. § 331(e)(2).

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 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, 2016, 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.[5]

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 provisions of applicable laws, including those governing the use of budget authority; regulations; contracts; and grant agreements, noncompliance with which could have a 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

[5]A 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.

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, 2016, and 2015, 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.

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, IRS's 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,[6] nor do they include information on tax expenditures.[7] 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.

[6]The tax gap arises when taxpayers, whether intentionally or inadvertently, fail to (1) accurately report tax liabilities on tax returns (underreporting), (2) pay taxes due from filed returns (underpayment), or (3) file a required tax return altogether or on time (nonfiling). The tax gap does not include actual or estimated refund payments disbursed because of IDT-based fraudulent refund claims, which are financial management challenges for IRS and are discussed later in this report. Based on its most recent study which relied on 2008-2010 data, IRS estimated the average annual net tax gap to be about $406 billion.

[7]Tax expenditures are revenue forgone because of preferential provisions of the tax structure, such as special exclusions, exemptions, deductions, credits, deferrals, and tax rates.

Opinion on Internal Control over Financial Reporting

In our opinion, because of a material weakness in internal control over unpaid assessments,[8] IRS did not maintain, in all material respects, effective internal control over financial reporting as of September 30, 2016, based on criteria established under FMFIA.

Despite the material weakness in IRS's internal control over unpaid assessments, which 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 2016. 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. This material weakness, which is discussed in more detail below, is also disclosed by IRS in its fiscal year 2016 (1) FMFIA assurance statement to the Department of the Treasury[9] and (2) Management's Report on Internal Control over Financial Reporting. We considered this material weakness in determining the nature, timing, and extent of our audit procedures on IRS's fiscal year 2016 financial statements.

In addition, our fiscal year 2016 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 continuing and new issues affecting IRS's internal control over financial reporting systems collectively to be a significant deficiency[10] in internal control in fiscal year 2016. 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

[8]An unpaid 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 assessment reduced by IRS). Internal Revenue Manual § 1.34.4, *Unpaid Assessments* (Aug. 25, 2015).

[9]FMFIA requires the agency head to provide an annual Statement of Assurance on whether the agency has met the statutory requirements. 31 U.S.C. § 3512(d)(2).

[10]A 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.

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 along with related recommendations for corrective actions.

Material Weakness in Internal Control over Unpaid Assessments

During fiscal year 2016, we continued to find control deficiencies that affected IRS's management and reporting of unpaid assessments. Specifically, as we have reported in our prior audits of IRS's financial statements,[11] we continued to find system deficiencies in IRS's subsidiary ledger[12] and supporting financial systems for unpaid assessments and various other control deficiencies that led to errors in taxpayer accounts. Because of these deficiencies, IRS's financial systems currently do not produce reliable and useful information with which to manage unpaid assessments, and do not provide the accurate and complete transaction-level financial information necessary to enable IRS to reliably classify and report unpaid assessment balances in accordance with federal accounting standards.[13]

[11]GAO, *Financial Audit: IRS's Fiscal Years 2015 and 2014 Financial Statements*, GAO-16-146 (Washington, D.C.: Nov. 12, 2015).

[12]IRS's Custodial Detail Data Base functions as its subsidiary ledger for unpaid assessments. Internal Revenue Manual, § 1.34.1, *Definitions and Acronyms* (June 23, 2009).

[13]Federal accounting standards classify unpaid 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 a court has affirmed that the amounts are owed. Write-offs represent unpaid 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 taxes receivable, 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. See also Internal Revenue Manual, § 1.34.1.

As in prior years, for fiscal year 2016, IRS's balance for federal taxes receivable,[14] which comprised over 80 percent of total assets reported on IRS's fiscal year 2016 balance sheet, was not produced from its general ledger for tax transactions[15] through the summation of taxpayer account transaction data,[16] but rather was the product of a compensating, labor-intensive, and manual estimation process.[17] This process is necessary because limitations in IRS's financial systems render its systems unable to readily distinguish between taxes receivable, compliance assessments, and write-offs in order to accurately classify unpaid assessments in the proper category for financial reporting purposes. In addition to systemic limitations, IRS's management and reporting of unpaid assessments also continued to be hindered by inaccurate tax records resulting from IRS not recording information in taxpayers' accounts accurately and timely. Such errors directly affect the accuracy of the tax debt balances being classified by the system and place undue burden on taxpayers who either have already paid taxes owed or who owe significantly lower amounts than recorded.

For fiscal year 2016, similar to what we have reported in prior years,[18] we found that the system limitations and errors in tax records resulted in IRS having to make numerous adjustments to sampled taxpayer account balances as part of its process for estimating the balance of net taxes receivable and other unpaid assessments. Based on a statistical projection of these individual adjustments, IRS made multibillion-dollar adjustments to the year-end balances of unpaid assessments generated by its subsidiary ledger in order to produce reliable amounts for external reporting on its balance sheet and in its RSI. For example, through its

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

[15]IRS's Redesign Revenue Accounting Control System is the general ledger system IRS uses for tax-related transactions. Internal Revenue Manual § 3.17.63 (Apr. 1, 2014).

[16]For 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 reduces the adjusted gross taxes receivable amount by an allowance for uncollectible taxes receivable to report the amount of net taxes receivable on its balance sheet.

[17]This compensating process involves IRS testing statistical samples of unpaid assessments extracted from its master files (the detailed records of taxpayer accounts) 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.

[18]See GAO-16-146.

statistical sampling and estimation process, IRS recorded over $9 billion in adjustments to the 2016 fiscal year-end gross taxes receivable balance in its general ledger, essentially replacing the amount produced by its subsidiary ledger with the results of this estimation process. Once adjusted, IRS could not trace general ledger balances to its detailed supporting records. Such traceability is necessary to enable IRS to ensure that recorded transactions are complete, accurate, and supported by underlying records. This lack of traceability also leaves IRS unable to identify which taxpayers owe the tax debts summarized in the gross taxes receivable balance or how much each one owes.

Since IRS derives the taxes receivable balance reported on its balance sheet and the balances of compliance assessments and write-offs reported in its RSI from the results of an estimation process, IRS's reported balances for taxes receivable and other unpaid assessments were not supported by its general ledger, inhibiting IRS's ability to externally report unpaid assessments in accordance with federal accounting standards. Absent the use of this statistical estimation process, the various unpaid assessment balances produced by its subsidiary ledger may have been materially inaccurate, and IRS had no other means of evaluating the accuracy of these balances.

The cumulative impact of these control deficiencies is such that a reasonable possibility exists that a material misstatement of IRS's financial statements could occur and 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 assessments. Because of this material weakness and the associated system deficiencies that existed during fiscal year 2016, IRS's financial management systems did not substantially comply with two of the three requirements of the Federal Financial Management Improvement Act of 1996, based on criteria established under 31 U.S.C. § 3512.[19]

[19]Section 803 of the Federal Financial Management Improvement Act of 1996, which is reprinted in 31 U.S.C. § 3512 note, requires that agencies implement and maintain financial management systems that comply substantially with federal financial management systems requirements, applicable federal accounting standards, and the *U.S. Government Standard General Ledger* at the transaction level. IRS's financial management systems did not substantially comply with (1) federal accounting standards because they were unable to report financial information in accordance with these standards and (2) federal financial management systems requirements because of the financial management system internal control deficiencies discussed in this report. However, IRS's financial management systems did substantially comply with the *U.S. Government Standard General Ledger* at the transaction level.

In response to our recommendations from prior audits, IRS has taken actions over the years to improve its management and reporting of unpaid assessments, including the development of a long-term corrective action plan to address the unpaid assessments material weakness. However, IRS still has not documented milestones or target completion dates for most of the actions on the plan, and its actions to date have not been effective at fully addressing the issues that continue to cause a lack of transaction traceability and material inaccuracies produced by this subsidiary ledger. Consequently, it is unclear when IRS will be able to fully address the issues that cause significant inaccuracies in the unpaid assessments information it maintains.

Significant Deficiency in Internal Control over Financial Reporting Systems

During fiscal year 2016, IRS made progress addressing previously reported control deficiencies related to its financial reporting systems. Key among its corrective actions were improvements in access controls over some system administrator accounts and updates to certain software to prevent exposures to known vulnerabilities.[20] However, control deficiencies in IRS's information security continued to exist. Specifically, we continued to find control deficiencies in (1) monitoring system activities to reasonably assure compliance with security policies (monitoring), (2) limiting or preventing unnecessary access and unauthorized changes to systems (access controls), (3) segregating incompatible duties, (4) reasonably assuring that software was supported by the vendor and updated to protect against known vulnerabilities, and (5) effectively managing information system security risk as part of IRS's security management program.[21] These control deficiencies limit IRS's

[20]Access controls include those related to identifying and authenticating users, authorizing access needed to perform job duties, encrypting sensitive data, auditing and monitoring system activities, and physically protecting computing resources.

[21]An effectively designed and implemented security management program provides a framework and a continuing cycle of activity for managing risk, developing and implementing effective security policies, assigning responsibilities, and monitoring the adequacy of the entity's information system controls.

effectiveness in protecting the confidentiality and integrity of sensitive taxpayer data and financial information.[22]

Our fiscal year 2016 audit found continuing and additional monitoring control deficiencies involving certain key financial reporting systems. For example, IRS did not fully implement controls for logging and monitoring audit trails pertaining to activities involving systems key to financial reporting and for a system that processed hundreds of thousands of e-mails. In addition, IRS did not update mainframe policies and procedures to address logging and monitoring controls. These monitoring control deficiencies limit IRS's ability to detect and respond to unauthorized access or unusual activity affecting its systems that contain sensitive information, including systems supporting financial management.

In fiscal year 2016, deficiencies also persisted in access controls and segregation of incompatible duties. For example, while IRS did take action to further restrict access to certain systems, it did not restrict unnecessary functions on a database that provides IRS employees with access to and management of taxpayer accounts. IRS also did not implement a secure method for managing administrator passwords. In addition, certain communications between key financial applications were still at risk of compromise because the applications were not using sufficiently strong encryption in order to prevent the unauthorized disclosure of information (confidentiality) and to detect changes to information (integrity). Another access control deficiency we noted during this year's audit concerns the physical safeguarding of IRS's information technology media storage devices. Specifically, as part of its inventory process in fiscal year 2016, IRS could not locate hundreds of media storage devices, such as hard drives, servers, and disk arrays. IRS reported these items as lost; however, it could not determine whether these lost devices contained taxpayer or other sensitive data at the time the loss occurred.[23] This lack of control over information technology resource handling increases the risk of unauthorized access to and use of

[22]We have reported these control deficiencies and made recommendations to address them, as well as IRS's associated corrective actions, in various reports to IRS concerning its information security. See for example, GAO, *Information Security: IRS Needs to Further Improve Controls over Financial and Taxpayer Data*, GAO-16-398 (Washington, D.C.: Mar. 28, 2016).

[23]These losses were reported to IRS's Computer Security Incident Response Center which is responsible for documenting losses of equipment, virus protection, and addressing attempted security breaches, and to the Treasury Inspector General for Tax Administration.

taxpayer or other sensitive data. Further, IRS continues to have control deficiencies concerning segregation of incompatible duties, which allow certain IRS employees to have both security and nonsecurity access roles to a key financial system. Because of these access and segregation of duty control deficiencies, IRS has limited assurance that its information resources are being protected from unauthorized access, alteration, and disclosure.

Although IRS took steps to correct some software vulnerabilities, control deficiencies with maintaining vendor supported software and installing appropriate security updates on certain databases and servers that support its financial systems continued to exist in fiscal year 2016. Such control deficiencies increase the risk that known information security vulnerabilities could be exploited. We also identified additional control deficiencies in IRS's processes for managing risk concerning its information systems. Specifically, in fiscal year 2016, IRS allowed certain systems to operate with uncorrected database control deficiencies, where the support for and approval of the risk-based decision to allow such operation was not sufficient. Unsupported risk decisions and failures to acknowledge existing risk by responsible officials reduces the effectiveness of IRS's risk management.

The cumulative effect of the control risks created by IRS's ongoing and new information security control deficiencies, while not collectively considered a material weakness, is important enough to merit the attention of those charged with governance of IRS and therefore represents a significant deficiency in IRS's internal control over financial reporting systems as of September 30, 2016. Continued and consistent management commitment and attention to an effective information security program will be essential to addressing existing deficiencies and continually improving its information system controls. Until IRS takes the necessary steps to address these unresolved recurring and newly identified control deficiencies, its financial reporting and taxpayer data will remain at increased risk of 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 RSI be presented to supplement the financial statements. Although 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 IDT, 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.[24]

Safeguarding Taxpayer Receipts and Associated Information

Although levels of electronic filing of tax returns have been steadily increasing, IRS faces an ongoing management challenge from the millions of hard copy tax returns and hundreds of billions of dollars in associated taxpayer payments it continues to receive and process 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.[25] 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 constituting a significant deficiency or material weakness either individually or in the aggregate, 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] It is critical that IRS continues to maintain the effective internal control necessary to appropriately mitigate the significant risk related to these receipts and associated taxpayer information, including ongoing monitoring to reasonably assure that the operating effectiveness of controls does not deteriorate over time.

[24] IRS's budgetary resources have declined approximately $900 million (7 percent) from fiscal year 2011, and its staffing has declined by about 12,000 full-time equivalents, or 13 percent, from fiscal years 2011 through 2016. IRS's full year appropriation for fiscal year 2016 was approximately $11.2 billion. Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, 129 Stat. 2242, 2428-30 (Dec. 18, 2015).

[25] 26 U.S.C. § 6103 states that all return and return information shall be confidential subject to certain limited exceptions.

[26] We have reported these control deficiencies and made 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, *Management Report: Improvements Are Needed to Enhance the Internal Revenue Service's Internal Controls over Financial Reporting*, GAO-16-457R (Washington, D.C.: May 18, 2016).

Preventing and Detecting Fraudulent Refunds Based on Identity Theft

IRS continues to face an ongoing management challenge associated with IDT tax refund fraud, which occurs when a perpetrator seeking a tax refund obtains an individual's identifying information, such as a Social Security number, and uses it to file a fraudulent tax return. IDT tax refund fraud burdens taxpayers because authenticating their identities is likely to delay processing of their legitimate tax returns and tax refunds. Given current and emerging risks, in 2015 we expanded the enforcement of tax laws high-risk area to include IRS's efforts to address IDT tax refund fraud.[27] According to IRS, it estimates that at least $14.59 billion in IDT tax refund fraud was attempted in calendar year 2015 of which it prevented at least $12.35 billion (85 percent). Of the amount attempted, IRS estimated that at least $2.24 billion (15 percent) was paid.[28]
IDT tax refund fraud takes advantage of the timing of IRS's compliance process. Because of pressures to issue tax refunds quickly, IRS issues tax refunds before completing all compliance checks and fully verifying the information on tax returns.[29] After the tax refunds are issued, IRS performs further validation of the information, which has enabled IRS to detect significant amounts of IDT tax refund fraud after the fact.[30] IRS has developed tools and programs to detect and prevent IDT tax refund fraud, including (1) using automated filters (IDT filters) to identify suspicious returns and confirm taxpayers' identities before issuing returns, (2) asking taxpayers whose returns are flagged as high risk by the IDT filters to authenticate their identities, and (3) issuing personal identification

[27]GAO, *High-Risk Series: An Update,* GAO-15-290 (Washington, D.C.: Feb. 11, 2015). GAO maintains a high-risk program to focus attention on government operations that it identifies as high risk because of their greater vulnerabilities to fraud, waste, abuse, and mismanagement or the need for transformation to address economy, efficiency, or effectiveness challenges.

[28]Because of the difficulties in estimating the amount of undetectable fraud, the actual amount could differ from these estimates.

[29]IRS informs taxpayers to anticipate their tax refunds generally within 21 days after filing and actively tries to meet this target. Further, IRS is required by law to pay interest if it takes longer than 45 days after the due date of the return to issue a tax refund. 26 U.S.C. § 6611(e). Therefore, IRS issues tax refunds after only doing some selected, automated reviews of the information the taxpayers submit to verify identity (e.g., name and Social Security number); filtering out returns with indicators of fraud, such as a mismatched name and Social Security number; and correcting obvious errors, such as calculation mistakes, and claims for credits and deductions exceeding statutory limits.

[30]Such 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.

numbers to IDT victims.[31] To further enhance IRS's ability to detect tax refund fraud, in December 2015, Congress passed legislation that will require employers to accelerate the Form W-2 (Wage and Tax Statement) filing deadlines to January 31 starting in calendar year 2017.[32] With earlier access to Form W-2 data, IRS could match and validate information reported on a tax return (e.g., wages and compensation) with information reported by a third party before issuing refunds. According to IRS, pre-refund matching would potentially save a substantial part of the billions of taxpayer dollars currently lost to perpetrators of IDT tax refund fraud.

IDT tax refund fraud is a costly problem that continues to evolve as perpetrators create new schemes in an effort to obtain fraudulent tax refunds despite IRS's ongoing efforts to identify and prevent this fraud. IRS recognizes that IDT tax refund fraud is a major challenge affecting the agency and has responded to the threat with new ways to combat it. However, evidence suggests that the agency's efforts in filing season 2015 may not have kept pace with the evolving threat of IDT tax refund fraud.[33] If IRS is to minimize the effects of IDT tax refund fraud on taxpayers and the associated loss to the federal government, IRS needs to continue to explore available options in order to effectively identify, design, and implement the most effective systems, processes, and internal controls for preventing and detecting IDT tax refund fraud.

Implementing Patient Protection and Affordable Care Act Tax-Related Provisions

PPACA included provisions to expand access to public and private health insurance, including the creation of health insurance exchanges, also

[31]For details on IRS's IDT tools for identifying and combating tax refund fraud, see GAO, *Identity Theft: Additional Actions Could Help IRS Combat the Large, Evolving Threat of Refund Fraud*, GAO-14-633 (Washington, D.C.: Aug. 20, 2014) and *Identity Theft and Tax Fraud: Enhanced Authentication Could Combat Refund Fraud, but IRS Lacks an Estimate of Costs, Benefits and Risks*, GAO-15-119 (Washington, D.C.: Jan. 20, 2015).

[32]Pub. L. No. 114-113, div. Q, § 201, 129 Stat. 2242 (Dec. 18, 2015). This change goes into effect for Form W-2s reporting 2016 earnings and filed in 2017.

[33]See GAO, *Identity Theft and Tax Fraud: IRS Needs to Update Its Risk Assessment for the Taxpayer Protection Program*, GAO-16-508 (Washington, D.C.: May 24, 2016), for a more detailed discussion of this and other challenges and risks.

known as marketplaces, in each state beginning in 2014.[34] IRS faces ongoing management challenges as a number of PPACA provisions continue to become effective, increasing the complexity of the nation's tax laws and IRS's responsibilities.[35] One requirement that became effective for tax year 2015 provides that applicable large employers must either offer minimum essential coverage of health insurance to their full-time employees or make an Employer Shared Responsibility Payment (ESRP) to IRS.[36] These applicable large employers are required to report information to IRS regarding minimum essential coverage offered to their employees.[37]

Implementing PPACA's tax-related provisions is a significant undertaking for IRS and requires extensive coordination, not only within IRS but also with multiple agencies and external partners.[38] For example, IRS must work closely with partner agencies, such as the Department of Health and Human Services' Centers for Medicare & Medicaid Services (CMS), to fully implement information systems that can share data among IRS, CMS, and other agencies. CMS has overall responsibility for key federal systems supporting Healthcare.gov, the website through which consumers access the marketplaces to shop for and enroll in private health insurance coverage. 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

[34]PPACA's provisions involve 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. The requirement for health exchanges is found at Pub. L. No. 111-148, §§ 1311(b), 1321(c), 124 Stat. 173, 186 (codified at 42 U.S.C. §§ 18031 (b), 1841(c)).

[35]PPACA was enacted in March 2010. While some provisions took effect immediately or retroactively, others will phase in through 2020.

[36]26 U.S.C. § 4980H. ESRP is a penalty imposed by law. Depending on an applicable large employer's decisions about offering minimum essential coverage to its full-time employees and their dependents, the applicable large employer may be subject to one of two ESRPs.

[37]26 U.S.C. § 6056.

[38]PPACA required the establishment of a health insurance exchange-referred to as a marketplace-in each state where eligible individuals can compare and select among insurance plans offered by participating issuers of health coverage. The Centers for Medicare & Medicaid Services is responsible for overseeing the establishment of these marketplaces, including creating a federally facilitated marketplace in each state that did not establish its own.

health plans, agents, and others, may also connect to systems that support enrollment in coverage offered through the marketplaces.

In addition to the necessary system coordination, IRS must work closely with CMS concerning PPACA-related payments. For example, while CMS management administers PPACA programs that process, approve, and calculate the monthly Advance Premium Tax Credit (APTC), Cost-Sharing Reduction (CSR), and Basic Health Program (BHP) payments to health plans for qualifying individuals,[39] IRS management is responsible for managing and administering the federal appropriations used to pay qualified health plans to cover the payments.[40] IRS is also responsible for processing and paying the Premium Tax Credit to taxpayers,[41] processing the Shared Responsibility Payment (SRP) which is paid to IRS by taxpayers,[42] and processing the ESRP received from applicable large employers. Further, IRS is responsible for the financial reporting of PPACA-related payment transactions.
IRS has developed a strategic approach to implement the tax-related provisions of PPACA; however, it has continued to face ongoing management challenges and risks. For example, because IRS relies on CMS for APTC, CSR, and BHP payment information, any deficiencies in CMS's controls over the payment information could adversely affect the

[39]APTC 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. CSR 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 CSR include co-payments and deductibles. BHP refers to health benefits coverage program for low-income individuals who would otherwise not be eligible to purchase coverage through the marketplace. See Pub. L. No. 111-148, §§ 1331, 1401, 1402, 124 Stat. 199, 213, 220. 26 U.S.C. § 36B sets forth the refundable credit for a qualified health plan.

[40]See 26 U.S.C. § 36B.
[41]Premium Tax Credit is generally available to help pay the cost of premiums for taxpayers and their dependents who have coverage through a marketplace but are not eligible for other health insurance, such as employer-provided coverage, and with household incomes from 100 percent to 400 percent of the federal poverty level, among other requirements. See 26 U.S.C § 36B. Individuals can choose to have the Premium Tax Credit paid in advance to their insurance companies, thus lowering their monthly premium payments or may claim all of the credit when they file their tax returns.

[42]Individuals must pay a penalty, known as the individual SRP, if they do not maintain certain levels of health care coverage for themselves and their dependents and do not qualify for an exemption. Individuals who owe SRPs are required to report the SRPs on their tax year 2014 tax returns, which were due in 2015. See 26 U.S.C § 5000A.

amounts reported on IRS's financial statements. Consequently, IRS must coordinate closely with CMS to reasonably assure that CMS has effective controls over the integrity of the payment information that it provides to IRS. IRS must also continually monitor CMS's controls and develop procedures to mitigate any risks to IRS's financial reporting. In addition, for tax year 2015, according to IRS, because of challenges taxpayers and employers faced in complying with the new and complex reporting requirements of PPACA, IRS did not always have sufficient information with which to verify (1) the health coverage exemption,[43] (2) whether taxpayers had duplicate health coverage,[44] and (3) whether the employer provided the required minimum essential coverage.[45]

These ongoing and new implementation and compliance difficulties are significant management challenges for IRS. Given the necessary coordination between IRS, CMS, and the marketplaces, until these challenges are fully addressed, IRS faces increased risk of receiving incomplete or inaccurate data from outside sources, which could affect the accuracy of PPACA-related payment amounts. Therefore, it is important for IRS to continue to work closely with the agencies and external partners involved in carrying out its responsibilities in order to improve the timeliness and accuracy of the information provided by those entities and continue to design and implement effective systems and processes to reasonably assure that valid and accurate PPACA-related payment amounts are processed.

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

In connection with our audits of IRS's financial statements, we 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

[43]Taxpayers may be granted relief from paying the individual SRP if they qualify for a coverage exemption. See 45 C.F.R. § 155.605. Taxpayers who qualify for a coverage exemption must submit Form 8965, Health Coverage Exemptions, to IRS.

[44]Individuals enrolled in subsidized exchange coverage who are found to be eligible for Medicaid are not permitted to be enrolled in both types of coverage under federal law. See 26 C.F.R. §1.36B-2(b)(5)(i).

[45]26 U.S.C. § 4980H.

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.

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 IRS's 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 2016 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 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, IRS stated that it was pleased to receive an unmodified opinion on its financial statements for the 17th consecutive year. IRS stated that it is dedicated to continuing to improve its financial management, internal controls, and information security. The complete text of IRS's response is reprinted in appendix II.

Cheryl E. Clark

Cheryl E. Clark Director Financial Management and Assurance

November 9, 2016

Accessible Text of Management’s Discussion and Analysis

Fiscal Year 2016
Management's Discussion and Analysis

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

IRS VISION, MISSION, AND ORGANIZATION

The Internal Revenue Service (IRS) is responsible for administering the nation’s tax system. In Fiscal Year (FY) 2016, the IRS collected more than $3.3 trillion in tax revenue. This revenue funds most government operations and public services. As stewards of the nation's revenue, the leadership and employees of the IRS continually work to ensure that the agency maintains an appropriate balance between taxpayer service and tax enforcement and administers the tax code with fairness and integrity.

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).

Employees

In FY 2016, the IRS employed, on average, approximately 85,000 people, including more than 16,000 temporary and seasonal staff.

Location

The IRS headquarters is located at 1111 Constitution Ave., NW, Washington, DC 20224. There are also approximately 540 offices in all states and territories as well as a few U.S. embassies and consulates.

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 (Specialized IRS units report directly to the Commissioner's Office)	**Deputy Commissioner for Services and Enforcement (Reports directly to the Commissioner and oversees the four primary operating divisions and other service and enforcement functions)**	**Deputy Commissioner for Operations Support (Reports directly to the Commissioner and oversees the IRS support functions, facilitating economy of scale efficiencies, and better business practices)**
Appeals Chief Counsel Communications and Liaison Equity, Diversity and Inclusion Research, Applied Analytics, and Statistics Taxpayer Advocate Service	Affordable Care Act Office Criminal Investigation Large Business and International Division Office of Online Services Office of Professional Responsibility Return Preparer Office Small Business/Self Employed Division Tax Exempt and Government Entities Division Wage and Investment Division Whistleblower Office	Agency-Wide Shared Services Chief Financial Office Human Capital Office Information Technology Office of the Chief Risk Officer Office of Planning, Programming, and Audit Coordination Privacy, Governmental Liaison and Disclosure Office of Procurement

Tax Statistics Highlights

FY 2016 Tax Stats At-a-Glance

IRS stats	Amount
Total Returns Processed	202 million
Total Returns and Other Forms Processed	244.9 million
Total Revenue Collected	$3.3 trillion
Enforcement Revenue Collected	$54.3 billion
Total Refunds and Outlays	$426 billion
Average Individual Refund	$2,795
E-File Rate – Individual	86.4%
E-File Rate – Business	50.0%
IRS.gov Page Views	1.9 billion
"*Where's My Refund?*" Usage	299.6 million
Number of Downloads from IRS.gov	121.5 million

FINANCIAL RESOURCES

The IRS's FY 2016 operating level was $11.2 billion, a $290 million increase over the FY 2015 enacted level. An administrative provision in the *Consolidated Appropriations Act of 2016*, Internal Revenue Service Administrative Provisions Section (§) 113, provided the additional funding. This increase was specifically for the IRS to achieve "measurable improvements in the customer service representative level of service rate, to improve the identification and prevention of refund fraud and identity theft, and to enhance cybersecurity to safeguard taxpayer data." With the additional funding, the IRS was able to achieve several successes in the designated areas, including improving the telephone level of service (LOS) to 72.1 percent during the 2016 filing season, and developing and deploying several new cybersecurity initiatives.

In addition to the annually appropriated budget, IRS funding also included $1.2 billion from user fees, offsetting collections, and unobligated balances from prior years. This raised the IRS's budget authority (discretionary and mandatory) to $12.4 billion.

Unfortunately, resource challenges remain for the IRS. The enacted level did not provide for about $200 million to fund increased labor requirements resulting from legislated employee pay raises as well as non-labor inflation. An additional $100 million was required for other mandatory labor increases, including career ladder promotions and step increases. The IRS absorbed these unfunded requirements by continuing to defer critical information technology (IT) infrastructure refresh, development, modernization and enhancement of IT systems, facilities projects, and by continuing to restrict attrition replacement resulting in further staffing level declines. The IRS staffing at the end of the year was about 15,000 fewer permanent employees than were on board in 2010.

The IRS's dwindling workforce is a very critical challenge made worse by the reduced budget, which is approximately $900 million below the fiscal year 2010 level. The IRS expects more than 34 percent of its workforce will be able to retire by 2019, creating a significant risk of a large knowledge and experience gap. Current resource constraints challenge the IRS to address this risk through efforts to hire new multi-generational staff. With a workforce of more than 85,000 employees, only 758 are of age 25 or younger. Without a sustained ability to hire a workforce with a greater projected longevity, the IRS will have great difficulty developing the leaders it will need five to ten years in the future.

The IRS has shouldered these losses all across the agency. The IRS full-time permanent workforce that has been lost since 2011 includes more than 6,200 key enforcement personnel (Revenue Officers and Revenue Agents). These employees include Revenue Agents and Revenue Officers who audit returns and perform collection activities; Special Agents in our Criminal Investigation division who investigate stolen identity refund fraud and other tax-related crimes; and other staff who engage in critical Compliance activities. The result of these losses has been a steady decline in the number of individual audits over the past six years. Last year, the IRS completed the fewest audits in a decade and the audit coverage rate in 2015 was the lowest since 2004. Audit revenue has continued to decline as well. Historical collection results suggest that the reductions to the IRS budget have resulted in the government forgoing more than $5 billion a year in enforcement revenue in order to achieve budget savings of a few hundred million dollars. For every $100 the government collects in taxes, we spend only thirty-five cents. This makes the IRS one of the most efficient tax administrators in the world according to the Organization for Economic Cooperation and Development (OECD). Similarly, additional investments in Compliance help to address the tax gap; or the difference between the amount owed to the government in taxes and the amount actually paid, currently estimated at $406 billion. In addition to weakening compliance programs, these cuts also create risk for the system of voluntary compliance.

The lack of funding to address the increased workload associated with identity theft, refund fraud, improper payments and resources needed to develop innovative tools to drive both the efficiency and effectiveness of these programs and continued changes in tax law legislation also weakens the IRS's ability to perform. For the past few years, the IRS has experienced an increased demand for IT projects and services, with significant resources going toward implementing largely unfunded legislative mandates passed since 2010. Some of the most recent being the Foreign Account Tax Compliance Act (FATCA), the Affordable Care Act (ACA), the Achieving A Better Life Experience Act (ABLE), retroactive extension of the Health Coverage Tax Credit (HCTC), and Private Debt Collection (PDC). This has severely affected the IRS's capacity to address other operational areas, including maintenance for newly deployed IT infrastructure. Since 2013, the IRS has incurred more than $95.5 million in increased annual requirements due to business systems modernization (BSM) deployments but has not received commensurate increases to the Operations Support appropriation. Ultimately, continued underfunding of the IRS threatens to erode its effectiveness and ability to be efficient.

Funding by Appropriations

($ thousands)

Taxpayer Services

[$2,333,376, includes §113 allocation of $176,822] funded staffing for the processing of tax returns and related documents, and assistance for taxpayers in filing returns and paying taxes due.

Enforcement

[$4,864,936, includes §113 allocation of $4,936] funded staffing for the 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 as well as other refundable tax credits.

Operations Support

[$3,746,688, includes §113 allocation of $108,242] funded overall planning, direction, operations management and control, and critical infrastructure activities for the IRS. These activities include IT and cybersecurity that keep tax systems running and protect taxpayer data, the financial management activities that ensure effective stewardship of the nation's revenues, and the physical infrastructure and security that helps keep IRS employees and customers safe and well served in our office, campus, and Taxpayer Assistance Center (TAC) sites. Telecommunications, human resource, and communications infrastructure are also critical components of this appropriation and are vital to maintaining adequate levels of customer service and the post-filing processes that ensure the tax system's fairness and equity.

Business Systems Modernization

[$290,000] funded capital asset acquisitions of IT systems to modernize key tax administration systems. (This three-year fund does not expire until FY 2018.) In addition to the core appropriations, the IRS had the following appropriations (special funds):

Other Resources: User Fees

[$379,124] from payment for services provided and *[$193,074]* from prior year balances brought forward October 1; **Offsetting Collections Resources** *[$123,570]*, **Unobligated Balance Transferred In (50% Carryover)** *[$16,712],* and **Unobligated Balances** *[$453,467]* 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."

Use of Resources ($)

Program	FY 2015	FY 2016
Taxpayer Assistance and Education	$636,587	$539,685
Filing and Account Services	$3,906,070	$3,938,665
Compliance	$7,672,207	$7,868,447
Administration of Tax Credit Programs	$153,872	$141,480

Taxpayer Assistance and Education activities [*four percent*] include taxpayer education and outreach, tax publication issuance and distribution.

Filing and Account Services activities *[32 percent]* include filing tax returns, maintaining customer accounts, processing taxpayer information, providing service to taxpayers, and resolving issues.

Compliance activities *[63 percent]* include pre-filing agreements, document matching, examination, collection, and criminal investigation activities.

Administration of Tax Credit Programs *[one percent]* primarily includes costs for EITC program activities.

In addition to the EITC, which is the single largest refundable tax credit program, the IRS also administers numerous other refundable and non-refundable tax credit programs. The IRS Financial Statements reflect those tax credits and the associated costs.

THE IRS STRATEGIC PLAN AND FUTURE STATE VISION

IRS Strategic Plan

The IRS 2014-2017 strategic plan provides a unified direction for the attainment of the IRS 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 primary strategic goals align to the service and enforcement areas.

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

Taxpayer Service: Deliver high quality and timely service to reduce taxpayer burden and encourage voluntary compliance.

Enforcement: Effectively enforce the law to ensure compliance with tax responsibilities and combat fraud.

Future State Vision

Even as the IRS continues to strive for success within the architecture of the current strategic plan, the IRS is looking toward the future and the development of a new strategic plan that will encompass the challenges and opportunities of tomorrow. The IRS is envisioning its Future State in which it would provide a more integrated delivery of services to taxpayers through efficient customer-focused channels similar to those of other financial institutions.

Delivering top-quality service to America's taxpayers requires the IRS to catch up with and meet those same expectations American consumers have of instantaneous service from, and transactions with, their banks, lenders, and brokers. The IRS Future State includes using capabilities proven in the private sector, enabling taxpayers to operate seamlessly in a digital and global environment with the ability to interact with the IRS as they do with financial services and insurance companies. This requires the IRS to invest in the right IT building blocks to deliver services and enforcement actions efficiently and effectively and attract tomorrow's workforce and give them the tools they need to do their jobs effectively.

The IRS is streamlining its compliance program to identify and resolve issues more quickly. In addition, with the §113 funding received this year, the IRS continues to administer the tax system and make new investments to keep pace with technology, taxpayer expectations, and criminal activity related to stolen identity/refund fraud, and preventing cyber-crime.

In order to achieve this Future State of tax administration, the IRS established six strategic themes and one focus area to guide its strategy and resource allocation. These themes align with existing Strategic Goals. The themes are:

- Facilitate voluntary compliance by empowering taxpayers with secure innovative services, tools, and support
- Understand non-compliant taxpayer behavior, and develop approaches to deter and change it
- Leverage and collaborate with external stakeholders

- Cultivate a well-equipped, diverse, skilled, and flexible workforce
- Select highest value work using data analytics and a robust feedback loop
- Drive more agility, efficiency, and effectiveness in IRS operations

The focal area for the Future State is:

- Strengthen cyber defense and prevent identity theft

By leveraging these themes and the focal area, the IRS seeks to transform its operations by modernizing the taxpayer experience and empowering IRS employees to operate more efficiently. Taxpayers and the tax administration system will benefit when filing is simpler and voluntary compliance increases. Targeted outcomes for the Future State initiative include:

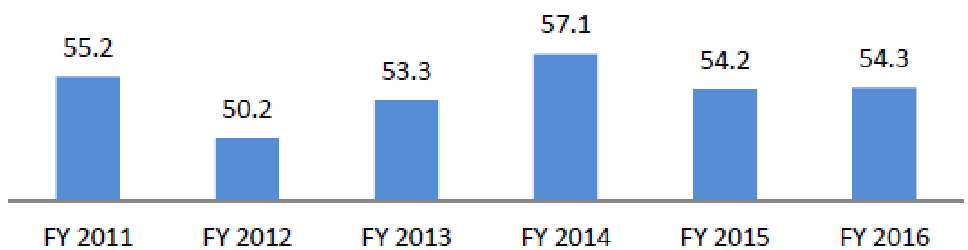
- Taxpayers are able to find information quickly and efficiently
- Taxpayers are able to adjust accounts independently
- Cases are resolved more quickly, usually within one year of filing
- Taxpayers have a high rate of compliance year after year
- Employees are highly engaged in and equipped for their work
- Taxpayers are satisfied with their IRS interactions

The Future State envisions a tax administration system where taxpayers connect with the IRS through proactive communication and outreach channels during pre-filing, where taxpayers are independent and empowered during the filing process as they utilize secure online channels for adjustments and corrections, and when taxpayers receive timely resolution of issues through point-of-filing error detection and early notification. But, at the same time, the IRS recognizes and welcomes its responsibility to deal with all taxpayers, no matter how they want to communicate with the agency. While most taxpayers have shown a desire to handle much of their communications with us digitally, some may not have access to the necessary technology or be comfortable with on-line activities. The IRS will continue to be available to those taxpayers through the phone or in person.

PERFORMANCE SUMMARY

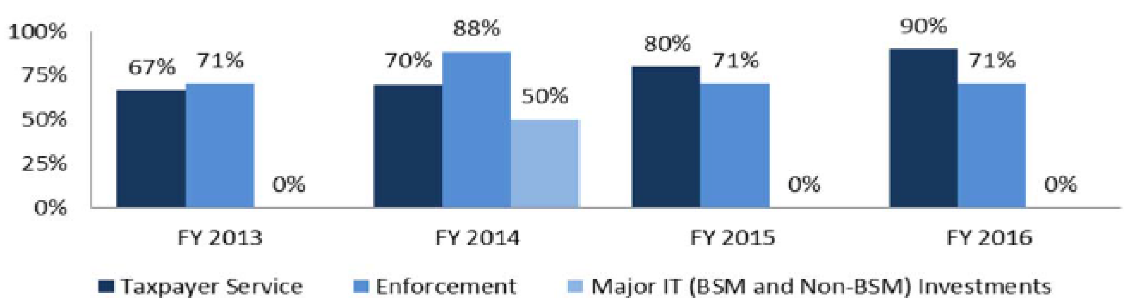
Enforcement of the tax law is an integral part of the IRS effort to enhance voluntary compliance, especially as tax administration becomes increasingly complex. The IRS has maintained a balanced enforcement program despite many challenges, collecting more than $54.3 billion in enforcement revenue in FY 2016. The volume of collections is in part due to IRS efforts, but is also partly a reflection of the strengthening economy.

IRS Enforcement Revenue Collected ($ Billions)



In FY 2016, the IRS met or exceeded the targets for 21 of its 29 performance measures for an overall success rate of 72 percent. Detailed information on performance measures is contained in Appendix A, Performance Measures Descriptions; Appendix B, Performance Measurement Data; Appendix C, Explanations of Shortfalls; Appendix D, Long-Term Measure Definitions; and Appendix E, Long-Term Measure Data.

Actual Performance Measures (percent met or exceeded Target



The IRS continuously looks for ways to increase compliance. The gross tax gap is the difference between true tax liability for a given tax year and the amount that is paid on time. It is comprised of the nonfiling gap, the underreporting gap, and the under-payment (or remittance) gap. The net tax gap is the portion of the gross tax gap that cannot be recovered through existing compliance or enforcement activities, or other late payments.

In FY 2016, the IRS released updated tax gap estimates covering tax years 2008-2010. The analysis found no significant change in the tax gap or in the rate of compliance since issuance of the last report for tax year 2006. The 2008-2010 average annual tax gap is $458 billion, compared to $450 billion for tax year 2006. IRS enforcement activities and late payments resulted in an additional $52 billion in tax paid, reducing the net tax gap for the 2008-2010 period to $406 billion per year. The current estimated voluntary compliance rate is 81.7 percent compared to the prior estimated rate of 83.1 percent. After accounting for enforcement and late payments, the net compliance rate is 83.7 percent. These updated estimates provide the IRS with a current assessment of the nature and extent of noncompliance for use in formulating tax administration strategies. Improvements in methods and data enabled the estimation of the net tax gap by type of tax and provided for a separate estimate of the individual income tax underreporting gap attributable to errors in filing status.

The IRS gains further understanding of compliance through its National Research Program (NRP). The NRP analyzes 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. Using data from the NRP individual income tax reporting compliance study, the IRS updated and implemented IRS Discriminant Function (DIF) models. The updates implemented for processing year 2016 are the latest in a series of updates to DIF models made possible because of new data available annually from NRP. The IRS expects that these improved models will reduce the selection for audit of compliant taxpayers, thereby focusing limited examination resources on returns with noncompliance, particularly returns with larger expected tax changes. The result will be an overall reduction in the number of audits for fully compliant taxpayers while ensuring that problematic returns receive the necessary amount of scrutiny.

The IRS conducts research studies and analytics on behavioral responses to IRS taxpayer service operations and enforcement activities and provides measures of taxpayer compliance and the tax gap. For example, in FY 2016, the IRS developed an Offer in Compromise (OIC) Simulation Model to determine how changes to the OIC program affect the taxpayer experience. The OIC is an important program that allows taxpayers to settle tax debts for less than the full amount owed. The intent of the OIC Simulation Model is to provide the IRS with a flexible and responsive decision support and planning tool capable of assessing the effect of changes to the OIC program (such as change in resources, routing of workload, trends in offer characteristics, etc.). The OIC Simulation Model will simulate offers from receipt to disposition as well as how offers evolve over time within the OIC process.

PERFORMANCE GOALS, OBJECTIVES, AND RESULTS

The IRS strives to deliver a high level of performance in both taxpayer service and enforcement of the tax laws to ensure everyone meets his or her obligation to pay taxes. The IRS Operations Support function provides the strategic foundation necessary to accomplish the taxpayer service and enforcement strategic goals. Strategic foundation investments include enhancing IT systems, processes, and tools to improve IRS efficiency and productivity; using data and research across the organization to make informed decisions and allocate resources; ensuring the safety and security of our employees; and providing our employees with excellent technology systems, processes, education, and tools.

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 mission and goals, the IRS must invest in a skilled workforce, efficient processes, and innovative, secure technology. The IRS strategic foundation delivers the internal programs required to support taxpayer-facing actions.

In FY 2016, the IRS invested in innovative technology to expand core capabilities, developed and empowered current employees by focusing on knowledge management, developed leadership training, continued efforts to protect taxpayer data, developed program efficiencies, and ensured operational readiness.

Strategic Foundation Facts

The IRS takes pride in its ability to administer the Tax Code each filing season, and the strength of IRS IT systems and applications are a substantial reason for its ongoing success. The Customer Account Data Engine 2 (CADE 2) is the IRS's IT modernization investment and implements fundamental changes to the core IRS business systems. It is the IRS's single database taxpayer account processing system; it defines the target-state architecture for managing individual taxpayer accounts and leads the transition to the data centric vision for tax administration. The CADE 2 project is accountable for managing and integrating all the required components of modern business operations including: enhancement projects, new and legacy applications, business processes, organizational changes, and policy and procedure modifications.

The IRS's most significant IT-related achievements in FY 2016 include the following:

- CADE 2 posted more than 149.1 million returns and issued more than 114.7 million refunds totaling more than $312.5 billion.
- The ACA Information Returns (AIR) system processed more than 126,000 Forms 1094- B, *Transmittal of Health Coverage Information Returns* and more than 108 million Forms 1095-C, *Employer-Provided Health Insurance Offer and Coverage Insurance*, submitted for the first time as required by the ACA.
- Increased activities to mitigate vulnerabilities to systems and preemptively address security threats.

Investments in IT services and solutions to improve efficiency and productivity are crucial to the IRS's success. In FY 2016, the IRS implemented several enhancements to CADE 2, which included:

- **Integrated Production Model Phase 1** - Established an Operational Data Store, which is an IRS data warehouse designed to accumulate taxpayer data and make it available to organizations across the IRS for internal projects such as recovering unpaid taxes, identifying tax fraud schemes, and the ACA program.
- **Pending Payments Transactions Phase 1** - Delivered pending payment transactions to multiple IRS systems to adjust the taxpayer's unpaid assessment balance by the pending payments for evaluation purposes.
- **Database Conversion** - Expanded the system to retain taxpayer history from the previous tax season, allowing the IRS to more effectively make year-to-year comparisons for auditing and analytical purposes.
- **Penalty and Interest Adjustable Refundable Credit** - Provided capabilities to compute consistent penalty and interest for refundable credits.

The IRS recognizes its workforce as its most important resource. Dedicated, talented employees with a strong history of successful execution are what propel the success of the IRS. By providing enhanced training and tools to all employees and developing future leaders, the IRS helped its workforce better serve taxpayer needs and guide the next generation of IRS employees.

Knowledge Management

The IRS developed strategies for a Servicewide approach to knowledge management solutions based on best practices of organizational programs worldwide, with a goal of promoting collaboration, knowledge capture before attrition, data sharing, and building expertise across the IRS. These planned strategies included:

- A centralized online content repository (virtual library and video library) to capture and transfer best practices from an experienced workforce in real time, promoting cross collaboration on mission-critical job resources, and providing consistency in messaging
- A learning portal designed to consolidate various resources into a one-stop site for all aspects of training, course development, curriculum development, and career enhancement
- A robust corporate interactive platform to identify and transfer knowledge and expertise across the IRS

Another IRS knowledge management effort established Practice Units. Practice Units are electronic documents contained in a virtual repository that focuses on specific international tax transactional scenarios and topics commonly encountered by examiners, taxpayers, and practitioners. The IRS developed Practice Units through collaboration between IRS technical personnel, examiners, counsel attorneys, and management. They are a means for collaborating and sharing knowledge among IRS employees and serve as both job aids and training materials on international tax issues. Practice Units provide information for those who are new to particular issues, as well as guidance to assist in the identification of issues, and therefore helped to cultivate a well-equipped, diverse, skilled, and flexible workforce. The IRS published 132 Practice Units, which are available on IRS.gov for public viewing and the solicitation of feedback. Practice Units are not official pronouncements of law or directives and cannot be cited or relied upon as authoritative guidance; however, taxpayers and tax practitioners often use these units to enhance their understanding of tax compliance issues encountered in the context of a tax audit. The topics cover inbound and outbound international transactions and issues, such as:

- Foreign Entities
- Offshore Arrangements
- Foreign Tax Credits
- Jurisdiction to Tax
- Withholding
- US Business Activities
- Repatriation
- Transfer Pricing Operations

Leadership Development

With IRS attrition rates increasing, leadership succession planning and development activities are essential to maintaining highly qualified and well-trained leadership. Despite the difficult funding environment, the IRS supported several efforts to maintain access to sources of high- caliber talent and to prepare leaders to lead complex organizational structures across the IRS.

In 2016, the IRS continued support of its automated Leadership Succession Review (LSR) planning process, providing managers an opportunity to identify potential leaders at all management levels. This process allows the IRS to prepare for business continuity at each leadership level and to address organizational needs in a timely, efficient manner. An LSR assessment is required as part of the application for managerial positions, details, and readiness programs. LSR participation for FY 2016 reached 14,022 completed assessments representing potential future successors for the 8,098 current managerial positions in the IRS.

The IRS created its own internal leadership coach-training program, resulting in the design and delivery of a comprehensive virtual coach-training program. This program is the only federal internal virtual coach-training program in government. The IRS shared this program with other federal agencies including the Peace Corps, the Department of Defense (DOD), the Department of Health and Human Services, the Environmental Protection Agency, the Transportation Security Administration, and the Office of Personnel Management (OPM), which recognized it as a best practice. In 2016, the IRS leadership-coaching cadre serviced 111 internal leadership clients. Sixty-six IRS employees received coaching from internal IRS coaches and 45 received coaching by external coaches. In total, 20 IRS coaches delivered 518 hours of internal coaching.

One of the IRS's key defenses against the loss of taxpayer data is to maintain a trustworthy, suitable workforce. In FY 2016, the IRS conducted suitability reviews to ensure new and existing federal and contract personnel who accessed IRS systems and data met and maintained the high standards established by Congress, the OPM, and the IRS. The IRS determined employment suitability by analyzing sufficient identifiable character traits and conduct to decide whether a new or existing employee would or would not protect the integrity or promote the efficiency of the IRS. FY 2016 suitability review activities included:

- Completion of 13,500 pre-employment suitability cases for IRS applicants and contractors (prior to giving access to sensitive data, systems, or facilities).
- Adjudication of more than 7,300 full investigations conducted by OPM.
- Completion of more than 11,000 Federal tax compliance checks on contractors; which resulted in an initial compliance rate of 95.1%. An additional 2.3% became compliant after being contacted by the IRS. Of the non-compliant contractors, IRS revoked the access of 176 contractors, removing their ability to access IRS systems, data, and facilities.

The IRS continued efforts to realize operational efficiencies and effectively manage costs by improving enterprise-wide resources and streamlining processes.

Other than payroll, rent is the IRS's largest operating expense; therefore, the IRS continued to identify opportunities to reduce the high cost of rent and improve usage of office space across the country. In FY 2016, the IRS completed 61 projects to release more than 558,000 square feet of rented space from inventory for an annual rent savings of about $16 million. As part of a more aggressive effort to contain costs and improve space usage, the IRS developed the Strategic Facility Plan process, which focused on closing or consolidating workspace at the time of lease expiration. Through the Strategic Facility Plan, the IRS is considering closure or consolidation of 100 offices.

The IRS also continued program efficiencies through the Lean Six Sigma (LSS) process. The IRS applied the LSS methodology to implement techniques to streamline, standardize, and improve the speed and quality of scanning forms and correspondence received from taxpayers. Due to regulatory changes related to the depreciation of tangible property, filings of Form 3115, *Application for Change in Accounting Method,* increased almost thirtyfold. The LSS methodology enabled the IRS to process about 562,000 Forms 3115, up from an average of 20,000 forms processed in prior years. The IRS scanned these forms and captured data from them in a usable database, resulting in increased usability of data by internal stakeholders.

To ensure the IRS remains in a constant state of readiness, the IRS conducted continuity of operations exercises testing organizational readiness in response to emergency events. These exercises allow the IRS to test its ability to support and render services to taxpayers by ensuring the three mission essential functions, Processing Tax Returns, Processing Remittances, and Processing Refunds, remain operational during an emergency event. Exercises centered not only on natural disasters (hurricanes, tornadoes, earthquakes, wild fires, etc.) but also man- made disasters (bombs, biohazard situations, riots, etc.) that could affect IRS operations. The continuity exercises required extensive coordination with IRS leadership and assessed continuity readiness at all levels of the organization.

Strategic Foundation Missed Opportunities

While the IRS was able to make significant progress in achieving Strategic Foundation objectives, reduced funding levels undercut the IRS's ability to improve IT, human capital, and operating efficiencies.

The IRS had significant plans to invest in people, hardware, and software to improve IT at all levels of the organization. Budgetary limitations have diminished the IRS's ability to accomplish those plans, putting the stability and reliability of IRS IT systems at risk.

Continued lack of funding for refreshment of the IRS's IT infrastructure further increased operational risks. The IRS's base infrastructure components need to be refreshed in order to run tools, updates, fixes and vulnerability protections to ensure a clean filing season and mitigate emerging threats. Approximately 50 percent of the IRS's hardware inventory is aged, with some inventory three to four times older than industry standards. The IRS should be spending about $180 million each year to reduce the aged backlog and to minimize the operational risks that the aging infrastructure poses to tax administration. However, budgetary cutbacks limited such expenditures in 2016 to $121 million, which includes $51 million that was not a part of the FY 2016 appropriated base budget, the largest portion being from the security supplemental. Thirty-two percent of the software products in the IRS's primary filing season systems infrastructure are two or more releases behind the latest versions. Without adequate funding to address the aged and aging mission-critical components of the infrastructure, the IRS's tax administration systems and cybersecurity efforts become increasingly vulnerable.

Components of the infrastructure and systems are interrelated and interdependent causing a ripple effect making outages and failures unpredictable and widespread. Deficits in infrastructure refresh and replacement are being realized with increased outages, increased support costs, and increased dependency on contractors for support. Specifically, the IRS realized a 53 percent increase in the number of trouble tickets for non-filing season systems over the past two years. With cyberattacks and other fraud proliferating in numbers and sophistication, delays in infrastructure refresh and replacement yield increased risk to the personally identifiable information of Americans. Despite resource challenges, the IRS's core tax processing systems remain secure, currently withstanding more than one million malicious access attempts each day.

Lack of funding for IT modernization efforts is putting key programs at risk, such as CADE 2 and FATCA. Without funding to obtain sufficient staff, the IRS was unable to define and implement several current business processes and applications in CADE 2 and was unable to fully deliver and ensure the success of the FATCA program. Annual spending on new Unfunded Mandates has increased from less than $1 million in FY 2011 to $353 million in FY 2016. Unfunded and underfunded legislative mandates, such as the ACA, the FATCA, ABLE, the Health Coverage Tax Credit (HCTC), and Private Debt Collection (PDC) required the IRS to use approximately

$1.3 billion in funds from FY 2013 to FY 2016 that would have otherwise supported the operation and maintenance of existing programs, including refreshing the aging infrastructure. In fact, the IRS spent $353 million on unfunded mandates in FY 2016, which accounted for nearly 16 percent of the overall non-BSM IT spending. FY 2017 requires another $356 million for unfunded mandates.

With internal operations for about 85,000 employees at more than 540 locations, the IRS needed to modernize its communications infrastructure. The IRS established a shared infrastructure that unified voice and data, which resulted in reduced operational costs and improved operational efficiency. The IRS completed about 90 percent of the installations; however, a lack of funding caused the IRS to postpone the remaining installations. As a result, the IRS faces increased maintenance costs on aging equipment, and an increased risk of outages in a large-scale voice service system.

The IRS strives to cultivate a well-equipped, diverse, skilled, and flexible workforce to support America's taxpayers. Unfortunately, inadequate funding and limited resources hindered the IRS's ability to advance key human capital programs, such as workforce planning and performance management.

Budget constraints prevented the IRS from implementing the OPM's mandate to convert employee official personnel folders from paper to electronic official personnel folders (eOPF). An additional $15.4 million would have allowed the IRS to convert about 85,000 current employee official personnel folders from paper files to an eOPF version to comply with the OPM mandate.

The reduced budget continued to restrict hiring throughout the IRS. In FY 2016, the IRS lost 380 IT personnel, many of whom were experts that are not easily replaceable, such as Cybersecurity Specialists, who protect the nation's tax systems against system vulnerabilities, and other high-level critical IT positions. Cyber threats posed a strategic, economic, and security challenge to our nation, creating a national necessity to develop a highly capable cybersecurity workforce. In collaboration with the Department of the Treasury, the IRS engaged in the Federal Cybersecurity Workforce Strategy initiative, which elevated a risk-based decision document to the OPM to review its current guidelines and standards and to generate the flexibility needed for an agile and timely hiring process, including retention incentives.

Unfortunately, without additional hiring flexibility, this remains an area of high risk for the IRS. The Restructuring and Reform Act of 1998 granted the IRS use of the Streamlined Critical Pay (SCP) authority to appoint individuals with an extremely high level of expertise to executive-level administrative, technical, and professional positions that are critical to accomplishing an important project or program. This authority allowed the IRS to designate up to 40 SCP positions at a time; however, the authority expired on September 30, 2013. Losing this critical hiring flexibility has made it extraordinarily difficult to recruit and retain highly skilled and sought- after executive talent from both internally within the federal government and private sector. The IRS has already lost a number of executives supported by streamlined critical pay, including the agency's Chief Technology Officer, its architectural design leader, and its leader in cybersecurity. The IRS currently has 10 remaining SCP appointees whose appointments expire on or before September 30, 2017, which puts the IRS at risk of losing these appointees to the private sector. Losing this level of executive talent is extremely detrimental to the IRS's mission and causes significant delays to major project milestones. Amongst the most vulnerable disciplines are IT Architecture, IT Engineering, Cybersecurity, and Risk Management.

The IRS faced resource challenges restarting moderate-risk background reinvestigations of continuing employees, which are required every five years. On May 1, 2016, the OPM began employing new investigative techniques, which increased the cost for each moderate risk reinvestigation from $372 to $1,204.

Budget constraints also have impeded progress on the IRS rent reduction initiative. An investment of $19 million would have allowed the IRS to reduce its footprint through building closures, consolidations and space releases. This additional funding would have allowed the IRS to support moving expenses such as excessing or realigning furniture, making alterations, and moving telecommunications, security wiring, and equipment; ultimately releasing 726,641 square feet of rented space. The release of this space in future years would have resulted in an annual cost savings of $23.6 million.

TAXPAYER SERVICE

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

Providing high-quality service to taxpayers is crucial to ensuring confidence in the tax system and enabling taxpayers to manage their tax responsibilities as efficiently as possible. In

FY 2016, delivering excellent service, reducing taxpayer burden, and helping taxpayers understand and meet their tax obligations remained top priorities for the IRS.

Highlights of the 2016 Filing Season

Through months of planning and collaboration with key stakeholders, the IRS delivered another successful filing season - opening on time on January 19, 2016. The slight budget increase in FY 2016 enabled the IRS to increase staffing for taxpayer telephone service operations to address demand and provide a higher LOS during the filing season.

Prior to the filing season, the IRS finalized revisions to 635 tax products, which included analyzing the tax provisions associated with the Protecting Americans from Tax Hikes (PATH) Act of 2015 and implementing more than 400 required changes to more than 150 different tax products. Results of the 2016 filing season included:

- Delivered a filing season telephone LOS of 72.1 percent, a substantial improvement over the 37.4 percent delivered in the FY 2015 filing season

- Answered more than 13.1 million calls, an increase of 5.3 million calls more than the prior filing season. The average speed of answer was 11 minutes, compared to a wait time of 23 minutes in the prior year
- Received more than 136.5 million individual returns, 1.7 percent more than last year. Electronically filed returns increased by 2.6 percent and accounted for 89.8 percent of the returns filed
- Received more than 29.9 million business returns, 3.2 percent more than last year. More than 17.5 million returns were filed electronically, an increase of 7.6 percent from the prior year
- Issued more than 97 million refunds for a total of $263 billion with an average refund of $2,711, 83.7 percent of which took advantage of direct deposit

In FY 2016, the IRS provided millions of taxpayers valuable services, which made it easier for them to participate in the tax system. The IRS:

- Received almost 2.5 million Free File returns
- Provided Volunteer Income Tax Assistance (VITA) training to 596 overseas military personnel who assisted with the preparation of more than 158,490 military VITA returns
- Assisted more than 20,000 taxpayers with issues related to the ACA, an increase of 55.5 percent from the prior year
- Expanded the number of eBook tax products available to 99, up from 17 in 2015. An eBook is an electronic format of existing PDF and HTML tax publications readable by mobile devices such as tablets, e-readers, and smartphones. Taxpayers downloaded nearly 86,000 eBooks in FY 2016

Quality taxpayer service remains a priority for the IRS, and in FY 2016, the IRS continued its collaboration with state taxing authorities, volunteer groups, and other organizations.

Earned Income Tax Credit

The EITC is one of the federal government's largest benefit programs, providing help to low and moderate-income wage earners. In FY 2016, the IRS reached out to taxpayers eligible for this tax credit through its 10th Annual EITC Awareness Day. Through collaboration with IRS national, state, and local partners as well as Congressional and government officials, the IRS held more than 240 local events, resulting in media coverage that helped spread the word about the EITC tax credit. The IRS also held interviews in English and Spanish with more than 1,500 radio stations and 480,000 newspapers sharing the interviews. Social media continues to be a good way to reach the EITC audience and this year the IRS used a new social media tool, Thunderclap.

Thunderclap is a crowd-speaking social media platform that allows individuals and organizations to rally supporters to spread a message through each of their social media accounts. The IRS gained support from 250 IRS partners and stakeholders to promote an EITC Thunderclap, which the IRS released on EITC Awareness Day. The Thunderclap message blasted out automatically on the social media platform of each organization and person that supported it, which in turn reached every one of their friends and followers at the same time, potentially reaching more than one million people. Use of Thunderclap resulted in more than 1,500 individuals accessing the main EITC page on IRS.gov.

Tax Preparation Services

Each year, the IRS and its partners provide free tax assistance to the elderly, disabled, and limited English proficient individuals and families at VITA and Tax Counseling for the Elderly (TCE) sites. During the filing season:

- Partners prepared more than 3.67 million tax returns at nearly 12,000 VITA/TCE sites, compared to more than 3.61 million returns last year.
- The VITA/TCE return e-File rate increased to 98.8 percent, while the Return Preparation Accuracy rate increased to 94.6 percent, both exceeding FY 2016 goals and last year's rates.
- The IRS conducted field site visits and remote site quality reviews on more than 20 percent of the VITA/TCE sites. Quality results were attributable to several factors, such as program familiarity, consistency in processes, and thousands of committed, well-trained volunteers, including the more than 140 dedicated IRS employees who serve as VITA volunteers.

Taxpayer Assistance Centers

While the IRS continued to support traditional services from its national TAC walk-in sites, in FY 2016, the IRS improved upon traditional means of taxpayer service by expanding the use of appointments. On-site contacts and resulting wait times at TACs decreased as the IRS continued to roll out the appointment service to 310 TAC sites and 24 virtual sites located in external partner offices. The IRS increased the appointment service to some of its busiest TACs, which alleviated many taxpayer and Congressional concerns about long lines. The appointment service also provided the IRS with the opportunity to advise taxpayers of what documentation they need to bring with them to the meeting when they call for an appointment.

The appointment service enabled the IRS to realize a significant reduction in taxpayer wait time, with more than 91 percent of customers receiving service within 30 minutes. Wait times on the TAC appointment line averaged over five minutes, and more than 52 percent of taxpayers who called to make an appointment had their issues resolved during the call without the need to make an appointment. This allowed the IRS to reserve face-to-face service for more complex issues. As a result, appointment service has significantly reduced taxpayer burden by eliminating the need for time and travel to IRS offices.

In addition, the IRS met taxpayer demand for technology-driven services by expanding the Virtual Service Delivery (VSD) project. VSD is one of the early steps in providing a safe, secure environment for taxpayers to get service in a face-to-face setting without visiting a TAC. Through VSD, taxpayers are able to interact with live assistors located in a different geographic location via an IRS computer. Previously, the IRS used VSD primarily to provide service in TACs with limited or no staffing. Now, through collaboration with community partners, the IRS is using VSD to provide face-to-face opportunities to more taxpayers in rural geographic areas.

Collaborating with trusted community partners, the IRS increased the number of partner locations with VSD capability from 11 to 24, expanding face-to-face service to taxpayers in non- TAC locations.

Web-Based Services

IRS.gov continued to be the primary method for providing tax information and services to taxpayers. The IRS enhanced existing online and self-help service options by increasing the amount of tax information and services available to taxpayers through IRS.gov. Self-service applications on IRS.gov enabled taxpayers to exchange information online with the IRS, decreasing service requests from higher-cost channels, such as telephone assistance.

IRS.gov ensures the public has access to current and accurate IRS information with near real-time updates of more than 140,000 forms, publications, news items, rules, and articles. IRS web services infrastructure continues to support IRS.gov, which has maintained 100 percent availability for public access and use since 2012. Compared to FY 2015, IRS.gov experienced:

- More than a 2.5 percent increase in overall website visits
- An 18 percent increase in mobile and tablet website visits with a 13 percent increase in page views
- A 35 percent increase in the use of the web-based Online Payment Agreement (OPA) application
- More than 190 million “Where's My Refund?” Web inquiries
- More than 7.7 million “Where’s My Amended Return?” Web inquiries
- More than five million users of the IRS2Go application, with more than 97 million sessions

The IRS implemented advanced security capabilities for all IRS.gov applications to provide protection from various, ever-expanding cyber-attacks and exploits. These capabilities will detect and block criminal access as well as perform analytics to identify and assess vulnerabilities leading to the development and implementation of risk mitigations.

In FY 2016, taxpayers viewed IRS.gov web pages more than 1.7 billion times, using the website to retrieve tax information and to gain access to applications and products. The IRS developed and launched several web and mobile tools allowing taxpayers and third parties to communicate and transact with the IRS, including:

- **IRS Direct Pay application** - The IRS Direct Pay is an electronic application available on IRS.gov for individual taxpayers to use at no charge to make payments on their federal tax obligations from their bank account. Improvement efforts included responsive design to ensure the application performed as intended on desktop computers and mobile devices, browser support, and additional tax types such as civil penalty; and the introduction of Heartbeat Monitoring, an application that allows for quick identification and resolution of system problems. The IRS Direct Pay volumes increased to 8.6 million payments (53 percent) and dollars increased by $30.5 billion (61 percent) for FY 2016.
- **PayNearMe** – PayNearMe is a new cash payment option on IRS.gov for individual taxpayers who prefer to pay their taxes with cash. This secure cash payment method converts cash payments to electronic transactions through retail partners. Taxpayers can make payments of up to $1,000 per day at participating retail stores for a convenience fee of $3.99. External publicity began late in the filing season, and in the early stages, the IRS received 182 payments for a total of about $82,000 through this new service.
- **Online Payment Agreement application -** The Online Payment Agreement (OPA) application is an easy, safe, and secure process that reduces taxpayer burden by providing qualified taxpayers, or their valid representatives, the ability to establish a payment agreement online and receive immediate notification of approval without having to

call, write, or visit an IRS office. The average time to complete an online agreement was 10 minutes. In FY 2016, OPA accounted for about 12 percent of total Installment Agreements with more than 556,000 total completions.

- **Web Chat Feature** - The IRS launched a web chat feature on IRS.gov for tax return preparers seeking general information about Preparer Tax Identification Number (PTIN) requirements and the registration process. This new communication channel provided a convenient and cost-effective way to get real-time support for general PTIN inquiries. In FY 2016, Web Chat:
  - Was used more than 17,400 times
  - Achieved an average level of service of 93 percent with an average chat time of eight minutes
  - Referred 37 percent of the chats to the PTIN telephone line
- **Get Transcript Re-launch** - The IRS re-launched the Get Transcript Online application, which provides a current digital display and the ability to print an individual's tax record across five transcript types using electronic authentication. The IRS redesigned the Secure Access e-Authentication process, which required multi-factor remote authentication techniques applied to web applications requiring "high confidence in the asserted identity's validity." The IRS also raised the risk assessment level of the Get Transcript Online application from moderate to high to reflect more accurately the risk demonstrated during the previous unauthorized accesses. The re-launch of the Get Transcript Online application with Secure Access e-Authentication protections allowed more than 524,000 taxpayers to complete the Secure Access e-Authentication process and view more than 3.7 million online transcripts. While this was lower usage than with the prior authentication protocols, the new Secure Access protections focused on the security of the initial identity verification and two-factor authentication for returning users, which resulted in fewer taxpayers completing the process. Taxpayers continued to have the options of obtaining transcripts through other online and telephone self-service channels.

The IRS also resolved a critical need to provide the online filing tool for Form 990-N, Electronic Notice (e-Postcard) for Tax-Exempt Organizations Not Required to File Form 990 or Form 990.

Future State for Taxpayer Experience

The envisioned Future State is highly reliant on efficient interactions between the IRS and taxpayers and those who support them in discharging their tax responsibilities. This ultimately involves taxpayers being able to interact with the IRS through their own secure online tax account, including self-correcting errors or omissions. While, over the years, the IRS has increased online offerings from electronic filing to IRS.gov to applications such as "Where's My Refund?" and OPAs, the offerings are still transactional rather than transformational in the way taxpayers interact or do business with the IRS. Consequently, the IRS established a Digital Subcommittee (DSC) to advance IRS digital capabilities and offerings farther and faster toward the Future State.

In FY 2016, the IRS established six enterprise Future State themes and instituted ongoing efforts to develop goals to measure progress toward theme attainment. Integral to Future State and to IRS interactions with taxpayers and those who serve them are digital capabilities for those who prefer to deal with the IRS online, as they do with their bank, broker, or retailer.

The DSC reviewed all digital capabilities referenced in the Future State vision as well as all planned IT initiatives, ongoing major projects, and essential administrative projects. The DSC initially reviewed the entire universe of digital capabilities, discussed needs to deliver the related functionality, and estimated delivery of that functionality between FY 2016 and FY 2020 in an unconstrained environment. All of the digital capabilities align within six digital functional projects - three of them taxpayer facing and the others supporting internal operations:

1. Account - an online tax account that a taxpayer and those the taxpayer authorizes can access, initially for read-only and ultimately for self-correction
2. Taxpayer Digital Communications (TDC) - a means for efficient electronic transmission of information between the IRS and taxpayers to resolve issues more timely
3. Modernized IRS.gov - enhanced content, presentation and accessibility of IRS information to all taxpayer types as well as those who serve them
4. e-Authentication, Authorization, and Access (e-A3) - enabling an identity-proofed, purpose-validated person to securely enter IRS systems
5. Enterprise Case Management (ECM) - efficient capture of interactions with taxpayers through electronic data capture, organization and analysis
6. Event Driven Architecture (EDA) - a means of displaying and adjusting files electronically, initially allowing taxpayers to amend/adjust returns

External Partnerships

In FY 2016, the IRS continued collaboration with external partner organizations at the federal, state, and local levels to improve the tax return process.

The IRS continued the Refund Status Application Programming Interface (API) Pilot Project (formerly called the Third Party Data Services Pilot), which enabled the IRS to share refund taxpayers' status data with their tax preparation firms. In FY 2015, the IRS tested the concept and operation of a system to deliver taxpayer data securely to a tax preparation firm using an API. In FY 2016, the Refund Status API pilot project focused on expanding the IRS understanding of early season filers' behaviors of increased taxpayer participation on security, data accuracy, and system performance. Outcomes of the Refund Status API Pilot Project included:

- Nearly 400,000 taxpayers' data processed, compared to 70,000 in FY 2015
- About 4.1 million API transactions executed, compared to 915,000 in FY 2015
- Nearly 3.9 million (93 percent) successful transactions, compared to 700,000 (76 percent) in FY 2015
- Eight volunteer tax preparation firms participated in the pilot, compared to seven in FY 2015
- No security breaks or violations detected
- No increase in telephone support calls by taxpayer participants
- Extremely positive feedback from volunteer participants
- A survey of taxpayer participants indicated 98 percent of respondents said that the messages received through this pilot were valuable and clear

The IRS continued its collaboration with the Social Security Administration (SSA) resulting in three pilot activities designed to enhance the taxpayer experience:

- Shared Technology: The IRS included the SSA web link on 100 Facilitated Self-Assistance kiosks and monitored hits to the website. In addition, the SSA placed the IRS.gov web link onto the SSA's Self-Help personal computers at 18 offices. The IRS identified a test location for placement of VSD in an SSA office and began exploring techniques that will allow the SSA and the IRS video networks to connect securely.
- Co-location: The IRS reached a tentative agreement for a one-year proof of concept to share office space with the SSA to provide a convenient location to assist taxpayers.

- Identity Proofing: The IRS and the SSA agreed to explore leveraging the SSA's depth of experience with authenticating taxpayer identities. This will expand location options for taxpayers affected by identify theft.

Taxpayer Service Missed Opportunities

Providing taxpayers top-quality and timely service to help them understand and meet their tax obligations is one of the IRS's primary goals. Although the IRS had substantial accomplishments serving taxpayers in FY 2016, budget constraints prevented the IRS from implementing new and enhanced services and products that would have improved taxpayers' tax-filing experiences and enabled the IRS to operate more efficiently. Increased funding would have allowed the IRS to improve communications, the online experience for taxpayers and stakeholders, and information processing.

Many components of the systems used to process tax forms and maintain correspondence with taxpayers and employees are nearing the end of their lifecycle, or the lifecycle has expired.

This places the IRS at an increased risk of losing the ability to process tax returns timely and correspond with taxpayers, which would result in an increased burden to the taxpayer.

One of those systems is the Correspondex System (CRX), used to issue letters to taxpayers. CRX is decades old, is hard coded, and creates an antiquated letter that does not allow customization or the use of IRS letterhead. Communications to taxpayers do not meet modern standards in design, format, and effectiveness, and the IRS has had the legitimacy of letters questioned by taxpayers. An estimated investment of $11.5 million to acquire a new correspondence system would have enabled IRS correspondence to match professional appearance standards and create user interfaces for computer-generated notices.

With additional funding, the IRS could have implemented the Address Quality Initiative (AQI), which would have reduced the cost of undelivered mail significantly. The IRS had an undelivered mail rate of nearly 10 percent, which increased IRS costs by approximately $58.0 million annually. The AQI would have improved the delivery of IRS correspondence through process and system improvements that would have enhanced the taxpayer address data, allowed the IRS to automate follow-up actions and reduce subsequent non-delivery and handling. In addition, the AQI would have provided the IRS with additional means to detect identity theft through non-delivery of correspondence and quality improvement of addresses.

The IRS uses an Appointment Calendar Scheduling system for scheduling taxpayer appointments in more than 310 TACs. In the near future, the IRS will expand the appointment scheduling process to its approximately 370 TACs. The IRS anticipates that the current system's software will not be able to operate as consistently and effectively when expanding the scheduling system to the remaining TACs due to the resulting increase in the volume of appointments the system would have to handle. Acquiring a new appointment calendaring system, which would have cost less than $1 million, would have allowed scheduling online or through a call center in advance, permitting the IRS to transfer customers from online browsing to an in-person visit with the staff member best suited to address their needs. Confirmation messages and automated reminders sent directly to the taxpayer's email or their cell phone would have been another benefit of a newer system.

Investments in customer callback (virtual queue) technology would have improved the telephone level of service. Customer callback technology would have provided taxpayers with a customer callback option designed to retain the taxpayer's information and place them in line to receive a call back through a virtual hold (queue). This technology is widely used in government call centers, such as the SSA and the Department of Veterans Affairs, and in private industry.

Providing callers with a virtual hold experience would have benefited the caller by reducing the time spent on hold and could have reduced the number of abandoned calls and redials. Virtual hold could have benefited the IRS by reducing circuitry costs for time taxpayers spent with a line open on hold, and could have reduced talk time with customer service representatives. In the President's FY 2016 budget, the IRS proposed this initiative and estimated the net cost would be about $3.3 million ($5.2 million investment and $1.9 potential cost savings for reduced circuity and ports). The investment would have integrated this technology with the new call- center infrastructure upgrade project launched in FY 2016.

Investing in Authentication Retention (AR) Technology is another initiative that would have improved the telephone level of service for taxpayers. AR technology would have enhanced the call center environment for taxpayers who call various IRS product lines for account-related inquiries when a caller needs to speak to more than one Customer Service Representative (CSR). Currently, callers provide authenticating information to establish their identity and authorize account information. When callers need to speak to more than one CSR, the caller must repeat this process with each CSR, thereby increasing the call time and burden to the caller.

An estimated investment of $6.3 million for AR technology would have allowed the IRS to improve telephone authentication practices, benefiting an estimated 31 million callers annually. This technology would have enabled taxpayers to provide information to the IRS to authenticate or verify their identity only once per call. When a caller needs to speak to more than one CSR, the Computer Telephone Integration tool would have used the AR technology to retain the authentication information provided to the first CSR and present it to the next CSR. AR technology would have prevented unauthorized disclosures by decreasing the number of times a CSR would have to authenticate callers, and would have reduced taxpayer burden, the risk of identity theft and fraud, and the overall time a taxpayer spends on the phone with the IRS as well. This investment would have integrated AR technology with the new call-center infrastructure upgrade project launched in FY 2016 and would have created a seamless taxpayer experience during interactions with CSRs.

The IRS has long championed providing information and services through the channels that best meet taxpayers' needs and are the most efficient use of resources. Because of budget constraints and increased legislative mandates, the IRS was not able to allocate as much of its technology spending to innovative, robust tools on IRS.gov. This is especially true as it relates to the development of an Online Account for taxpayers and tax professionals. The vision of Online Account is for it to be the central place for taxpayers to access their account and IRS services and information with seamless, easy-to-use, integrated functionality for payments and payment history, transcripts and other tax records, refund status, secure messaging, and more.

The IRS is currently developing an initial version of an Online Account that builds upon several stand-alone tools on IRS.gov such as Get Transcript, Direct Pay, and OPA. However, this initial version of Online Account will have fewer features than desired; specifically, it will only display a taxpayer's balance due and will link to IRS online tools to assist users with tax payment options.

Additional staff with the right skillset mix (usability design and analysis and technical skills) would have mitigated issues encountered during development of this product and would have enabled the IRS to implement the initial version of Online Account earlier in the year. Lengthy project timelines and reduced scope limited the effect Online Account would have had on reducing live assistance calls and walk-in interactions this fiscal year. The IRS received about two million phone calls related to taxpayers' account balances during FY 2016 that an online account may have been able to address, even with a limited public release before tax season.

ENFORCEMENT

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

Enforcement of the tax laws is an integral component of the IRS's effort to enhance voluntary compliance. IRS enforcement activities, such as examination and collection, remained a priority in FY 2016. During the past year, the IRS maintained its international enforcement presence, continued actions to leverage the tax return preparer community, and made refund fraud a top priority.

Highlights of Enforcement Performance

In FY 2016, the IRS collected $54.3 billion in total enforcement revenue. Demonstrated achievements in key enforcement programs were:

- 116,804 high-income audits
- 46,204 small business audits (assets <$10 million)
- 9,448 large corporate audits (including partnership and flow-through returns)
- 1,035,995 individual audits

Other indicators of IRS enforcement performance included:

- Closing more than 2.6 million collection cases
- Closing more than 3.47 million automated underreporter contact closures
- Completing more than 35,000 tax-exempt and government entities compliance contacts
- Collecting more than $692.4 million through the Federal Payment Levy Program
- Collecting more than $360 million from taxpayers who owe a federal tax debt through the State Income Tax Levy Program

Significant Areas of Focus

International

During FY 2016, the IRS emphasized several areas in compliance and enforcement programs. With ongoing trends in globalization and the migration of wealth across borders, international and offshore compliance continues to be a strategic area of importance to the IRS. The IRS's efforts in this area have included responding to offshore tax evasion and global financial crimes. International compliance programs have provided the IRS with a wealth of information on various banks and advisors, which the IRS used to continue its international enforcement efforts.

For example, the Voluntary Disclosure Program (VDP) continued to be the entry point for taxpayers' voluntary disclosure of the income they failed to report from offshore bank accounts, as well as unreported domestic income. In FY 2016, the IRS received 1,437 Voluntary Disclosures (International and Domestic), of which 1,095 were Offshore Voluntary Disclosure Applications.

Similarly, the IRS collaborated with the Department of Justice Tax Division to support the Swiss Bank Program, which is a voluntary disclosure program for banks that assisted U.S. citizens in hiding their money offshore. In FY 2016, the U.S. Government completed negotiations with 80 Swiss banks to enter into non-prosecution agreements. The negotiations resulted in 78 signed non-prosecution agreements and more than $1.3 billion in penalties paid by the Swiss banks.

In addition, to strengthen efforts to reduce international tax fraud and non-compliance, the IRS continued to deliver new capabilities and enhancements to the FATCA system. FATCA requires foreign financial institutions to report detailed information about foreign account holders to the IRS or face a 30 percent withholding tax. This unprecedented program affects stakeholders worldwide, including the global financial industry, taxpayers in the U.S. and overseas, and foreign tax administrations.

In FY 2016, the IRS implemented two new FATCA system enhancements:

- **FATCA Release 3.0** - FATCA Release 3.0 was a multi-phased release strategy that delivered new capabilities and system enhancements as part of three separate deployment efforts:
    - Phase I - enabled new capabilities for the IRS to exchange reciprocal taxpayer data through enhancements to the International Data Exchange Service (IDES) and the interrelated International Compliance Management Model (ICMM) system
    - Phase II - provided the IRS the ability to capture and manage bulk uploaded Sponsored Entity registration information through the registration system
    - Phase III - provided withholding and refund (W&R) capabilities that established streamlined compliance methods and activities, including comparisons of actual deposits and reported payments. These new W&R capabilities helped with comparing, matching, and validating forms used to deny fraudulent credit claims
- **FATCA Release 4.0** - FATCA Release 4.0 provided updates that affected FATCA reporting and modifications to the existing classifications of financial institutions. The enhancements to the Financial Institution Registration system included:
    - Inclusion and capture of additional data on Form 8938, *Statement of Specified Foreign Financial Assets*, Form 8966, *Foreign Account Tax Compliance (FATCA) Report*, and Form 1042-S *Foreign Person's U. S. Source Income Subject to Withholding*
    - Validation of the data in files received from all sources (exchanges and other existing IRS systems)
    - Ability for the IRS to change the registration status of all Limited Financial Institutions that meet specified criteria and send a message to those FIs regarding the reason for the change of status.

In FY 2016, almost 190,000 foreign financial institutions registered with the IRS and received a Global Intermediary Identification Number (GIIN); a number assigned to foreign financial institutions for use in identifying themselves to withholding agents and tax administrators for FATCA reporting purposes. Additionally, more than 5,000 foreign financial institutions have enrolled in the International Data Exchange Service (IDES) to submit FATCA information returns to the IRS.

Domestic Programs

Domestically, one of the ongoing compliance challenges faced by the IRS requires the IRS to work closely with the paid preparer community (1) to ensure that tax returns are prepared carefully and correctly so that taxpayer accounts are accurate and (2) to stop the small subset of negligent or unscrupulous preparers from harming taxpayers or the tax system. Paid tax return preparers are a critical component of tax administration and provide a unique opportunity to influence taxpayer behavior and improve compliance with tax laws. The IRS improved compliance in the return preparer community through education, outreach, and coordinated cross-functional publicity.

In the second year of the Annual Filing Season Program (AFSP), the IRS strengthened communication with tax return preparers to promote program participation. The AFSP is an incentive program that encourages non-credentialed tax return preparers to improve their knowledge of federal tax law and filing season requirements through continuing education. Promoting the program in FY 2016 had added importance given that, beginning January 1, 2016, the rules for limited representation before the IRS changed, and only those participating in the Annual Filing Season Program have limited practice rights for returns prepared and signed on or after that date. IRS communication efforts included a webinar, news releases, emails, social media messages, and a YouTube video tutorial that demonstrates how to participate in the program, which received more than 117,000 views. Participation for the FY 2016 filing season increased 42 percent above participation in FY 2015.

Most paid tax return preparers are professional, honest, and trustworthy. However, the IRS is committed to investigating those who act improperly. In FY 2016, the IRS took several actions to improve efficiency in processing complaints against tax return preparers. To increase the quality of the complaints received, the IRS updated IRS.gov to clarify guidance to taxpayers on completing and submitting Form 14157, *Complaint: Tax Return Preparer*. In addition, the IRS enhanced cross-functional guidance to improve the quality of information shared among IRS divisions and conducted additional training. These actions improved the amount and quality of the information received from the public and enabled the IRS to process complaints more efficiently, reducing complaint processing from 151 days in FY 2014 to 22 days in FY 2016.

The Return Preparer Program (RPP) is an effort to enforce compliance of paid return preparers. By engaging in enforcement strategies targeting unscrupulous or incompetent return preparers, the IRS RPP achieved several enforcement outcomes in FY 2016, including:

- 252 RPP Criminal Investigations Initiated
- 248 RPP Criminal Investigations Completed
- 216 RPP Convictions
- 98.6 percent RPP Conviction Rate
- 88.6 percent RPP Publicity Rate
- 118 EITC “Knock and Talk” visits with at-risk return preparers

The IRS also continued its EITC Return Preparer Strategy. This strategy is designed to increase the accuracy of EITC returns by focusing on return preparers who appear not to be exercising due diligence when preparing taxpayers’ returns claiming the EITC. The use of interventions for EITC preparers before and during the filing season included monitoring 26,000 preparers. FY 2016 EITC return preparer strategy results included:

- Conducted more than 800 pre-filing season due diligence visits that resulted in more than $25 million in proposed penalties - a penalty rate of 82 percent - this included over 80 visits to tax preparation firms
- Completed more than 118 “Knock and Talk” visits with a revenue agent and special agent and an additional 46 visits with only a revenue agent
- Closed 28 “Knock and Talk” follow-up due diligence visits, with almost $249,000 in proposed penalties
- Issued more than 18,000 pre-filing season compliance and educational letters
- Closed 295 filing season due diligence visits, with more than $4.4 million in proposed penalties (penalty rate of 82 percent)
- Mailed more than 9,400 educational notices during the 2016 filing season

- Proposed due diligence penalties to more than 130 preparers who failed to attach Form 8867, *Paid Preparer's Earned Income Credit Checklist*, to tax year 2014 returns prepared after receiving a warning letter or alert
- Proposed due diligence penalties to nearly 80 preparers who failed to attach Form 8867 to tax year 2015 returns

Employee Plans

Additionally, the IRS continued its efforts to improve the employee plan examination process and tax-exempt compliance activities. The EP Examination program is responsible for ensuring that qualified retirement plans comply with qualification, reporting/disclosure, and excise and income tax matters. It uses a centralized case selection process to identify plans and then reviews the plan's books and records for operational compliance with the law to protect plan assets and the interests/rights of participants.

In FY 2016, the IRS developed specialized EP Examination programs by using issue-focused models designed to concentrate on specific types of non-compliant retirement plans within certain specialty areas. Cases contained pre-identified issues for review during the audit process. To enhance future case selections, examiners completed information questionnaires to provide feedback and results for a complete feedback loop.

Compliance Improvements

To improve compliance activities, the IRS provided taxpayers the option to pay Employee Plans Compliance Resolution System (EPCRS) sanctions electronically on PAY.gov in lieu of submitting a check. This process benefitted both taxpayers and the IRS by processing payments electronically in a self-service operation.

The IRS also focused on selecting high-value work, improving customer service, and identifying opportunities to improve program efficiency and effectiveness. In FY 2016, the IRS identified several opportunities to improve program efficiency and effectiveness when unresolved cases move to the Automated Collection System (ACS):

- **Notice Redesign** - Making ACS notices simpler and easier for taxpayers by modifying letters to determine their effectiveness in obtaining a taxpayer response
- **Accelerated ACS Treatments** - Finding new, faster ways to work with taxpayers who were likely to enter into installment agreements by simultaneously sending the taxpayer all of the necessary information and required forms, including the agreement amount request needed for the installment agreement process. This reduces the time it takes to get a portion of the ACS taxpayer base into an installment agreement
- **Digital Outreach Channels** - Enhancing traditional taxpayer contacts through text, video chat, secure messaging, and screen sharing to aid ACS taxpayers
- **Focused Treatment on Aged Debt** - Selecting high-value cases and finding more efficient ways to resolve them
- **ACS Referrals to Online Payment Agreement (OPA)** - Referring ACS taxpayers to the OPA application for self-input of installment agreements, increasing OPA usage, and enabling ACS to service more taxpayers requiring help from collection representatives

Criminal Investigation

The IRS criminal investigation program examines potential criminal violations of the Internal Revenue Code and related financial crimes, such as money laundering, currency violations, tax-related identity theft fraud, and terrorist financing that adversely affect tax administration. Using its unique statutory jurisdiction and financial expertise, the IRS criminal investigation program contributed to important national law enforcement priorities. Performance highlights included:

- Completed 3,721 criminal investigations
- Achieved 2,672 convictions with a conviction rate of 92.1 percent
- Achieved a Department of Justice case acceptance rate of 89.8 percent and a U.S. Attorney case acceptance rate of 89.0 percent

The IRS takes appropriate enforcement action against taxpayers who file fraudulently. The IRS criminal investigation program continued identifying and stopping fraudulent return filings and refunds through use of the Questionable Refund Program (QRP). The QRP identified schemes that involved one or more individuals that used genuine identities for the purpose of preparing and filing fictitious tax returns to generate fraudulent claims for refund. In FY 2016, the IRS identified 930 QRP schemes comprised of 157,218 individual tax returns with more than $919 million in potentially fraudulent refund claims. QRP performance accomplishments included:

- 495 QRP criminal investigations initiated
- 688 QRP criminal investigations completed
- 609 QRP convictions
- 95.5 percent QRP conviction rate
- 86.7 percent QRP publicity rate on adjudicated investigations

Enforcement Missed Opportunities Collections Generally

The IRS places mission-critical importance on enforcement of the tax law, especially as tax administration becomes increasingly complex. Budget reductions for the IRS as a whole over the past several years have eroded the IRS's human capital and IT infrastructure and adversely affected its ability to support core tax administration processes, risking reduced voluntary compliance and loss of revenue. Large staffing reductions have led to a consistent reduction in audit coverage and have impaired the IRS's ability to work the growing collection inventory and bring taxpayers who fail to pay their tax debt into compliance. The IRS has 6,200 fewer revenue agents, revenue officers, and criminal investigators compared to 2010. Assuming that the IRS's underlying services, such as IT, were to be adequately funded, investing an additional $249.8 million in examination, collection, and underreporter programs would have generated nearly $2.8 billion in additional annual revenue, and allowed the IRS to resolve an additional 1.5 million cases.

International

As the globalization of the world's economy continues, so have the threat and the proliferation of cross-border financial crimes. In order to continue to build on the successes of its existing program and to maintain an effective program of international enforcement, the IRS should open additional foreign posts. Not being able to expand further into South and Central America, to locations such as Brazil and Belize, are key opportunities missed. Recent anecdotal and case-related matters have uncovered significant money movement in locations such as Belize and Panama. These are locations known for facilitating the offshore movement of significant wealth and income by U.S. taxpayers engaged in tax non-compliance and other illegal financial crimes, such as securities fraud. Moreover, the tri-border region of South America, where the borders of Argentina, Brazil, and Paraguay meet, is a haven for the fund-raising activities of many terrorist organizations. The lack of presence and law enforcement relationships in these areas, due to existing Attaches' large areas of responsibility, will have a negative effect on the IRS's ability to develop and support investigations in these emerging threat areas. Additional funding of $8.4 million and 36.5 full-time equivalents (FTE) in FY 2016 would have allowed the IRS to expand its pursuit of international tax and financial crimes.

In addition, budget limitations prohibited the IRS from expanding the use of the IDES to support communications with foreign governments and private entities beyond the limited scope provided to support FATCA third party reporting. As a result, the IRS conducted government-to-government data exchanges via email or postal mail with reduced efficiency and a lower level of security to protect against accidental loss of data or a data breach. Currently, the IRS is developing the capability to make these types of exchanges via IDES in a browser-based environment without the need to make modifications to existing systems.

Employee Plans

Due to Cybersecurity concerns, the ability to correspond electronically with taxpayers in the employee plans community via secure email is not readily available. Communicating electronically with customers would enable the IRS to resolve issues and reduce the time it takes to complete cases. Current budget issues prevent the IRS from continuing efforts to develop secure email such as the Taxpayer Digital Communication initiative for compliance examinations.

Charitable Organizations

Due to legislative changes, the IRS identified necessary updates to tax-exempt application Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code,* Form 1024, *Application for Recognition of Exemption Under Section 501(a),* and Form 1023-EZ, *Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*. However, due to the lack of resources, the IRS was unable to make these changes or incorporate further changes to remove information that is no longer applicable or would further assist taxpayers in submitting complete applications. Some of the changes consist of: Form 1023 references to an advance ruling period eliminated by Treasury Regulation and user fee information; Form 1023 and Form 1024 updates required by the PATH Act; and Form 1023-EZ clarifications for eligible levels of income and assets. As a result, taxpayers may be confused and find it more difficult to complete the applications correctly.

CYBERSECURITY AND IDENTITY THEFT

Cybersecurity has been an IRS priority for many years. Staying ahead of ever-changing cyber criminals is a constant challenge and requires extreme vigilance. The IRS was able to continue to build robust cybersecurity programs due to the §113 funding it received in FY 2016 to improve the identification and prevention of refund fraud and identity theft and to enhance cybersecurity to safeguard taxpayer data. Due to increasing cyberattacks on critical government systems, the IRS took steps to mitigate the escalating risk by strengthening its cybersecurity defenses.

Maintaining and Promoting Cybersecurity

In FY 2016, the IRS identified and mitigated 678 cyber incidents and blocked the transmission of 66,378 unencrypted emails from leaving the IRS network, preventing the possible inadvertent disclosure of sensitive data such as social security numbers and passwords. The IRS also completed the first release of its Short Messaging Service Platform (SMSP), which allowed for the issuance of a one-time password to a taxpayer via text messaging services, paving the way for two-factor authentication for taxpayers trying to access their tax records.

The IRS is committed to ensuring that the contracts it awards protect against known cybersecurity risks. In a proactive measure, the IRS created a Procurement Cyber Cell to ensure compliance with legislative mandates for cybersecurity risks early in the acquisition process. The Cyber Cell reviewed internal processes to ensure identification of requirements with a cyber-component prior to solicitation, and that all pertinent contract clauses were included in the award document. In order to address cybersecurity risks as quickly as possible, the Cyber Cell also took steps to reduce the time it takes to put a cyber-contract in place without sacrificing quality or increasing risk to the IRS. Additionally, the Procurement Cyber Cell successfully reviewed more than 8,000 contracts awarded between September 2014 and September 2016 to verify incorporation of the appropriate cyber-related clauses and requirements. It also analyzed the effects of recent changes to laws and regulations to assess potential impacts to the contracting process, including factors such as competition, cost, and the ability to award contracts to small businesses. Furthermore, the Cyber Cell performed a comprehensive review of existing cyber-related audits to ensure concerns were being addressed consistently, and participated in a working group that focused on ensuring contractors hat support the IRS completed mandatory cybersecurity awareness and role-based training.

The Security Summit

The Security Summit Group, established on March 19, 2015, is a collaboration of public and private sector leaders from the IRS, tax industry, and state tax authorities whose focus is to enhance cybersecurity and combat identity theft refund fraud. One of the most important aspects of the Security Summit's charge is to combat identity theft and fraud and to improve the ability of the IRS, tax administrators, and tax industry leaders to share information with one another and among their work groups. In FY 2016, the IRS held three Security Summit meetings and created seven working groups:

- **Authentication group**: This group developed short-term and long-term objectives to improve authentication based on data analysis, including:
  - W-2 Verification Code: A pilot program that provides a new way to verify Form W-2 wages and withholding data on electronically-filed Forms 1040. The W-2 includes additional instructions for entering the information if prompted by tax return preparation software. This will help confirm the accuracy and integrity of electronically filed returns and will be an extra layer of protection that will help taxpayers and the tax system.
- **Lead Reporting and Information-Sharing group**: This group worked to establish a data-sharing process and received signed agreements from 21 Industry Partners, 40 state departments of revenue, and 7 endorsing organizations. The working group also established a Rapid Response Team to share details around attempted cybersecurity attacks on IRS systems.
- **Strategic Threat Assessment and Response group**: This group identified best cybersecurity practices, shared information with other Security Summit work groups, and made recommendations to help protect the tax ecosystem.
  - **Financial Services group**: This group worked with financial services and tax-product groups on refund-related payment processing issues. This group continued the development and implementation of the following projects:
  - The External Leads Process: The External Leads Program is responsible for receiving leads from partner financial institutions about questionable tax refunds identified by a variety of stakeholders, including: national banks, state banks, savings and loan associations, mutual savings banks, credit unions banks, financial institutions, brokerage firms, government and law enforcement agencies, state agencies, tax preparation entities, and various other sources.

  - The Automated Clearing House Naming Convention: A standard naming convention for state government refunds that would create a regular trusted identifier for refunds submitted for deposit by state governments; help states protect revenue and aid in refund recovery efforts related to fraud and identity theft, and improve identity filters and the understanding of fraudulent refunds through financial institutions.
- **Tax Professionals group**: This group determined how new requirements affect professional tax preparers that utilize pro-tax software. Industry partners and Tax Professional Associations distributed a survey on refund fraud and stolen identity issues to members and colleagues with the following results:
  - More than 90 percent of respondents have never suffered a data breach resulting in compromised client data
  - More than 90 percent of respondents reported having a process for protecting client data
  - 83 percent of respondents have dealt with taxpayers who have experienced tax related identity theft
- **Communications and Public Awareness group**: This group increased public awareness and encouraged better protection of personal data by publicizing key messages, resulting in broad and continued coverage in traditional and social media outlets.
- **Refund Fraud Information Sharing & Analysis Center (RF-ISAC) group**: This group will centralize, standardize, and enhance data compilation and analysis to facilitate sharing actionable data and information

Additional Security Summit accomplishments included:

- Establishing lead reporting requirements for industry partners that ensured the IRS received a weekly report of suspicious activity for the detection and prevention of identity theft/tax fraud:
  - This year through September, leads from industry partners directly resulted in the suspension of 57,000 returns, on which a total of $244 million in refunds was claimed; a 211 percent increase.
  - The number of suspicious refunds that financial institutions returned to the IRS for review was 55 percent lower in the first nine months of this year compared to the same period last year. That indicates that fraud filters are getting better and are stopping more false returns before refunds can be issued.
  - The IRS Identity Theft Victim Assistance function experienced a marked drop of 54 percent in receipts, which includes Identity Theft Affidavits (Form 14039) filed by victims and other identity theft related correspondence.
  - The number of refunds that banks and financial institutions returned to the IRS because they appear suspicious dropped by 55 percent, indicating that improved data led to better filters, which reduced the number of bad refunds issued.
- The primary “Identity Protection” web page of IRS.gov received more than 1,446,417 views since the Security Summit campaign launched.
- New protocols required all individual tax software customers to update their security credentials to a minimum eight-digit password and establish security questions.
- Software providers shared approximately 20 data elements from tax returns with the IRS and states to help identify possible fraud. These elements are confidential but include information to identify returns prepared quickly by automated programs.

Protecting Against Identity Theft

The IRS continued collaboration with internal and external partners to ensure an effective approach to deterring identity theft and refund fraud. FY 2016 accomplishments included:

- **Identity Theft Clearinghouse (ITC)**: The ITC continued to develop and refer identity theft and refund fraud schemes for investigation. In FY 2016, the ITC received 1,328 identity theft related refund fraud leads associated with 113,960 tax returns and more than $642 million in refund claims.
- **Law Enforcement Assistance Program (LEAP)**: The Law Enforcement Assistance Program helped state and local law enforcement lawfully obtain tax return data vital to their local efforts in investigating and prosecuting specific cases of identity theft. In FY 2016, 300 state and local law enforcement agencies from 49 states participated in the program and the IRS received 1,465 requests.
- **Identity Theft Outreach:** The IRS promoted events designed to educate private sector entities, law enforcement partners, and taxpayers about identity theft and tax scams. The IRS participated in 183 outreach presentations focused on theft from tax preparation and payroll service businesses. Additionally, the IRS continued to issue identity theft communications via news releases, Tax Tips, and social media platforms. One of the most highly publicized of the year, the pervasive phone scam involving IRS impersonators targeting taxpayers, was highlighted dozens of times through the “Dirty Dozen” in special editions of Tax Tip warnings and throughout the year in social media.
- **Identity Theft Victim Assistance (IDTVA) Organization**: The IRS centralizes victim assistance in one unit that focuses on identifying and improving processes and procedures to provide optimal service to the victims of identity theft. The team identified opportunities to decrease taxpayer burden and decrease case resolution time for the taxpayers. To date, the IRS answered more than 1.4 million calls with more than 500,000 total closures.
- **Personally Identifiable Information (PII) Redaction Tool**: The IRS developed a tool that automates redaction of personally identifiable information (PII) on e-filed Forms 990, *Return of Organization Exempt from Income Tax*. This was a critical step toward making e-filed Form 990 data publicly available in a machine readable and searchable format without disclosing PII. By providing information in this format, the IRS streamlined the process to respond to information requests and enabled the public to conduct more efficient data analysis.

The IRS continued to refine and develop new identity theft filters based on analytical models, known schemes, and data validation. Shifting the inventory from the Electronic Fraud Detection System, in which the return posts as fraud, to inventory in the Taxpayer Protection Program (TPP), where the return is detected as identity theft and remains unposted, continued to provide a viable system that effectively detected and prevented fraudulent submissions. To date, the cumulative number of cases selected for TPP treatment is 2.3 percent higher than at the same time in FY 2015.

Another mechanism the IRS introduced is the Device ID. The Device ID is the serial number (or fingerprint) of the computer used to file a return, and is filed return. It enables the IRS to associate fraudulent returns filed from the same device. In

FY 2016, 99.3 percent of electronically filed returns included the Device ID. For processing year 2016, the IRS protected more than $106 million in revenue by using the Device ID filter.

In calendar year 2016 through September, the IRS stopped over $ 4 billion in fraudulent refunds claimed by identity thieves on more than 787,000 tax returns. Using multiple channels to identify and stop refund fraud, some of the accomplishments included:

- The Blue Bag Program, a partnership with 1,081 prison institutions in 50 states to address prisoner non-compliance, has helped stop identity theft by prisoners who file false returns using fraudulent or stolen information.
- The Scheme Tracking and Referral System (STARS) stopped more than 25,700 fraudulent prisoner returns with associated refunds of more than $827 million.
- The IRS collaborated with the Bureau of Fiscal Services (BFS) and the National Automated Clearing House Association to implement a voluntary program for direct deposit rejects due to name mismatch, identity theft, and questionable refunds. To date, 266 financial institutions have opted-in, resulting in more than 29,900 rejects associated with more than $70 million in refunds.
- The Automated Questionable Credits (AQC) program contains filters that identify questionable credits and the IRS corresponds with taxpayers to obtain substantiation of questionable information on the returns. The AQC program has protected or assessed more than $55 million to date.

The IRS deployed maintenance and enhancements for the Return Review Program (RRP) system in preparation for the 2016 filing season, which allowed for receipt of Forms W-2, *Wage and Tax Statement*, directly from reporting agents and other Form W-2 issuers earlier in the filing season in order to verify income and reduce fraud and anomalies. Receiving the Form W- 2 information earlier allowed the IRS to release good returns sooner in the fraud detection process, which reduced burden to taxpayers. While this was the first year, 16 reporting organizations, two federal agencies, and five state governments participated.

The Wage and Withholding Only program identified returns that contained questionable income and withholding. When identified, the taxpayer received a notice requesting substantiation to support wages and withholding. If the taxpayer did not respond within the allotted time, the IRS removed the income and withholding from the return. In FY 2016, the IRS protected $697 million through this process.

The State Fraud Referral project leveraged state tax agencies as an additional source of fraud data. The IRS signed agreements to participate with 37 states and received referrals from 13 states. Results included:

- More than 410,100 referrals and more than 196,400 IRS filed returns based on those referrals
- More than 32,500 returns stopped with more than $169 million in refunds claimed
- More than 19,750 returns identified by IRS filters for more than $117 million in stopped refunds

Cybersecurity and Identity Theft Missed Opportunities

Cybersecurity concerns and identity theft crimes have emerged as increasingly prevalent threats to the IRS. Assuming the IRS received adequate funding for underlying services such as IT, the following cybersecurity and identity theft initiatives, if funded, would have generated the following benefits:

- **Enhancing Investigations of Transnational Crime (TOC)** - Additional funding ($42.5 million/194 FTE) in FY 2016 would have allowed the IRS to hire Criminal Investigation (CI) staff to address the growth in criminal activity of a global nature. TOC refers to associations of individuals who operate in multiple countries for obtaining power, influence, and financial gains, wholly or in part by illegal means, while protecting their activities through a pattern of corruption that often funds terrorist activities. The threat of transnational organized crime has become more severe because criminal networks are using increasingly sophisticated tactics that exploit the borderless, interconnected nature of the global economy.

- **Expansion of the Identity Theft Clearinghouse** - Additional funding ($9.4 million/47 FTE) would have allowed the IRS to expand the Identity Theft Clearinghouse to process, analyze, and evaluate all identity theft leads received from special agents, other IRS sources, and external sources. The Identity Theft Clearinghouse monitors emerging identity theft refund schemes, tracks activity to assist in preventing the release of fraudulent refunds, and combats schemes where fraudulent refunds finance other illegal activities.
- **Pursuing Employment Tax and Abusive Tax Schemes** - Additional funding ($17.2 million/52 FTE) would have allowed the IRS to apply social network analysis to the investigation of employment tax fraud and abusive schemes; redeploying two program areas that have seen decreased investigations as resources to combat identity theft. By establishing and implementing a financial and criminal intelligence database, the network analysis software could proactively identify potentially noncompliant taxpayers by enabling the IRS to link multiple potentially abusive returns or information items to identify the central figure behind a scheme versus applying resources to individual returns one at a time.

SYSTEMS CONTROLS AND LEGAL COMPLIANCE

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

As required by Office of Management and Budget (OMB) Circular No. A-123, Management's Responsibility for Internal Control, the IRS evaluated its internal controls and financial management systems to ensure the IRS was operating in accordance with the procedures and standards prescribed by the Comptroller General and OMB guidelines. Results showed that the IRS met the objectives of the below internal controls and financial management systems.

Federal Managers' Financial Integrity Act (FMFIA)

The IRS provided a modified statement of assurance that its internal controls and financial management systems met the objectives relative to the Federal Managers' Financial Integrity Act (FMFIA) Sections 2 and 4, due to the existing material weakness in internal control over financial reporting related to unpaid tax assessments; and the IRS financial management systems do not substantially comply with Federal Financial Management Improvement Act (FFMIA).

The systems of management control for the IRS organizations ensured that:

- Programs achieve their intended results
- Resources used were consistent with the overall mission
- Programs and resources were free from waste, fraud, and mismanagement
- Laws and regulations were followed
- Controls were sufficient to minimize improper or erroneous payments

- Performance information was reliable
- System security was in substantial compliance with all relevant requirements
- Continuity of operations planning in critical areas was sufficient to reduce risk to reasonable levels
- Financial management systems were compliant with federal financial systems standards, such as FMFIA Section 4 and FFMIA
- Complete and accurate data was reported on USAspending.gov
- Controls and policies were in place to prevent fraud and inappropriate use of government charge cards
- Risks were reviewed with appropriate frequency
- New or emerging risks were addressed

OMB Circular A-123, Management's Responsibility for Enterprise Risk Management and Internal Control

The IRS conducted its assessment of the effectiveness of internal control over financial reporting, which includes the safeguarding of assets and compliance with applicable laws and regulations, in accordance with the requirements of OMB Circular No. A-123, Appendix A.

The FY 2016 OMB Circular A-123 testing included the following activities:

- Tested internal control sets for the 26 transaction processes identified by the Department of the Treasury that are material to its Consolidated Financial Statements. The tests included 14 administrative processes covering material portions of the $11.2 billion in annual administrative transactions, seven information system processes, and five custodial processes covering material portions of the more than $3.3 trillion in tax revenue receipts through September 30, 2016. 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 2016 transactions during the fourth quarter to verify that, with the exception of internal controls over financial reporting relative to unpaid tax assessments, controls remained effective throughout the year
- Conducted a self-assessment of the IRS internal control environment using an abbreviated Internal Control Evaluation Checklist based upon the Government Accountability Office's (GAO) Internal Control Management and Evaluation Tool and Standards for Internal Control in the Federal Government
- Developed the first internal control test plan for the Foreign Accounts Tax Compliance Act (FATCA) process, including controls related to the following components: Online Registration, Withholding Refunds, International Data Exchange Services (IDES), and International Compliance Management Model (ICCM)
- Reviewed the Centers for Medicare and Medicaid Services (CMS) documented testing of internal controls related to certifying and making the Basic Health Program (BHP), Advance Premium Tax Credit (APTC) and Cost Sharing Reduction (CSR) payments
- Performed an independent evaluation of CMS's testing of its internal controls
- Reviewed CMS's representation letter indicating there were no material changes to the control environment around the processes executed in support of the BHP, APTC, and CSR payment amounts during the period July 1, 2016, through September 30, 2016. Specifically, CMS management represented that:
    - Internal controls in place at CMS for the period January 1, 2016, through June 30, 2016, 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, 2016, through September 30, 2016.
- CMS management is not aware of any fraud or non-compliance with laws and regulations, and did not have any uncorrected misstatements affecting the IRS's financial statements

Based on the results of this assessment and due to the continued material weakness related to unpaid tax assessments, the IRS provided modified assurance that its internal controls over financial reporting as of September 30, 2016, were operating effectively.

The IRS continued to monitor the unpaid tax assessments material weakness (UAMW) in internal control over financial reporting and the corresponding corrective action plan.

Assessment of Risks

The IRS identifies and assesses risks, including new and emerging risks, at each level of the organization on an ongoing basis. Risks are elevated to the appropriate level within the IRS, depending on the nature of the risk, for a suitable risk response. Each IRS business unit is responsible for identifying and assessing the risks to its objectives on an ongoing basis and for maintaining a risk register to capture the associated risk information. The business units select appropriate risk responses and elevate any risks that they are unable to address adequately at their level. In addition, business units discuss their highest risks at quarterly Business Performance Reviews. At the enterprise level, the IRS conducts an annual enterprise risk assessment to identify and assess the most significant risks to the IRS's strategic objectives. The IRS Executive Risk Committee (ERC) determines the top enterprise risks based on an analysis performed by the Risk Working Group (RWG), selects any additional actions to be taken, and assigns accountability for implementing those actions.

Federal Financial Management Improvement Act (FFMIA)

In November 2014, the IRS approved a new CADE 2 Transition State 2 (TS2) implementation plan for deployment over seven releases, five affecting the UAMW, with a target completion date of November 30, 2020. The level of detail outlined in the November 2014 TS2 release plan enabled the IRS to revise the UAMW remediation plan with more detail on each CADE 2 release, including the associated functionality. As a result, the IRS received OMB agreement that the new remediation plan satisfies the Circular A-123 Appendix D requirement, replacing the need for a waiver from OMB for remediating a material weakness taking longer than three years under FMFIA.

The IRS made good progress under the CADE 2 TS2 plan to date. During this fiscal year, the IRS implemented a pending payment project as part of a multi-phase approach to reduce adjustments to the financial statements. This functionality will allow the IRS to account for payments received but not posted through all financial systems, which can take up to six weeks, and improve the accuracy of financial reporting. The IRS also implemented a systemic correction to address a long-standing issue on the calculation of failure to pay penalties, allowing it to pass the penalty and interest component of the Unpaid Assessment (UA) audit with no errors for the first time.

The November 2014 CADE 2 TS2 Release Plan assumed that the IRS would have adequate resources to support this modernization effort, beginning with FY 2015. However, continued budget shortfalls in FY 2015 and FY 2016, along with significant legislative requirements that came with no additional funding (e.g., Affordable Care Act (ACA), FATCA, Achieving a Better Life Experience (ABLE) Act, and reauthorization of the Health Coverage Tax Credit (HCTC)), have stressed the IRS's modernization efforts on CADE 2 TS2 and other programs. While the IRS has made, and will continue to make, progress in modernizing its information technology systems within the constraints of its budget, this work has slowed. As a result, the IRS is reviewing the November 2014 CADE 2 TS2 implementation plan.

Information Security Significant Deficiency

The IRS worked diligently during FY 2016 to continue to enhance its IT security, currently identified as a significant deficiency. The IRS implemented a strategy and assessment process to verify the effectiveness of internal controls for the financial systems that affect the financial statements. The process supports the IRS's overall internal control framework and provides assurance that the likelihood of a material weakness reoccurring in the IT environment is low.

In FY 2016, the IRS completed the following activities:

- Complied with Federal Information Security Management Act (FISMA), OMB, National Institute of Standards and Technology (NIST), Department of the Treasury, and IRS security requirements
- Performed security assessments to provide an integrated view of the security controls affecting confidence in and integrity of the financial statements, enabling the IRS to assess the effect of control deficiencies on the financial statements, prioritize mitigation efforts, and demonstrate progress as the IRS resolves deficiencies
- Met with GAO to gain a better understanding of how audit findings and IT recommendations issued affect the financial statements, resulting in GAO grouping recommendations into categories that include: Infrastructure, UNIX, Oracle, Mainframe, and Other
- Analyzed and prioritized 2016 activities based on the greatest effect on the financial statements, developed mitigation and compensating controls to address potential risks, and communicated the strategy to key stakeholders
- Tested and validated prior year GAO recommendations to prevent premature closure
- Performed continuous monitoring of internal controls for systems that affect the financial statements to demonstrate that management, technical, and operational controls are in place and are effective
- Reviewed 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

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 addressed required Plans of Actions and Milestones (POA&Ms) for identified weaknesses.

Continuity of Operations (COOP)

The IRS Information System Contingency Plan (ISCP) testing program incorporates critical business processes and system infrastructure into ISCPs and ensures that each plan has a documented Business Impact Analysis. The IRS validated that each ISCP 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 280 exercises and tests to determine that the plans were current and executable, backup data was readily available and readable, and Critical Infrastructure Protection systems were recoverable within their defined Recovery Time Objective.

Improper Payments Elimination and Recovery Act (IPERA) of 2010

As of September 30, 2016, the IRS also complied with applicable laws and regulations, except for the noncompliance with Improper Payments reporting related to reporting an overall Earned Income Tax Credit (EITC) improper payment rate below ten percent. The IRS continues to face challenges to reduce the EITC error rate and has reported on the actions being taken in the 2016 Treasury Agency Financial Report (AFR). The AFR discussion includes a report on the root causes of EITC improper payments and future planned corrective actions intended to reduce the program's payment error rate. During FY 2016, a prior IRS proposal was included in the Consolidated Appropriations Act of 2016, and starting next year, employers must file Form W-2 with the Social Security Administration by January 31, 2017. The earlier filing date for paper and electronic forms should assist the IRS in combating refund fraud by allowing the IRS time to identify erroneous EITC and ACTC claims and stop the refunds before they are paid. The IRS will hold the entire refund on EITC and Additional Child Tax Credit (ACTC) related returns until February 15, 2017, to take advantage of the time provided by this earlier filing date.

The IRS also included a number of proposals in the FY 2017 budget request that would help improve EITC compliance. These proposed legislative changes include:

- Giving the IRS explicit authority to require minimum standards for tax return preparers, which would allow the IRS to reduce erroneous EITC claims by weeding out unscrupulous and incompetent preparers
- Providing more flexible correctable error authority; which would allow the IRS to deny certain erroneous claims, including erroneous EITC claims, before refunds are paid
- Increasing civil and criminal penalties for tax-related identity theft, which would help prevent erroneous EITC claims
- Simplifying the rules for claiming EITC for taxpayers who reside with a child that they do not claim as a dependent, in order to reduce taxpayer burden and improve EITC compliance

If enacted, these legislative changes would provide the IRS with additional tools to combat waste and fraud and additional authority to take actions to prevent payment errors and improve EITC compliance.

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 the Treasury Charge Card Management Plan and provided agency-wide purchase card guidance for the proper use of government charge cards. The IRS conducted monthly and quarterly reviews of charge card activity to verify proper card use and to address potential inappropriate use. Charge card policies and procedures were updated to mitigate the risk of repeating previously identified inappropriate use. In the TIGTA report (Reference #2016-10-055) dated July 15, 2016, TIGTA reviewed the IRS's current credit card guidance and determined that the IRS had established policies and controls designed to mitigate the risk of fraud and inappropriate government travel and purchase charge card practices, including controls that address centrally billed travel card accounts.

USAspending.gov

In accordance with the requirements of the OMB Memorandum, *Improving Data Quality for USAspending.gov*, the IRS provides assurance that its internal controls over the underlying spending reported on USAspending.gov are effective. Specifically, the IRS performed a quarterly 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 its analysis, IRS records through the third quarter on USAspending.gov are 99.99 percent accurate for contracts and 99.98 percent accurate for grants.

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 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 collected consistently and accurately over time.

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.

MAJOR MANAGEMENT CHALLENGES AND HIGH-RISK AREAS

GAO Management Challenges and High-Risk Areas

The GAO updates its High Risk Report every two years at the start of each new Congress. The high-risk area below appears in the GAO report, "High Risk Series: An Update (GAO-15-290)," published on February 11, 2015. In addition, the GAO identified three significant financial management challenges in its report, "Financial Audit: IRS's Fiscal Years 2015 and 2014 Financial Statements (GAO-16-146)," published on November 12, 2015. The IRS is dedicated to improving its financial management, internal controls, and information security, and has identified specific steps and actions to address these issues through its existing program activities.

GAO High-Risk Area

Enforcement of Tax Laws:

1. Improving tax compliance and addressing the tax gap
2. Refund fraud related to identity theft

GAO Financial Management Challenges

1. Safeguarding Taxpayer Receipts and Associated Information
2. Preventing and Detecting Fraudulent Refunds Based on Identity Theft
3. Implementing Patient Protection and Affordable Care Act Tax-Related Provisions

Safeguarding Taxpayer Receipts and Associated Information

Summary of Major Issues: Prevent unauthorized access to IRS facilities, hard copy taxpayer receipts, and related sensitive information.

Actions Taken:

In FY 2016, the IRS implemented the following controls to prevent unauthorized access to IRS facilities, hard copy taxpayer receipts, and related sensitive information:

- Updated the Procurement page on IRS.gov as a one-stop-shop where Contractors can find information about security, badging, and access.
- Conducted four-hour long training sessions for Contracting Officer's Representatives (CORs) on IRS security and badging requirements.
- Recommended changes to the IT Cyber Review Checklist, which included the addition of five questions to make it easier for Contract Specialists/Contracting Officers to add the appropriate cyber clauses to solicitations and contracts based on the responses indicated on the revised IT Cyber Review Checklist.
- Conducted a review of all contracts awarded since October 1, 2014, to ensure that proper cyber clauses had been included. Contract Specialists/Contracting Officers are now required to include a specific code in the description field of the award record indicating whether the cyber clauses are applicable or not and if applicable, that they were included in the award. Quarterly reports will be pulled to review the codes and to ensure that all applicable awards include the appropriate cyber clauses.
- Implemented an Enterprise Governance, Risk and Compliance (eGRC) database to track contractor compliance of security-awareness training requirements. The database allows a direct upload of training completion certifications by contract and provides access for Contracting Officer's Representatives and contractors.
- Issued interim guidance outlining current awareness training requirements for non-IRS contractors.
- Met with Federal Protective Service (FPS) and General Services Administration (GSA) to establish a process of communicating the requirement for security awareness training to non-IRS contractors with unescorted access and concluded that a study was needed to determine the types of non-IRS contractors requiring unescorted access and their need for security awareness training.

Actions Planned or Underway for FY 2017 and Beyond:

To ensure continued education on preventing unauthorized access to IRS facilities, the IRS will:

- Develop a course in the Enterprise Learning Management System (ELMS) for Contracting Officer's Representatives on their roles and responsibilities in providing contractors access to systems, facilities, and information.
- Complete a study to determine the types of non-IRS contractors requiring unescorted access and their security awareness training and collaborate with FPS and GSA to implement established processes.
- Collaborate with the Federal Protective Services (FPS) and the General Services Administration (GSA) to implement a process and establish procedures to monitor the compliance of whether non-IRS contractors with unescorted physical access to IRS facilities are receiving unauthorized access awareness training.

Preventing and Detecting Fraudulent Refunds Based on Identity Theft Summary of Major Issues: Effectively identify, design, and implement the most appropriate measures and internal controls for preventing and detecting identity theft-related refund fraud.

Actions Taken:

The IRS worked on a number of initiatives related to the Security Summit, a collaborative effort between the IRS, state tax administrators and private-sector tax partners. In FY 2016, the IRS:

- Collaborated with Security Summit participants to implement additional safeguards to protect taxpayers' federal and state tax accounts from identity thieves. Additional safeguards included:
  - Creating the "Taxes. Security. Together." campaign, which reached out to taxpayers to enlist their help in the battle against identity theft and refund fraud
  - Producing Publication 4524, *Security Awareness for Taxpayers*, which provided simple steps to protect personal and financial data online and at home and asking tax preparers to share the publication with their clients to help raise awareness about important security steps
  - Marketing Publication 4557, *Safeguarding Taxpayer Data*, which provided tax preparers an easy checklist for review and update of their security features and security plan
  - Publishing 10 Security Awareness Tips for taxpayers
  - Sharing news releases on phishing schemes and phone scams with Security Summit partners to disseminate through their communication channels
  - Developing publications, articles, YouTube videos, and other identity theft-related outreach events under the joint consumer campaign
  - Sharing information across IRS.gov, state web sites, and platforms used by the tax software community and others in the tax community

Steps taken on fraud related to prison issues included:

- Collected and analyzed inmate data from 50 states, the District of Columbia, and federal correctional agencies to prevent the payment of false returns to inmates. This effort resulted in stopping more than 99 percent of the refunds at the point of filing.
- Established an MOU with the SSA, the BFS, and the IRS in order to strengthen the

value of the prisoner data received from the SSA.

- Added two prison institutions to the Blue Bag Program (BBP) for a total of 1,081 correctional facilities participating throughout the 50 states.

Actions Planned or Underway for FY 2017 and Beyond:

- Engage tax software developers and the tax preparer community to identify additional data elements from individual and corporate tax returns to improve taxpayer authentication and identify possible identity theft scams as part of the Security Summit effort.
- Continue to work with state departments of correction to collect and analyze inmate data from 50 states, the District of Columbia, and federal correctional agencies to prevent the payment of false returns to inmates.
- Perfect the use of Social Security prisoner information to assist with fraud detection.

<u>Implementing Patient Protection and Affordable Care Act Tax-Related Provisions</u>

Summary of Major Issues: Improve the timeliness and accuracy of information provided by agencies and external partners and ensure that valid and accurate payments are processed.

Actions Taken*:

*See TIGTA Management Challenge 2: Implementing the Affordable Care Act and Other Tax Law Changes, for actions taken.

Actions Planned or Underway for FY 2017 and Beyond*:

*See TIGTA Management Challenge 2: Implementing the Affordable Care Act and Other Tax Law Changes, for future actions planned.

TIGTA Management and Performance Challenges

The Reports Consolidation Act of 2000 requires that the Treasury Inspector General for Tax Administration (TIGTA) summarize for inclusion in the annual Department of the Treasury Agency Financial Report its perspective on the most serious management and performance challenges confronting the IRS.

Each year, the TIGTA evaluates IRS programs, operations, and management functions to identify the areas of highest vulnerability to the Nation's tax system and presents them to the IRS in a memorandum titled, "Management and Performance Challenges Facing the Internal Revenue Service." For FY 2016, the top management and performance challenges, in order of significance, were:

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

10. Human Capital

The IRS addresses these issues through new and existing program activities. Measures of these program activities serve to show progress in addressing these management challenges. The actions taken and actions planned below address the management and performance challenges facing the IRS in FY 2016.

Security for Taxpayer Data and IRS Employees

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

Actions Taken:

The IRS continued efforts to protect the integrity of taxpayer data, minimize opportunities for fraud, and protect other sensitive information. During the fiscal year, the IRS:

- Established two new offices to provide project management oversight for email policy and archiving implementation, and due to an acquisition protest, identified an alternative approach that affords the best opportunity to minimize delays and negative impacts to implementing the IRS enterprise-wide solution for all agency email by the end of FY 2017 and other permanent e-records by January 2020.
- Prepared a Risk Assessment Form and Tool (RAFT) outlining the risk and effect of not meeting the requirement for email records management by January 2017.
- Updated policy and developed procedures for monitoring the inventory of external interconnections with financial institutions, which included developing a new combined Memorandum of Understanding (MOU)/Interconnection Security Agreement (ISA) template to ensure that newly developed ISAs have the same expiration dates for both the MOU and ISA components.
- Partnered with the Federal Protective Service (FPS) and TIGTA to deliver site-specific, in-person security briefings to employees, holding 158 briefings.

Actions Planned or Underway for FY 2017 and Beyond:

In FY 2017, the IRS will build upon established practices to protect the integrity of taxpayer data, minimize opportunities for fraud, and improve physical and personnel security by:

- Developing major milestones and project plans to upgrade email servers and email archiving functionality, and configure retention policies to implement an IRS email records management policy.
- Continuing efforts to meet the OMB December 31, 2016, directive to electronically archive email by streamlining the Records Control Schedule and bringing plans into compliance with the National Archives and Records Administration electronic recordkeeping management practices.
- Establishing process improvements through better coordination with financial institutions in the development of Interconnection Security Agreements and maintenance of the centralized interconnections inventory.
- Updating policy and procedures, as needed, to document Interconnection Security Agreements' organizational standards and procedures to ensure effective process improvements and efficiencies.

Implementing the Affordable Care Act and Other Tax Law Changes

Summary of Major Issues: Correctly implement new tax provisions, including tax-related health care provisions of the ACA.

Implementing the Affordable Care Act

Actions Taken:

To improve filing season successes, the IRS engaged with stakeholders to expand ACA information availability:

- Developed and distributed education and outreach materials for employers, tax professionals, and taxpayers via employer webinars, news updates, and social media. Topics included information returns, ACA tax provision requirements related to return filing, and the Premium Tax Credit.
- Used publicly available data from the Food and Drug Administration (FDA) and Customs and Border Protection to identify non-filers of the Medical Device Excise Tax and mailed notices to a sample of taxpayers to evaluate the impact of the notices on compliance.
- Reconciled the Exchange Periodic Data (EPD) data, which contains the months covered, advance premiums paid, and total monthly premiums, to the CMS records of disbursements paid to the marketplace insurance companies. The reconciliations are prepared at a summary level and the IRS will work with CMS to evaluate any significant variances.
- Ensured adherence to established standards and guidelines during financial systems testing of the Individual Income Tax Credits report and APTC and PTC reconciliation reports through increased monitoring.
- Performed improper payment risk assessments, in conjunction with the Department of Health and Human Services (HHS), to identify areas that might affect the APTC, PTC, Cost-sharing Reduction and Basic Health Plan payment accuracy. Results determined the risk is medium. In addition, both departments have established internal controls to enable and monitor effective program operations, reliable financial reporting, and compliance with laws and regulations.

The IRS also took steps to clarify provisions of the Act as well as the forms and supporting documentation required by:

- Revising instructions for IRS Form 8962, *Premium Tax Credit*, Form 8965, *Health Coverage Exemptions*, other forms, publications, fact sheets, charts, and information graphics to help taxpayers understand their health care law responsibilities.
- Releasing the final versions of four forms for 2016 health coverage information reporting under the ACA: Form 1094-B, *Transmittal of Health Coverage Information Returns,* Form 1095-B, *Health Coverage*, Form 1095-C, *Employer-Provided Health Insurance Offer and Coverage*, and Form 1094-C, *Transmittal of Employer-Provided Health Insurance Offer and Coverage Information Returns*. Comments on the draft forms could be submitted on the IRS website's comments page.

The IRS continued efforts to safeguard ACA-related tax information by:

- Updating Publication 1075, *Tax Information Security Guidelines for Federal, State and Local Agencies*, which included a section for new agencies that informs them of their need to:
    - Conduct an independent assessment
    - Provide a security assessment report with mitigation for all high risk findings

  - Present a signed Authority to Operate (ATO) before the safeguard security report will be approved and the agency authorized to receive data

Other Tax Law Changes

The IRS also continued efforts to detect fraud by exploring new compliance efforts, such as:

- Piloting the viability of a data exchange Memorandum of Understanding (MOU) with the Federal Bureau of Prisons. This pilot revealed that other IRS fraud prevention methods, such as analyzing inmate data to prevent the payment of false refunds, were more effective in mitigating prisoner refund fraud than the data exchange MOU originally anticipated.
- Attempting to establish Safeguard Security Reports with state departments of correction (DOCs) who signed data exchange MOUs; however, due to their inability to protect federal tax information as required by law, state DOCs preferred to continue other fraud prevention methods such as the Blue Bag Program. One thousand eighty-one prison institutions in 50 states participate in the program by using IRS-supplied blue mailing bags to monitor inmates' tax-related communications.

Actions Planned or Underway for FY 2017 and Beyond:

The IRS will continue compliance activities to reduce instances of error and fraud related to ACA. For example, the IRS will:

- Analyze tax year 2015 data to identify potential “stop filers” - taxpayers who filed in prior years but not in 2015 - and develop a plan to test options to bring taxpayers into compliance.
- Implement recommendations resulting from the risk assessment study to strengthen controls around the Premium Tax Credit program.

The IRS will engage with stakeholders and undertake efforts to improve information availability and compliance activities by:

- Analyzing results of the non-filer soft notice test to determine the need for additional compliance actions.
- Ensuring adherence to established standards and guidelines during financial systems testing of the Individual Income Tax Credits report and Advanced Payments of Premium Tax Credit (APTC) and Premium Tax Credit reconciliation reporting through increased monitoring.
- Supporting agency requests to receive Federal Tax Information (FTI) under legislation related to tax information security.
- Updating agencies on revisions to Publication 1075, *Tax Information Security Guidelines for Federal, State and Local Agencies*, to include the requirements for new agencies and existing agencies requesting new FTI data streams.
- Providing draft Form 1095-C, *Employer-Provided Health Insurance Offer and Coverage*, and Form 1094-C, *Transmittal of Employer-Provided Health Insurance Offer and Coverage Information Returns,* for employer planning purposes prior to filing in 2017.

Tax Compliance Initiatives

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

Businesses and Individuals

Actions Taken:

The IRS has undertaken a number of efforts to improve compliance and engage more effectively with taxpayers, such as:

- Applying the Bi-Partisan Budget Act (BBA) of 2015 to FY 2013 filing data to analyze partnership data for the purposes of determining the number of affected partnership structures and to understand the potential effect on the partnership examination process. There were 746,000 partnerships subject to the BBA; however, how it affects the partnership examination process will depend on the number of returns adjusted.
- Revising Federal Tax Deposit soft notices into three versions that are dependent on the type of change/decrease in deposits or deposit penalty assessment identified in the selection process. The revised letters also allow for flexibility with regard to "call-back" information, making it a lower cost option.
- Reviewing current processes associated with backup withholding under IRC section 3406 and developing recommendations to improve backup withholding compliance and oversight.
- Implementing compliance programming to capture and track the volume of taxpayers who are subject to a Refund Hold in one year, and file their tax returns in the following five years.
- Sampling 500 Forms 1120, *U.S. Corporation Income Tax Returns*, to identify potential fraud, which resulted in adding seven rules-based decision models to a suite of fraud filters used to recognize and stop potentially fraudulent filings.

In addition, the IRS evaluated field collection revenue officers' level of burden for case inventories by measuring volume and complexity and determined they were operating at the maximum productivity level based on current Internal Revenue Manual (IRM) guidelines for case assignments.

Actions Planned or Underway for FY 2017 and Beyond:

In the coming year, the IRS will follow up on many of the projects and initiatives instituted during the current fiscal year. Efforts will include:

- Applying the Bi-Partisan Budget Act (BBA) of 2015 to tax year 2015 filing data to determine if the new law has affected partnership structures and to determine the potential effect on the partnership examination process.
- Testing the lower cost treatment using notices without "call back" information, and measuring the results as compared to the notices that require a call back response or a response by correspondence.
- Implementing the Field Inventory Process Improvement Team project - This Future State pilot will explore opportunities to increase revenue officers' productivity by testing three different inventory selection and assignment processes.
- Establishing an implementation plan for backup-withholding processes after approval of final recommendations.
- Adding future filing compliance programming to capture and track the volume of taxpayers who are subject to a Refund Hold when complete data is available for tax year 2015 filers.

Tax-Exempt Entities

Actions Taken:

In FY 2016, the IRS continued to monitor program performance and compliance activities in the tax exempt/government entities sector. The IRS:

- Analyzed applications rejected from the Form 1023-EZ, *Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, and updated the online form to add a secondary entry field for the employee identification number (EIN) to prevent procedural rejection of the form and provide quality customer service.
- Conducted 1,248 audits of all organizations that received tax-exempt status from a streamlined application review process. Of the 1,248 audits:
  - 1,066 closed without proposed changes
  - 110 required changes to organizing documents
  - 37 resulted in obtaining delinquent returns
  - 21 were referred for a future audit
  - Seven resulted in a proposed tax
  - Seven resulted in other outcomes
- Developed and implemented a process to audit a sample of 1,182 organizations that applied for tax-exempt status using the Form 1023-EZ's online application. Completed 137 audits; 125 with no changes, 1 resulted in securing a delinquent return, and 11 required amendments to the organizing documents.
- Published Revenue Procedure 2016-37, *New Determination Program Revenue Procedure,* to provide formalized guidance to align with IRS program changes, assist taxpayers, and promote consistent treatment of applications for qualification of individually designed plans.
- Completed the LSS review and implemented recommendations to reduce the total time needed to approve, process, and issue refunds for direct-pay bond credit payments. (A direct pay bond is a tax credit bond where the bond issuer receives tax credit and interest is taxable.)
- Posted interactive Form 8038-CP, *Return for Credit Payments to Issuers of Qualified Bonds*, to assist taxpayers with the accuracy of the calculation before submission. Since the IRS introduced the interactive form, 25 percent of the total Form 8038-CPs submissions were filed with the interactive form.

Actions Planned or Underway for FY 2017 and Beyond:

The IRS will continue its efforts to improve tax-exempt outreach and compliance activities. For example, in the upcoming fiscal year the IRS will:

- Analyze online Form 1023-EZ, *Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, rejection data to identify and initiate additional potential improvements to the form and/or instructions.
- Determine the eligibility of amended plan submissions for determination letter issuance under the new Revenue Procedure 2016-37.

<u>Fraudulent Claims and Improper Payments</u>

Summary of Major Issues: Increase the ability to detect, prevent, and track fraudulent tax returns, improve assistance to victims of identity theft, and identify, measure, and reduce improper payments.

Actions Taken:

The IRS continues to pursue opportunities to reduce fraud and improper payments. Addressing improper payments, identity theft, and fraud continues to be a priority. In FY 2016, the IRS:

- Held three Security Summit meetings and created seven working groups to enhance cybersecurity and combat identity theft refund fraud.
- Redesigned the Secure Access e-Authentication process, which required multi-factor remote authentication techniques applied to web applications requiring high confidence in the asserted identity's validity.
- Implemented two new rules designed to identify potential misuse of Employer Identification Numbers (EINs) on Form 1120, *U.S. Corporation Income Tax Return*, filings.
- Conducted a W-2 Verification Code (VC) pilot for filing season 2016 with four payroll service providers; which tested the capability of a VC to confirm the integrity of Form W-2 data.
- Developed a way to measure how paid return preparers respond to IRS efforts to curb erroneous and fraudulent EITC claims.
- Signed a five-year agreement with the BFS and SSA to receive SSA prisoner data to help identify identity theft and fraudulent return claims filed by prisoners.
- Developed new fraud filter rules tailored to the unique characteristics of Schedule C returns that should select about 40,000 potential identity theft returns for review, with a 23 percent false detection rate.
- Implemented filters in processing year 2016 in the Dependent Database (DDb), a compliance-scoring platform to identify potential issues pre-refund. The filters focused on cases not previously detected.
- Developed an IRS.gov ACA Information Center and other outreach materials designed to educate Applicable Large Employers (ALEs) on information return reporting requirements and other solutions targeting a range of issues and challenges facing ALEs. The content was disseminated actively through 90 events involving 55,745 audience members.

Actions Planned or Underway for FY 2017 and Beyond:

In FY 2017, the IRS will continue to pursue opportunities to combat identity theft, detect fraudulent tax returns, and reduce improper payments. Planned activities include:

- Implement additional improvements to Business Master File (BMF) identity theft filters for Form 1120, *U.S. Corporation Income Tax Return*, and Form 1041, *U.S. Income Tax Return for Estates and Trusts*.
- Monitor known bad EINs and addresses and cross-reference Social Security Numbers to identify and neutralize the misuse of Employer Identification Numbers (EINs).
- Increase the scope of the W-2 VC pilot in filing season 2017 by increasing the number of W-2s in the pilot to about 50 million forms and types of W-2 issuers to include additional payroll service providers and a large federal organization.
- Administer Public Law 114-113, *Protecting Americans from Tax Hikes (PATH)*, by incorporating paid preparer returns of the American Opportunity Tax Credit, Child Tax Credit, and Additional Child Tax Credit into a combined Refundable Credits Return Preparer program to reduce improper payments and erroneous claims filed by preparers who fail to exercise due diligence.

Achieving Program Efficiencies and Cost Savings

Summary of Major Issues: Improve program effectiveness and reduce costs.

Actions Taken:

The IRS continued to seek opportunities to achieve cost efficiencies and program operational efficiencies. In FY 2016, the IRS improved efficiency in the following IT-related and operational activities:

- Completed 61 projects to release more than 558,000 square feet of rented space from inventory for an annual rent savings of about $16 million; bringing the total annual rent savings to more than $159.3 million since 2010.
- Developed procedures and created an inventory system to review mainframe software licensing agreements, purchases, deployment, usage, and other related aspects of mainframe licensing to identify additional savings in software spending.
- Integrated the Enterprise Software Governance Board (ESGB) governance and executive review process into the Infrastructure Executive Steering Committee (IESC), standard operating procedures for mainframe software licensing.
- Developed an implementation plan for the IBM Big Fix Software Use Analysis toolkit that will allow Software Asset management data to be consolidated, stored, and tracked more efficiently.
- Collaborated with the DOD and the BFS to expand the use of the Federal Payment Levy Program (FPLP) and determined that DOD needed to make programming changes to exclude disability payments from the military retirement payment file.
- Collaborated with Federal Protective Services (FPS) to develop a process to obtain current and future FPS Facility Security Assessments (FSA) for IRS facilities; determining that IRS Security Staff would obtain copies of the FSAs and continue to conduct risk assessments in IRS occupied facilities, integrating the FPS FSA findings in risk assessments and revalidation processes.

Similarly, the IRS has taken a number of steps to improve resource management and internal prioritization practices. In FY 2016, the Service:

- Provided training to 29 Enterprise Risk Liaisons on two newly developed enterprise risk-management training modules.
- Established the Risk Acceptance Form and Tool (RAFT) directory. The RAFT form provides a consistent framework for the IRS to document business decisions in the context of risk appetite and/or acceptance. In FY 2016, the IRS completed 84 RAFTs.
- Developed key risk indicator examples for four enterprise risk themes.
- Completed a performance measures report that identifies cost and revenue data for IRS notices.

Actions Planned or Underway for FY 2017 and Beyond:

In FY 2017, the IRS will continue efforts to achieve program operational and cost savings efforts by:

- Maintaining software licensing inventory data to manage licensing and to identify additional savings in software spending
- Continuing governance activities to track accountability of software asset and license management across the IRS

- Adding military payments into the Federal Payment Levy Program (FPLP) upon notification of the DOD's programming changes

In addition, the IRS will focus on improving operational efficiency through efforts that will include:

- Refining notice cost calculations in the notice cost database to improve the downstream calculations
- Developing podcasts to foster awareness of Enterprise Risk Management for all IRS employees

Improving Tax Systems and Online Services

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

Actions Taken:

Protecting IRS systems and taxpayer data is essential for maintaining high-quality taxpayer service programs. In FY 2016, the IRS made the following improvements to taxpayer service and operations efficiency:

- Deployed several CADE 2 Transition State 2 projects for filing season 2016, which allowed a more effective way to record and retain taxpayer history, corrected automated failure to pay calculations for the adjusted refundable credits, and aggregated and provided taxpayer data to downstream systems across the IRS.
- Enhanced the capability to detect and block fraud in real-time by integrating other web-facing applications, including the Return Review Program, to determine an individual risk profile for taxpayers.
- Created the capability to stream e-Authentication log data to the Cybersecurity Data Warehouse for fraud analysis.
- Released the Future State vision for modernizing taxpayer service and enforcement, and prioritized investments in online accounts and other digital capabilities aligned with the vision.

Actions Planned or Underway for FY 2017 and Beyond:

In FY 2017, the IRS will continue to improve system performance and integrity. For example, the IRS will:

- Continue to align projects and investments with the Future State vision, and identify new opportunities to improve taxpayer service and compliance using digital services and other Future State capabilities.
- Leverage the CADE 2 database for all individual taxpayer account data and generate data necessary to build financial and legal transcripts.
- Leverage the CADE 2 database for:
  - Individual taxpayer refunds to the Department of the Treasury
  - Taxpayer transcripts for the annual financial statement audit and legal proceedings
  - Customer service and compliance functions on the Integrated Data Retrieval System (IDRS)
- Focus on the financial material weakness for individual taxpayer accounts in the Individual Master File (IMF).
- Implement the data services framework to provide CADE 2 data to downstream

systems via modernized data distribution services, providing legacy and modernized data formats.

- Create alerts and queries to monitor e-Authentication operations.
- Establish a foundation for a modernized individual tax-processing engine by reengineering core IMF posting, settlement, and analysis functions into Java-based programs.

Providing Quality Taxpayer Service Operations Summary of Major Issues: Improve taxpayer service

Actions Taken:

The IRS continued to conduct outreach, improve delivery of taxpayer service options, and educate taxpayers on their availability. In FY 2016, the IRS:

- Promoted the availability of self-service options for taxpayers by educating taxpayers using traditional service channels, social media, videos, and public service announcements.
- Optimized resources to deliver taxpayer services through the VITA and TCE programs using effective communication and training, virtual technology, and leveraging of IRS partner resources.
- Transitioned an additional 266 TACs to the appointment-based model, bringing the total to 310 TACs that operate using appointments for walk-in service. Appointment locations show improvements in wait time of almost 41 percent.
- Added five new topics to the Interactive Tax Assistant (ITA) on IRS.gov for the 2016 filing season:
  - Taxes Schedule A
  - Retirement Contribution Credit
  - Tip Income
  - Child and Dependent Credit
  - Scholarships, Fellowships, and Grants
- Developed a suite of products and tools based on IRS outreach priorities to provide awareness and education to taxpayers for both the filing season and post-filing season.
- Determined the current methodology for tracking the amount of time it takes to resolve taxpayer accounts affected by identity theft is the most practical.

Actions Planned or Underway for FY 2017 and Beyond:

In the upcoming year, the IRS will continue to look for opportunities to expand the scope and availability of taxpayer service options and to improve upon traditional means of taxpayer service. Improvements to service delivery methods will include:

- Continuing to educate and encourage taxpayers to use alternative services with a special emphasis on any changes dictated by recent Congressional requirements and the IRS's Future State initiatives.
- Providing appointment service at the remaining TACs by the end of calendar year 2016.
- Communicating best practices and strategies for resource optimization in the delivery of the VITA and TCE programs.
- Continuing to identify and share outreach priorities with partners to assist taxpayers in satisfying their tax responsibilities.

Globalization

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

Actions Taken:

The IRS remained diligent in increasing communication and compliance and enhancing interactions with global third parties. In FY 2016, the IRS:

- Investigated counter-terrorism referrals identified through the course of normal compliance activity, including investigations related to the use of charitable organizations suspected of knowingly being involved in illicit financing of terrorist activities.
- Conducted awareness and training programs for employees on how to recognize and understand indicators of the misuse of charities to fund terrorism, and participated in the Financial Action Task Force (FATF) Mutual Evaluation of the United States relating to U.S. efforts in the counter-terrorism arena.
- Deployed the FATCA registration system Releases 3.0, 4.0, and 4.1. Major enhancements included:
  - Enabled FATCA registration system and the Foreign Financial Institution (FFI) list functionality to provide sponsoring entities the ability to obtain a Global Intermediary Identification Number (GIIN) and to manage sponsored entities and sponsored subsidiary branches
  - Enabled an automated process for Financial Institutions (FIs) to update its registration status and to change FI types and/or transfer under a new lead FI
- Updated the FATCA Compliance Roadmap with activities for identifying non-compliance by FFIs.
- Conducted outreach and education to address errors made by paid preparers on Form 1116, *Foreign Tax Credit,* (FTC) and presented the topic at the 2016 National Tax Forums in an effort to educate as many paid tax practitioners as possible.
- Supported the OECD by providing three subject matter experts to serve on the Common Transmission System (CTS) Technical Evaluation Panel that evaluated vendor proposals to develop and operate the system.
- Implemented controls related to Form 1116, *Foreign Tax Credit,* by programming a new error code, updating policy and procedures to include instructions on processing the form, and updating the 2016 Coding and Editing Individual Income Tax Returns Training.

Actions Planned or Underway for FY 2017 and Beyond:

In FY 2017, the IRS will continue to address global third-party compliance and tax administration. Planned actions include:

- Use referrals to investigate tax-exempt entities related to counterterrorism matters and, if applicable, move those referrals into the larger national security arena.
- Continue to educate employees on fraud relating to counter-terrorism financing.
- Work closely with the FBI's Terrorist Financing Operations Section (TFOS) to identify those funding terrorist activities through the use/abuse of charitable organizations.
- Deploy FATCA Program Release 5.0 enhancements that will include:
  - Permitting FIs to renew their FFI agreements by December 31, 2016
  - Allowing Qualified Intermediaries (QIs), Withholding Foreign Partnerships

(WPs), and Withholding Foreign Trusts (WTs) to renew their agreements before the January 1, 2017, legislative deadline
  - Allowing QIs/WPs/WTs to apply online and allowing authorized IRS users to view FI & QI renewals and manage QI/WP/WT accounts
  - Allowing FIs to submit a certification of pre-existing accounts (once) and FIs/QI/WP/WT periodic certification (every three years)
- Provide Project Management support to the OECD Global Forum Secretariat during the remainder of FY 2017 as the CTS project begins. Work with the IDES vendor to determine steps necessary to transition from an IDES-only environment to one where IDES is complemented by CTS in order to ensure compatibility of systems, and that U.S. treaty obligations can be fulfilled in a safe and efficient manner.

Taxpayer Protection and Rights

Summary of Major Issues: Apply the tax laws fairly

Actions Taken:

In FY 2016, the IRS engaged in a number of activities with external stakeholders to promote data protection and updated its internal processes and policies to minimize the potential mistreatment of taxpayers:

- Expanded the Suspicious Filer Exchange to include 43 states and 6 municipalities whereby the IRS and states share information for confirmed identity theft and questionable returns through secure data transfers, for use with filter and authentication processes.
- Established a process to expedite the sharing of significant tax incidents or threats amongst Security Summit partners.
- Provided guidance to Automated Collection System Support (ACSS) sites to conduct research for a new taxpayer address when the lien notice envelope shows multiple reasons for return.
- Revised IRM 5.10.4, *Seizure and Sale, Actions Prior to Sale,* for advertising the sale of seized property and issued a memorandum to all Field Collection and Property Appraisal Liquidation Specialist (PALS) Group Managers and Revenue Officers reminding them of their responsibility to follow IRM 5.10.4.8 (5); which explains the process for documenting revisions to the fair market value.

Actions Planned or Underway for FY 2017 and Beyond:

In order to protect the safety and security of taxpayer data, the IRS will:

- Continue to analyze the value of data elements required by the Tax Software Industry (TSI) to transmit with returns and plan modifications based on results.
- Develop data elements for business returns so that the Tax Software Industry may provide suspicious business return information.
- Provide federal and state tax agencies with data fields for use in identifying suspicious tax returns.
- Test the address verification research procedures for effectiveness and revise IRM 5.19.6, *Liability Collection, ACS Support*, to align with the test findings and clarify the procedures, as needed.

Human Capital

Summary of Major Issues: Meet expectations in personnel management to enable the IRS to achieve its mission successfully.

Actions Taken:

The IRS values its workforce and recognizes human capital as its most important resource. Ensuring meaningful improvements to employee engagement, and developing a quality workforce to meet future challenges is critical to the success of the IRS. In FY 2016, the IRS:

- Selected nominees for two new recognition initiatives, the Treasury Customer Service Award and the President's Customer Service Award; which reinforce the importance of customer service in civil service positions.
- Identified engagement focal points from the FY 2015 Federal Employee Viewpoint Survey (FEVS) results and developed engagement activities for inclusion in the LEAP. Subsequently, administered the 2016 FEVS, providing IRS leaders the opportunity to listen to their employees' views on the previous year's activities and assess the impact on employee perceptions driving job satisfaction, commitment, and engagement.
- Held a Leadership Engagement Day for all managers to give them the opportunity to discuss 2016 successes and challenges and to contribute ideas for inclusion in the 2017 IRS LEAP. Conducted a cross-agency "Hack-A-Thon" for leaders to share and gather best practice ideas for employee engagement across organizational lines.
- Launched 11 knowledge network websites that were topic-based, provided technical information to field personnel, delivered 61 technical presentations, answered 384 technical questions from the field, and published 20 technical issue documents to IRS.gov.
- Amended Section 1203(b) policy to require documentation of the written coordination between the Deciding Official, 1203 Review Board, and the Commissioner when there is potential consideration of a personnel action other than termination following a 1203 violation.
- Utilized data from examination closure results to foster a culture of data-driven decision making to improve examination processes and procedures, assess training needs, and improve case selection models, including:
    - Performing workload studies bi-annually to determine hiring needs based on filer location by types of retirement plans and plan size/complexity
    - Conducting data analysis of results from case selection models and technical briefings to determine technical training needs for focused and emerging issues
    - Using audit results to select cases with the highest potential for non-compliance and distribute the work to employees with the proper skill sets to address the unique challenges of a specific case
    - Using case quality reviews to identify training needs to improve the audit quality and customer satisfaction

In addition, the IRS made these organizational changes to improve operations:

- Completed and approved the Small Business/Self-Employed Request for Organizational Change (S-ROC) to align Headquarters (HQ) Exam staff to the appropriate HQ Exam function
- Established team members in key areas of the Automated Collection System (ACS) program with oversight for ACS inventory, predictive dialer, incoming calls, and

correspondence
- Reviewed the strengths, weaknesses, opportunities, and threats faced by the Procurement organization and determined actions needed for process improvements
- Held Lean Six Sigma Process Improvement training on Procurement documentation.
- Realigned the Procurement organization to report directly to the Deputy Commissioner for Operations Support

Actions Planned or Underway for FY 2017 and Beyond:

In order to continue our human capital successes in FY 2017, the IRS will:

- Expand engagement activities and launch a Servicewide mentoring site and conduct developmental focus days for executives, senior managers, and front-line managers to share best practices.

The IRS will continue to assess training and hiring needs to foster a culture of data-driven decision-making:

- Implement approved compliance recommendations regarding procedures, staffing and organizational changes in support of the Future State vision.
- Develop subject matter experts to provide quarterly continual professional education training to employees.
- Increase usage of technical discussion forums.
- Capture ongoing training needs using data-driven issue metrics.
- Supplement published technical documents with 15-minute podcasts for employees and the public.
- Analyze additional data sources and incorporate applicable data into case selection models.
- Develop an automated feedback process to evaluate whether the case selection models need changes.
- Explore whether a composite score system would be effective in evaluating examination effectiveness.
- Determine staffing and workload reallocation for the Procurement organization.

FINANCIAL HIGHLIGHTS

Revenue and Refund Trend Information

FY 2016 revenue receipts collected by the IRS totaled $3.3 trillion. The IRS collects federal tax revenues through six major classifications: individual income and FICA/SECA, corporate income, excise taxes, estate and gift taxes, railroad retirement, and federal unemployment taxes.

FY 2016 tax refund and outlay activity totaled $426 billion, representing an increase from $403 billion in FY 2015. Federal tax refunds include refunds of tax overpayments, payments for interest, and disbursements for refundable tax credits such as EITC and the Additional Child Tax Credit.

Excise Tax Trust Fund

	FY 2014	FY2015
Airport & Airway Trust Fund	$13,601,102,077	$14,201,025,456
Black Lung Disability Trust Fund	$574,405,800	$540,950,252
Highway Trust Fund	$39,608,225,227	$41,364,513,585
Total	$53,783,733,104	$56,106,489,293

Form 720, *The Quarterly Federal Excise Tax Return,* 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 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 during 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 2013 through September 2015. 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 2016 Financial Statements, the unpaid assessment balance was $391 billion as of September 30, 2016, and $203 billion (52 percent) 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 for consideration as 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 $178 billion (46 percent) of unpaid assessments and increased $7 billion (4 percent) from $171 billion as of September 30, 2015. About $129 billion (72 percent) of this balance is uncollectible because of the economic situations of the taxpayers. In general, except for bankruptcy situations, the IRS may continue collection actions for 10 years after the assessment. About $49 billion (28 percent) of taxes receivable is collectible.

- Compliance assessments of $74 billion represent amounts not 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 $139 billion include amounts owed by defunct corporations with no assets and by failed financial institutions. Taxpayers with extreme economic and/or financial hardships, deceased taxpayers, and taxpayers who are insolvent due to bankruptcy owe the remaining amounts.

The Integrated Financial System (IFS)

The IFS is the financial management system for the IRS's 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, Budget Formulation, Labor Forecasting and Budget Execution decision support.

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 Major IT Investments within +/- 10% Cost Variance
- Number of major IT investments within +/-10 percent variance between planned total cost and projected/actual cost within a fiscal year divided by the total number of major IT investments in that fiscal year.
- Percent of Major IT Investments within +/- 10% Schedule Variance
- Number of major IT investments within +/-10 percent variance between planned days and projected/actual days within a fiscal year divided by the total number of major IT investments in that fiscal year.

Taxpayer Service: 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 IMF paper returns issued within 40 days or less.
- **Taxpayer Self Assistance Rate**
  - The percentage of taxpayer assistance requests resolved using self- assisted automated services.

Enforcement: 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 (TEGE) 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 National 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 National 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**
  - The 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 standards.
- **Examination Coverage – Business (Assets >$10M)**
  - 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, TEGE 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 we 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**
  - The volume of collection work disposed divided by the volume of collection work available.
- **Collection Efficiency**
  - The volume of collection work disposed divided by total collection FTE.
- **Field Collection National 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's) program divided by the number of convictions. The number of convictions is the total number of cases with the following statuses: guilty plea, nolo contendere, judge guilty or jury guilty.
  - The CI financial plan includes direct and reimbursable costs, including employees' salaries, benefits, and investigative expenses, as well as facility costs (office space, heating, cleaning, computers, security, etc.), and other overhead costs.
  - 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.

Appendix B

Performance Measurement Data

	Measurement	2013	2014	2015	2016 Target	2016 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 Major IT Investments within +/- 10% Cost Variance at the Investment Level[1]	0%	66.7%	73.7%	90.0%	76.2%
	Percent of Major IT Investments within +/- 10% Schedule Variance at the Investment Level[1]	83.3%	100.0%	89.5%	90.0%	85.7%
Taxpayer Service: *Deliver high quality and timely service to reduce taxpayer burden and encourage voluntary compliance*	Customer Service Representative (CSR) Level of Service	60.5%	64.4%	38.1%	47.0%	53.4%
	Customer Contacts Resolved per Staff Year	20,767	21,018	26,245	28,000	28,497
	Customer Accuracy – Tax Law Phones	95.7%	95.0%	95.0%	92.0%	96.4%
	Customer Accuracy – Customer Accounts (Phones)	96.0%	96.2%	95.5%	94.0%	96.1%
	Timeliness of Critical Filing Season Tax Products to the Public	58.9%	99.1%	89.0%	87.0%	92.5%
	Timeliness of Critical TE/GE and Business Tax Products to the Public	83.6%	98.7%	92.6%	87.0%	98.0%
	Percent Individual Returns Processed Electronically	82.5%	84.1%	85.3%	86.0%	86.4%
	Percent Business Returns Processed Electronically	40.2%	43.1%	47.0%	48.0%	50.0%

	Measurement	2013	2014	2015	2016 Target	2016 Actual
	Refund Timeliness – Individual (Paper)	99.0%	98.7%	98.8%	97.0%	98.7%
	Taxpayer Self Assistance Rate	83.3%	84.7%	88.7%	90.0%	89.0%
Enforcement: *Effectively enforce the law to ensure compliance with tax responsibilities and combat fraud*	Examination Coverage – Individual	1.0%	0.9%	0.8%	0.6%	0.7%
	Field Examination National Quality Review Score	89.2%	88.4%	86.7%	86.7%	86.8%
	Office Examination National Quality Review Score	90.3%	90.6%	88.3%	88.3%	88.4%
	Examination Quality – Large Business	92.0%	83.0%	86.0%	90.0%	83.0%
	Examination Coverage – Business (assets >$10M)	5.6%	4.3%	3.9%	3.5%	3.0%
	Examination Efficiency – Individual (1040)	142	138	148	122	143
	Automated Underreporter (AUR) Efficiency	2,025	1,935	2,209	2,036	2,196
	Automated Underreporter (AUR) Coverage	2.8%	2.6%	2.3%	2.2%	2.3%
	Collection Coverage	47.0%	45.9%	46.3%	41.8%	43.4%
	Collection Efficiency	2,057	2,051	2,448	2,208	2,266
	Field Collection National Quality Review Score	81.4%	81.6%	79.2%	79.7%	79.2%
	Automated Collection System (ACS) Accuracy	94.4%	95.2%	95.3%	95.0%	95.4%
	Criminal Investigations Completed	5,557	4,606	4,486	3,800	3,721
	Number of Convictions	3,311	3.110	2,879	2,500	2,672

	Measurement	2013	2014	2015	2016 Target	2016 Actual
	Conviction Rate	93.1%	93.4%	93.2%	92.0%	92.1%
	Conviction Efficiency Rate ($)	$211,048	$231,103	$221,782	$272,000	$250,563
	TE/GE Determination Case Closures	65,877	136,746	111,940	103,852	99,973

[1] Starting in FY 2015, this measure includes all major IT investments (BSM and non-BSM). In previous years it included BSM only.

Appendix C

Explanation of Shortfalls

Percent of Major IT Investments within +/- 10% Cost Variance Level:

Eighteen of 21 major investments (85.71 percent) were within the schedule variance threshold at the close of the fourth quarter. The IRS IT budget and resource limitations (hiring restrictions) have impacted schedules in FY 2016. The IRS IT organization will continue to closely monitor schedule reporting for investments in FY 2017 to improve current performance levels for this measure.

Percent of Major IT Investments within +/- 10% Schedule Variance Level:

Sixteen of 21 major investments (76.19 percent) were within the cost variance threshold at the close of the fourth quarter. Four investments did not meet the cost variance threshold due to under-spending. The IRS IT organization will continue to closely monitor cost reporting for investments in FY 2017 to improve current performance levels for this measure.

Taxpayer Self-Assistance Rate:

The Taxpayer Self Assistance Rate was one percentage point below plan. This is due to higher than expected Assistor Calls Answered (2.7M more calls, 12 percent over plan). In addition, Electronic Filing PIN (EFP) was disabled as of June 17, 2016 due to questionable activity involving the tool. Interactive Tax Assistant usage was significantly below plan by 26.4 percent. The IRS continues to create and promote self-help methods that support the needs of the taxpayer as well as our ability to manage resources as efficiently as possible in order to meet all future goals.

Examination Quality – Large Business:

The decline in the LB&I Overall Examination Quality Score is a result of low scores in the Planning and Execution technical standards. Some of the actions taken to improve quality include: providing “greatest areas of opportunity” in the reports shared with leadership; sharing detailed results on each case reviewed with the manager and team coordinator; and increasing communication with the field through presentations on case quality at team/territory meetings.

Examination Coverage – Business:

The IRS maintained planned closures on larger corporate returns while exceeding coverage on the largest corporate return category, which required more resources to close. As attrition depleted examination resources, unfinished cases were transferred to remaining examiners. Planned examination resources were diverted to reorienting new exam team members.

Field Collection National Quality Review Score (NQRS):

The shortfall is related to the low scoring NQRS attributes 203 (Requested/Secured Financial Information), 432 (Verify/Analyze Ability to Pay), 437 (Compliance), and 618 (Action Dates, Expectations and Consequences). To address the shortfall in Field Collection NQRS and improve performance, the IRS will hold Consistency Review Meetings to better identify quality review trends and issues. In addition, the IRS will conduct joint planning efforts to better inform managers in the quality process and develop focused communication and training materials to drive improvements in casework and achieve the targeted NQRS score.

Criminal Investigations Completed:

Year-end results are 97.9 percent of year-end target (3,800) and reflect a 17.1 percent decrease compared to FY 2015. Overall performance in FY 2016 continued to be impacted by a decrease in the number of special agents in recent years due to attrition and limited hiring, as well as a re-focus on more complex tax case programs, which take longer to complete. Cases of Legal, Illegal and Narcotics nature completed through fourth quarter decreased (21.8 percent, 4.2 percent and 24.9 percent, respectively) compared to the same period in FY 2015. The IRS will continue to utilize proven case development strategies, expand case development efforts, and leverage interagency partnerships to identify, initiate, and complete criminal investigations in all program areas.

TEGE Determination Case Closures:

The IRS finished 96 percent of FY 2016 planned determination case closures. While the closure goal for applications from organizations seeking tax-exempt status was exceeded by over 1,200 cases, employee plan determination application closures were approximately 5,100 cases short of the fiscal year goal because the IRS received fewer Forms 5307, *Application for Determination for Adopters of Volume Submitter Plans*, applications than initially forecasted, as customer behavior did not match expectations. As a result, the IRS focused on closing the over-age inventory in advance of the Employee Plans determinations program changes that will be effective January 1, 2017. In FY 2017, determination closures will be influenced by changes in the Employee Plans determination program where only initial plan qualifications, terminations, and some plan amendment applications will be accepted.

Appendix D

Long-Term Measure Definitions

Long-Term Measure	Definition
Voluntary Compliance Rate	The amount of tax paid on timely returns divided by the amount of tax that should have been paid for a given year
American Customer Satisfaction Index (ACSI)	Overall individual taxpayer satisfaction with the tax return filing process for both paper and electronic filing.
Employee Engagement	Using 11 questions from the OPM annual survey (formerly the Federal Human Capital Survey, currently the Federal Employee Viewpoint Survey), the IRS has developed an index that measures employee engagement and is using the index to compare itself to other large federal agencies with 20,000 or more civilian employees.
Enforcement Satisfaction Score	The enforcement satisfaction score attempts to measure the extent to which taxpayers contacted as part of the IRS compliance efforts feel that the process was satisfactory. It attempts to measure taxpayer interactions independent of the ultimate outcome of the enforcement activity
Service Satisfaction Score	The service satisfaction score attempts to measure the extent to which taxpayers who contacted the Service for assistance feel the service provided was satisfactory.
E-file Rate (Individual)	Percent of all major tax returns filed electronically by Individuals.
E-file Rate (Business)	Percent of all major business returns filed electronically by businesses, and tax-exempt entities.
IT – End to End	The availability of software and system components of 10 critical IRS systems from 15 of the largest IRS locations.
IT – Portal Availability	Availability to the customer.
Software Currency	Proportion of software products on critical systems within one version of the current release.

Service Interactions Processed Electronically	The percent of electronic interactions conducted by taxpayers relative to the total number of service interactions conducted by taxpayers across all channels (currently measured using individual taxpayer payments).
Service Interactions Available Electronically	The percent of electronic services available to the taxpayer on IRS.gov relative to the most frequent services provided to the taxpayer across all channels, including web, phone, walk-in, and mail.

Appendix E

Long-Term Measure Data

Long-Term Measure	FY 2014-2017 IRS Strategic Plan Target (Baseline and Year)	Update (Year)	FY 2017 Target
Voluntary Compliance Rate	83% (TY 2006) (2011)	81.7% (TY 2008-2010) (2016)	86%
American Customer Satisfaction Index (ACSI)	72 (2013)	73 (2015)	75
Employee Engagement	8th of 15 for large agencies (2013)	14th of 15 for large agencies (2015)	Top Quartile
Enforcement Satisfaction Score	72% (2012)	66% (2015)	75%
Service Satisfaction Score	91% (2013)	86% (2015)	94%
e-file Rate for Individual Returns	83% (2013)	86% (2015)	90%
e-file Rate for Business Returns	40% (2013)	48% (2015)	50%
IT - End to End	99% (2014)	99.8% (2014)	99%
IT - Portal Availability	100% (2014)	100% (2015)	100%
Software Currency	75% (2014)	75% (2015)	85%
Service Interactions Processed Electronically	23% (2014)	32.3% (2015)	50%
Service Interactions Available Electronically	50% (2014)	53% (2015)	75%

Accessible Text for 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 2016 and 2015 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.

Internal Revenue Service Balance Sheet,

As of September 30, 2016 and 2015 (in millions)

Intragovernmental **Assets**	**2016**	**2015**
Fund balance with Treasury (Note 2)	$ 2,580	$ 2,370
Due from Treasury (Note 6)	2,974	3,025
Other assets (Note 3)	10	10
Total intragovernmental	**5,564**	**5,405**
Cash and other monetary assets (Notes 4, 6)	671	455
Federal taxes receivable, net (Notes 5, 6)	49,000	41,000
General property and equipment, net (Note 7)	1,996	1,795
Other assets (Note 3)	14	14
Total assets	**$ 57,245**	**$ 48,669**

Intragovernmental **Liabilities**	**2016**	**2015**
Due to Treasury (Note 5)	$ 49,000	$ 41,000
Other liabilities (Note 8)	175	166
Total intragovernmental	**49,175**	**41,166**
Federal tax refunds payable	2,974	3,025
Other liabilities (Note 8)	2,104	1,853
Total liabilities	**54,253**	**46,044**

Net position	2016	2015
Unexpended appropriations	1,587	1,480
Cumulative results of operations	1,405	1,145
Total net position	2,992	2,625
Total liabilities and net position	$ 57,245	$ 48,669

For the Years Ended September 30, 2016 and 2015 (in millions)

Taxpayer Assistance and Education	2016	2015
Gross cost	$ 540	$ 636
Earned revenue	(2)	(2)
Net cost of program	538	634

Filing and Account Services	2016	2015
Gross cost	3,939	3,906
Earned revenue	(114)	(109)
Net cost of program	3,825	3,797

Compliance	2016	2015
Gross cost	7,868	7,672
Earned revenue	(387)	(410)
Net cost of program	7,481	7,262

Administration of Tax Credit Programs	2016	2015
Gross cost	141	154
Earned revenue	-	-
Net cost of program	141	154
Net cost of operations (Note 11)	$ 11,985	$ 11,847

Statement of Changes in Net Position For the Years Ended September 30, 2016 and 2015 (in millions)

	2016 Cumulative Results of Operations	2016 Unexpended Appropriations	2015 Cumulative Results of Operations	2015 Unexpended Appropriations
Beginning balances	**$ 1,145**	**$ 1,480**	**$ 994**	**$ 1,493**

Budgetary financing sources	2016 Cumulative Results of Operations	2016 Unexpended Appropriations	2015 Cumulative Results of Operations	2015 Unexpended Appropriations
Appropriations received		11,235		10,945
Transfers in/out without reimbursement	18	(1)	9	8
Other adjustments		(94)		(108)
Appropriations used	11,033	(11,033)	10,858	(10,858)

Other financing sources	2016 Cumulative Results of Operations	2016 Unexpended Appropriations	2015 Cumulative Results of Operations	2015 Unexpended Appropriations
Imputed financing	1,219		1,161	
Transfers in/out without reimbursement	-		-	
Transfers to general fund	(25)		(30)	

	2016 Cumulative Results of Operations	2016 Unexpended Appropriations	2015 Cumulative Results of Operations	2015 Unexpended Appropriations
Total financing sources	12,245	107	11,998	(13)
Net cost of operations	(11,985)		(11,847)	
Net change	260	107	151	(13)
Ending balances	$ 1,405	$ 1,587	$ 1,145	$ 1,480

Statement of Budgetary Resources For the Years Ended September 30, 2016 and 2015 (in millions)

Budgetary resources	2016	2015
Unobligated balance brought forward, October 1	$ 1,018	$ 1,088
Recoveries of prior year unpaid obligations	116	95
Other changes in unobligated balance	(63)	(91)
Unobligated balance from prior year budget authority, net	1,071	1,092
Appropriations (discretionary and mandatory)	11,614	11,344
Spending authority from offsetting collections (discretionary and mandatory)	123	112
Total budgetary resources	$ 12,808	$ 12,548

Status of budgetary resources	2016	2015
New obligations and upward adjustments (total) (Note 12)	$ 11,859	$ 11,530

Unobligated balance, end of year	2016	2015
Apportioned, unexpired accounts	467	611
Exempt from apportionment, unexpired accounts	7	7
Unapportioned, unexpired accounts	151	56
Unexpired unobligated balance, end of year	625	674
Expired unobligated balance, end of year	324	344
Unobligated balance, end of year (total)	949	1,018
Total budgetary resources	$ 12,808	$ 12,548

Change in obligated balance	2016	2015
Unpaid obligations brought forward, October 1	$ 1,382	$ 1,329
New obligations and upward adjustments (Note 12)	11,859	11,530
Outlays (gross)	(11,460)	(11,382)
Recoveries of prior year unpaid obligations	(116)	(95)
Unpaid obligations, end of year	1,665	1,382
Uncollected payments, federal sources, brought forward, October 1	(24)	(38)
Change in uncollected payments, federal sources	(6)	14
Uncollected payments, federal sources, end of year	(30)	(24)
Memorandum (non-add) entries:		
Obligated balance, start of year	1,358	1,291
Obligated balance, end of year	$ 1,635	$ 1,358

Budget authority and outlays, net	2016	2015
Budget authority, gross (discretionary and mandatory)	$ 11,737	$ 11,456
Actual offsetting collections (discretionary and mandatory)	(150)	(144)
Change in uncollected payments, federal sources (discretionary and mandatory)	(6)	14
Recoveries of prior year paid obligations (discretionary and mandatory)	33	18
Budget authority, net (total) (discretionary and mandatory)	$ 11,614	$ 11,344
Outlays, gross (discretionary and mandatory)	$ 11,460	$ 11,382
Actual offsetting collections (discretionary and mandatory)	(150)	(144)
Outlays, net (total) (discretionary and mandatory)	11,310	11,238

Distributed offsetting receipts	(348)	(352)
Agency outlays, net (discretionary and mandatory)	$ 10,962	$ 10,886

Statement of Custodial Activity For the Years Ended September 30, 2016 and 2015 (in billions)

Revenue activity - Collections of federal tax revenue (Note 13)	2016	2015
Individual income, FICA/SECA, and other	$ 2,875	$ 2,800
Corporate income	346	390
Excise	76	77
Estate and gift	22	20
Railroad retirement	6	7
Federal unemployment	8	9
Total collections of federal tax revenue	3,333	3,303
Increase in federal taxes receivable, net	8	1
Total federal tax revenue	$ 3,341	$ 3,304
Distribution of federal tax revenue to Treasury	$ 3,333	$ 3,303
Increase in amount due to Treasury	8	1
Total disposition of federal tax revenue	3,341	3,304
Net federal revenue activity	$ -	$ -

Revenue activity - Federal tax refund and outlay activities	2016	2015
Total refunds of federal taxes and outlays (Note 14)	$ 426	$ 403
Appropriations used for refund of federal taxes and outlays	(426)	(403)
Net federal tax refund and outlay activities	$ -	$ -

Accessible Text for Required Supplementary Information

Schedule of Budgetary Resources by Major Budget Accounts for 2016

(In Millions)

Budgetary resources	Taxpayer Services	Enforcement	Operations Support	Other	Total
Unobligated balance brought forward, October 1	$ 60	$ 112	$ 345	$ 501	$ 1,018
Recoveries of prior year unpaid obligations	13	15	80	8	116
Other changes in unobligated balance	12	10	37	(122)	(63)
Unobligated balance from prior year budget authority, net	85	137	462	387	1,071
Appropriations (discretionary & mandatory)	2,391	4,715	4,046	462	11,614
Spending authority from offsetting collections (discretionary & mandatory)	35	48	40	-	123
Total budgetary resources	$ 2,511	$ 4,900	$ 4,548	$ 849	$ 12,808
Status of budgetary resources					
New obligations and upward adjustments (total)	$ 2,448	$ 4,764	$ 4,250	$ 397	$ 11,859

Unobligated balance, end of year	Taxpayer Services	Enforcement	Operations Support	Other	Total
Apportioned, unexpired accounts	12	50	119	286	467
Exempt from apportionment, unexpired accounts	-	-	-	7	7
Unapportioned, unexpired accounts	-	3	-	148	151
Unexpired unobligated balance, end of year	12	53	119	441	625
Expired unobligated balance, end of year	51	83	179	11	324
Unobligated balance, end of year (total)	63	136	298	452	949
Total budgetary resources	$ 2,511	$ 4,900	$ 4,548	$ 849	$ 12,808
Change in obligated balance		$			
Unpaid obligations brought forward, October 1	$ 118	$ 268	$ 880	$ 116	$ 1,382
New obligations and upward adjustments	2,448	4,764	4,250	397	11,859
Outlays (gross)	(2,400)	(4,718)	(4,051)	(291)	(11,460)

Recoveries of prior year unpaid obligations	(13)	(15)	(80)	(8)	(116)
Unpaid obligations, end of year	153	299	999	214	1,665

Uncollected payments, federal sources, brought forward,	Taxpayer Services	Enforcement	Operations Support	Other	Total
October 1	-	(24)	-	-	(24)
Changes in uncollected payments, federal sources	-	(2)	(4)	-	(6)
Uncollected payments, federal sources, end of year	-	(26)	(4)	-	(30)
Memorandum (non-add) entries:					
Obligated balance, start of year	118	244	880	116	1,358
Obligated balance, end of year	$ 153	$ 273	$ 995	$ 214	$ 1,635

Budget authority and outlays, net	Taxpayer Services	Enforcement	Operations Support	Other	Total
Budget authority, gross (discretionary & mandatory)	$ 2,426	$ 4,763	$ 4,086	$ 462	$ 11,737
Actual offsetting collections (discretionary & mandatory)	(45)	(67)	(38)	-	(150)
Change in uncollected payments, federal sources (discretionary & mandatory)	-	(2)	(4)	-	(6)
Recoveries of prior year paid obligations (discretionary & mandatory)	10	21	2	-	33
Budget authority, net (total) (discretionary & mandatory)	$ 2,391	$ 4,715	$ 4,046	$ 462	$ 11,614
Outlays, gross (discretionary & mandatory)	$ 2,400	$ 4,718	$ 4,051	$ 291	$ 11,460
Actual offsetting collections (discretionary & mandatory)	(45)	(67)	(38)	-	(150)
Outlays, net (total) (discretionary & mandatory)	2,355	4,651	4,013	291	11,310
Distributed offsetting receipts	-	-	-	(348)	(348)
Agency outlays, net (discretionary & mandatory)	$ 2,355	$ 4,651	$ 4,013	$ (57)	$ 10,962

Schedule of Budgetary Resources by Major Budget Accounts for 2015

(In Millions)

Budgetary resources	Taxpayer Services	Enforcement	Operations Support	Other	Total
Unobligated balance brought forward, October 1	$ 60	$ 135	$ 368	$ 525	$ 1,088
Recoveries of prior year unpaid obligations	13	17	61	4	95
Other changes in unobligated balance	34	1	124	(250)	(91)
Unobligated balance from prior year budget authority, net	107	153	553	279	1,092
Appropriations (discretionary & mandatory)	2,191	4,777	3,907	469	11,344
Spending authority from offsetting collections (discretionary & mandatory)	30	40	42	-	112
Total budgetary resources	$ 2,328	$ 4,970	$ 4,502	$ 748	$ 12,548

Status of budgetary resources	Taxpayer Services	Enforcement	Operations Support	Other	Total
New obligations and upward adjustments (total)	$ 2,268	$ 4,858	$ 4,157	$ 247	$ 11,530
Unobligated balance, end of year					
Apportioned, unexpired accounts	13	20	151	427	611
Exempt from apportionment, unexpired accounts	-	-	-	7	7
Unapportioned, unexpired accounts	-	-	-	56	56
Unexpired unobligated balance, end of year	13	20	151	490	674
Expired unobligated balance, end of year	47	92	194	11	344
Unobligated balance, end of year (total)	60	112	345	501	1,018
Total budgetary resources	$ 2,328	$ 4,970	$ 4,502	$ 748	$ 12,548

Change in obligated balance	Taxpayer Services	Enforcement	Operations Support	Other	Total
Unpaid obligations brought forward, October 1	$ 118	$ 290	$ 840	$ 81	$ 1,329
New obligations and upward adjustments	2,268	4,858	4,157	247	11,530
Outlays (gross)	(2,255)	(4,863)	(4,056)	(208)	(11,382)
Recoveries of prior year unpaid obligations	(13)	(17)	(61)	(4)	(95)
Unpaid obligations, end of year	118	268	880	116	1,382
Uncollected payments, federal sources, brought forward, October 1	-	(38)	-	-	(38)
Changes in uncollected payments, federal sources	-	14	-	-	14
Uncollected payments, federal sources, end of year	-	(24)	-	-	(24)

Memorandum (non-add) entries:					
Obligated balance, start of year	118	252	840	81	1,291
Obligated balance, end of year	$ 118	$ 244	$ 880	$ 116	$ 1,358

Budget authority and outlays, net	Taxpayer Services	Enforcement	Operations Support	Other	Total
Budget authority, gross (discretionary & mandatory)	$ 2,221	$ 4,817	$ 3,949	$ 469	$ 11,456
Actual offsetting collections (discretionary & mandatory)	(36)	(61)	(47)	-	(144)
Change in uncollected payments, federal sources (discretionary & mandatory)	-	14			14
Recoveries of prior year paid obligations (discretionary & mandatory)	6	7	5	-	18
Budget authority, net (total) (discretionary & mandatory)	$ 2,191	$ 4,777	$ 3,907	$ 469	$ 11,344
Outlays, gross (discretionary & mandatory)	$ 2,255	$ 4,863	$ 4,056	$ 208	$ 11,382
Actual offsetting collections (discretionary & mandatory)	(36)	(61)	(47)	-	(144)
Outlays, net (total) (discretionary & mandatory)	2,219	4,802	4,009	208	11,238
Distributed offsetting receipts	-	-	-	(352)	(352)
Agency outlays, net (discretionary & mandatory)	$ 2,219	$ 4,802	$ 4,009	$ (144)	$ 10,886

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 fiscal year (FY) 2016, the total estimated payout (including principal and interest) for claims pending judicial review by the federal courts is $4.8 billion and by Appeals is $2.3 billion. In FY 2015, the total estimated payout (including principal and interest) for claims pending judicial review by the federal courts was $2.1 billion and by Appeals was $2.7 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:

(In Billions)

	2016	2015
Total unpaid assessments	$391	$389
Compliance assessments	(74)	(80)
Write-offs	(139)	(138)
Gross federal taxes receivables	178	171
Allowance for uncollectible taxes receivable	(129)	(130)
Federal taxes receivable, net	$49	$41

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 approximately $1 billion and $2 billion as of September 30, 2016 and September 30, 2015, respectively. 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.

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.

Accessible Text for Other Information

Schedule of Spending

The Schedule of Spending presented below is an overview of the fiscal years (FY) 2016 and 2015 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 “New obligations and upward adjustments” 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 agencies, 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.

(In Millions)

	Category	2016	2015
What money is available to spend?	Total resources	$ 12,808	$ 12,548
	Less amount available but not agreed to be spent	(474)	(618)
	Less amount not available to be spent	(475)	(400)
	Total amounts agreed to be spent	$ 11,859	$ 11,530
How was the money spent/issued?	Tax administration	-	-
	Personnel compensation	$ 6,242	$ 6,241
	Personnel benefits	2,178	2,132
	Rent, communications, and utilities	925	953
	Contracts	1,790	1,600
	Other	724	604
	Total amounts agreed to be spent	$ 11,859	$ 11,530
Who did the money go to?	Federal	$ 3,189	$ 3,163
	Non-federal	8,670	8,367
	Total amounts agreed to be spent	$ 11,859	$ 11,530

Refundable Tax Credits and Other Outlays

Refundable Tax Credits

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 non-refundable 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 amount of the credit, regardless of the underlying tax liability.

The following overview summarizes the refundable credits the IRS administers and pays. This overview describes refundable credits in existence for many years, as well as those created more recently by Congress, including 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.

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 specific 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.

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. This refundable credit, set to expire at the end of 2012, was extended through December, 2017, by the *American Taxpayer Relief Act of 2012*.

Build America and Recovery Zone Bonds

Build America Bonds (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 BABs. 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.

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 and Qualified School Construction Bonds

Congress created Qualified Zone Academy Bonds and Qualified School Construction Bonds to help schools raise funds to 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 the time remaining until their redemption.

Qualified Energy Conservation Bonds 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.

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.

Corporate Alternative Minimum Tax Credit

Section 168(k)(4) of the Internal Revenue Code (26 USC) 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.

Health Coverage Tax Credit

The federal Health Coverage Tax Credit (HCTC) was created by the *Trade Act of 2002* to help certain displaced workers and certain retirees pay for health insurance. Generally, those eligible to claim the credit fall into one of two categories: 1) trade-impacted workers who have lost their jobs because of increased imports or a shift in production to another country and are classified as Trade Adjustment Assistance (TAA) or Alternative Trade Adjustment Assistance (ATAA) and 2) individuals whose pensions are being paid by the Pension Benefit Guaranty Corporation (PBGC), are at least 55 years of age and not entitled to Medicare.

The *Trade Preferences Extension Act of 2015* (Public Law 114-27) extended and modified the expired HCTC. Previously, those eligible for the HCTC could claim the credit against the premiums they paid for certain health insurance coverage through 2013. The HCTC can now be claimed for coverage through 2019. Eligible participants are responsible for paying 27.5 percent of their insurance premium while the IRS is responsible for paying the remaining 72.5 percent.

In general, eligible taxpayers will claim the HCTC for 2016 when they file their federal income tax returns in 2017. However, the IRS implemented a limited interim process for making advance monthly payments in the summer of 2016. This process was only available to individuals for months they were enrolled in qualified health coverage and working with their Health Plan Administrator or a Third Party Administrator that was willing to meet certain IRS requirements and enter into a Memorandum of Understanding (MOU) with the IRS.

Individual Alternative Minimum Tax 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.

Adoption Tax Credit

The adoption tax credit was made non-refundable for tax years beginning in 2012. The credit had previously been refundable for tax years 2010 and 2011. The credit amounts listed in the table at the end of this section represent payments originating in tax year 2012. Individuals could qualify for the refundable adoption tax credit if they had adopted a child and paid out-of-pocket expenses relating to the adoption.

Small Business Health Insurance Tax Credit

Certain small employers are 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 cannot exceed the total amount of income and Medicare tax (i.e., hospital insurance) withholdings the employer must make and the related employer share of Medicare tax on employees' wages.

Other Outlays

Cost Sharing Reduction

In addition to receiving a premium tax credit, a person who obtains a Silver health care insurance policy through the Marketplace may be able to receive a government subsidy of their deductibles, copayments, and coinsurance costs depending upon their family size and family income. Unlike the premium tax credit, these subsidies are not tax credits and are not reported on the recipient's income tax return. These subsidies are administered jointly by the U.S. Department of Health and Human Services and the IRS and are outlays of the Federal Government.

Basic Health Program

The PPACA gives states the option of creating a health benefits coverage program for low-income residents who would otherwise be eligible to purchase coverage through the Health Insurance Marketplace. The Basic Health Program gives states the ability to provide more affordable coverage for these low-income residents and improve continuity of care for people whose income fluctuates above and below Medicaid and Children's Health Insurance Program levels. These subsidies, which are Federal Government outlays, are not tax credits and are not reported on the recipient's income tax return.

Interest on Tax Refunds

The IRS pays interest on refunds sent later than 45 days from the filing deadline of the return. Additionally, interest is generally paid on amended returns that result in a refund. Returns that have been examined and show an overpayment also result in the payment of interest. The interest rate on overpayments is adjusted quarterly.

The following table summarizes refundable tax credits in excess of tax liabilities and other outlays paid in FY 2016 and FY 2015. (In Millions)

	2016	2015
Earned Income Tax Credit	$ 60,579	$ 60,084
Premium Tax Credit *	23,051	20,926
Additional Child Tax Credit	20,188	20,592
Build America and Recovery Zone Bonds	3,646	3,499
Qualified Zone Academy Bonds	58	52
Qualified School Construction Bonds	746	643
Qualified Energy Conservation Bonds	36	34
New Clean Renewable Energy Bonds	38	29
American Opportunity Tax Credit	3,993	4,153
Corporate Alternative Minimum Tax Credit	108	152
Health Coverage Tax Credit	12	-
Individual Alternative Minimum Tax Credit	2	7
Adoption Tax Credit	-	16
Small Business Health Insurance Tax Credit	15	38
Cost Sharing Reduction	4,952	5,060
Basic Health Program	2,824	1,228
Interest on Tax Refunds	1,530	1,061
Refundable tax credits and other outlays	**$ 121,778**	**$ 117,574**

*Includes advanced amounts for the Premium Tax Credit. Beginning in FY 2015, preliminary outlay amounts are adjusted upward or downward based on information from tax returns. In FY 2016 and FY 2015, total Premium Tax Credit advances disbursed by the Center for Medicare and Medicaid Services totaled $28,331 and $23,770, respectively. The FY 2016 and FY 2015 advanced amounts were adjusted downward based on tax return information.

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 $118,500, and an employer matching amount of 6.2 percent, bringing the total rate to 12.4 percent for calendar year 2016. In calendar year 2015, the rate was 6.2 percent of wages and tips up to $118,500 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 on self-employment income up to $118,500 for both calendar years 2016 and 2015. 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 $818 billion and $778 billion in FY 2016 and FY 2015, respectively. Medicare taxes collected by the IRS were estimated to be approximately $248 billion and $236 billion in FY 2016 and FY 2015, 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 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.

Tax Gap and Tax Burden

Tax Gap

The estimated gross tax gap is $458 billion and is the amount of true tax liability not paid voluntarily and/or timely. There are three primary sources of noncompliance:

(1) nonfiling tax gap (the tax not paid on time by those who do not file required returns on time);
(2) underreporting tax gap (the net understatement of tax on timely filed returns); and
(3) underpayment tax gap (the amount of tax reported on timely filed returns not paid on time).

The estimated gross tax gaps for these components are $32 billion for nonfiling, $387 billion for underreporting, and $39 billion for underpayments. Additionally, the gross tax gap can be grouped by type of tax. The estimated gross tax gap by each type of tax is:

- $319 billion for individual income tax,
- $44 billion for corporation income tax,
- $91 billion for employment tax, and
- $4 billion for combined estate and excise tax.

The estimated net tax gap is the gross tax gap less tax subsequently collected, either voluntarily or from IRS administrative and enforcement activities. The net tax gap is the portion of the gross tax gap that will not be paid. The gross tax gap estimated to be eventually collected totals $52 billion, resulting in a net tax gap of $406 billion. The estimated net tax gap by each type of tax is:

- $291 billion for individual income tax,
- $35 billion for corporation income tax,
- $79 billion for employment tax, and
- $1 billion for combined estate and excise tax.

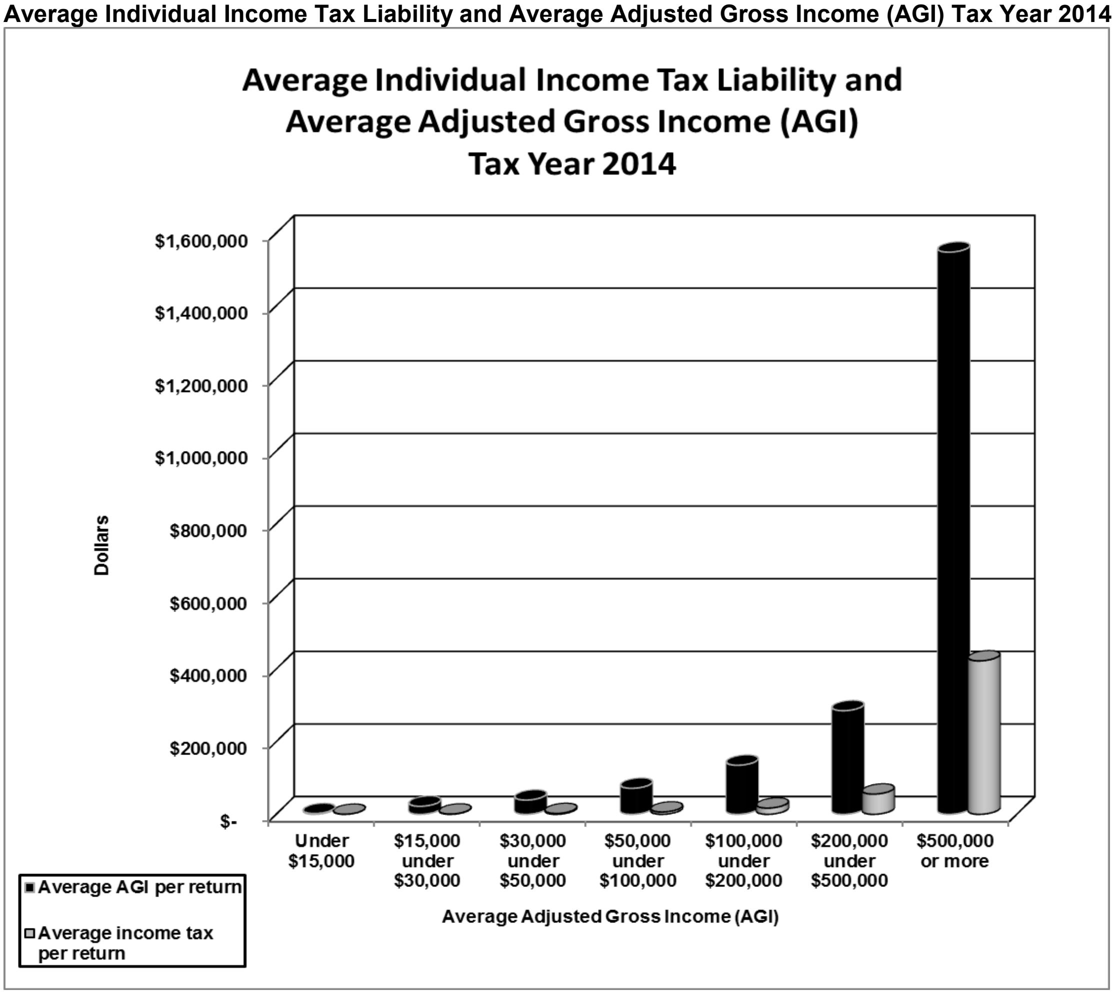
Unlike prior tax gap estimates that pertain to a single tax year, these estimates reflect an average compliance rate and average annual tax gap for the Tax Year 2008 - 2010 time frame. This approach was selected as it provides more reliable tax gap estimates by category and source of noncompliance.

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 tax liability levels reported by individuals and corporations (that is, these amounts do not account for tax burdens that taxpayers do not report on their returns). This information is the most recent available for individuals (tax year 2014) and corporations (tax year 2013). 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 that taxpayers bear 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.

Average Individual Income Tax Liability and Average Adjusted Gross Income (AGI) Tax Year 2014

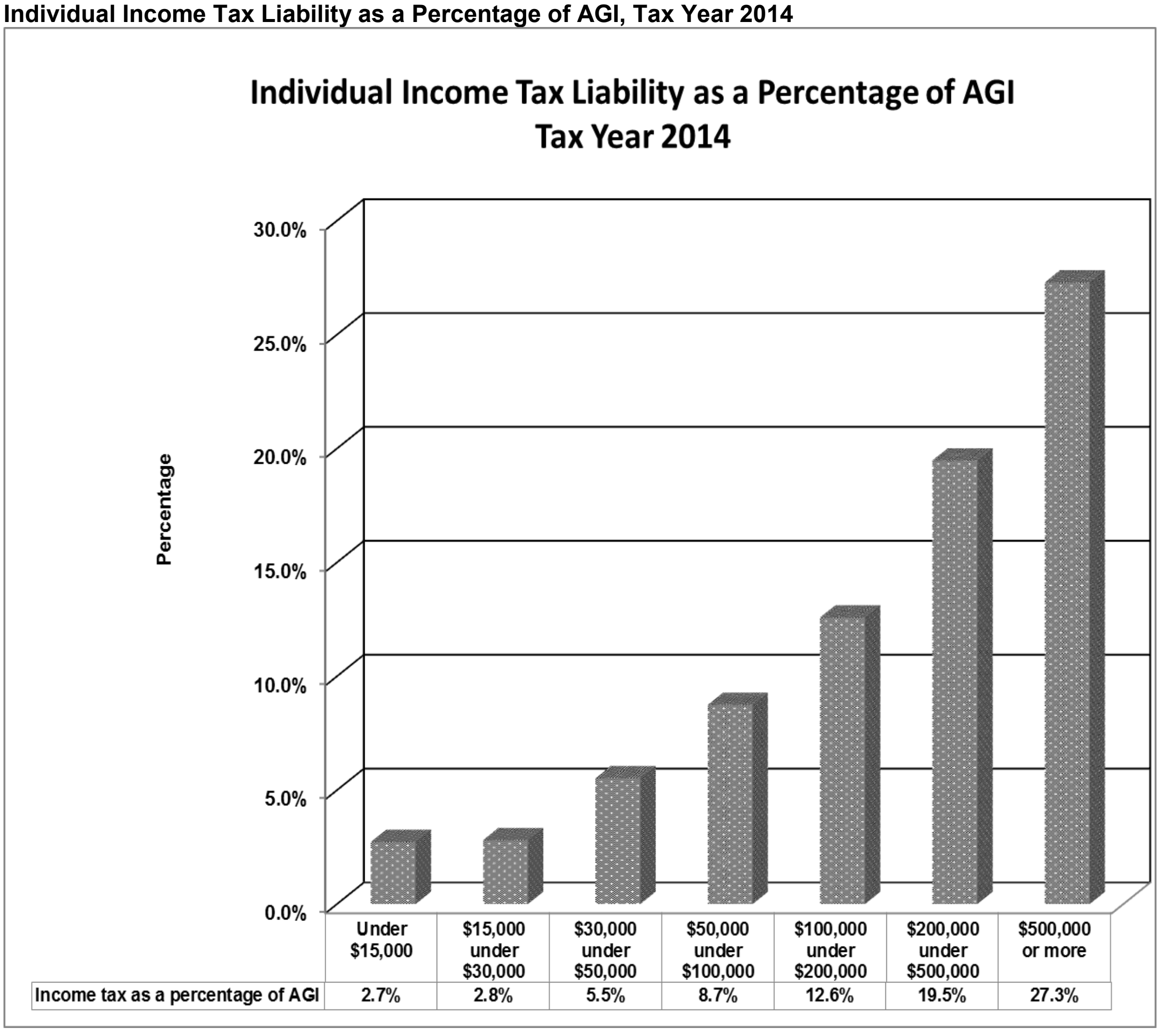


Adjusted gross income (AGI)	Number of taxable returns (in thousands)	AGI (in millions)	Total income tax (in millions)	Average AGI per return (in whole dollars)	Average income tax per return (in whole dollars)	Income tax as a percentage of AGI
Under $15,000	$ 36,377	$ 72,237	$ 1,968	$ 1,986	$ 54	2.7%
$15,000 under $30,000	30,212	665,587	18,657	$ 22,031	$ 618	2.8%
$30,000 under $50,000	26,072	1,021,446	56,423	$ 39,178	$ 2,164	5.5%

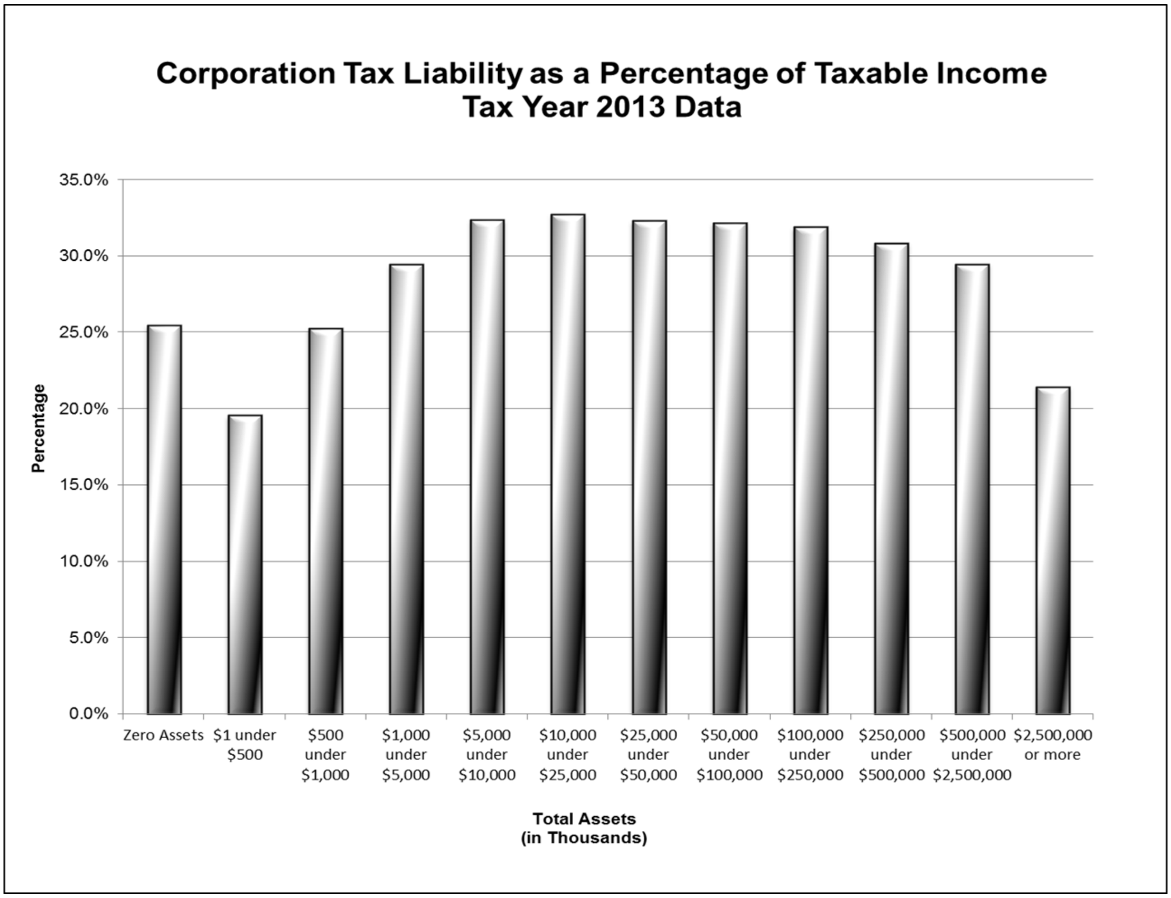
$50,000 under $100,000	32,221	2,303,583	201,406	$ 71,493	$ 6,251	8.7%
$100,000 under $200,000	17,501	2,361,756	297,112	$ 134,950	$ 16,977	12.6%
$200,000 under $500,000	4,979	1,419,777	276,487	$ 285,153	$ 55,531	19.5%
$500,000 or more	1,245	1,926,649	525,744	$ 1,547,509	$ 422,284	27.3%
Totals	$ 148,607	$ 9,771,035	$ 1,377,797			

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

Individual Income Tax Liability as a Percentage of AGI, Tax Year 2014



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



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

Total Assets (in thousands)	Income subject to tax (in millions)	Total income tax after credits (in millions)	Percentage of income tax after credits to taxable income
Zero Assets	$ 43,388	$ 11,044	25.5%
$1 under $500	6,981	1,364	19.5%
$500 under $1,000	4,100	1,035	25.2%
$1,000 under $5,000	11,476	3,376	29.4%
$5,000 under $10,000	7,737	2,502	32.3%
$10,000 under $25,000	12,949	4,236	32.7%
$25,000 under $50,000	12,133	3,918	32.3%
$50,000 under $100,000	14,511	4,666	32.2%
$100,000 under $250,000	25,250	8,047	31.9%
$250,000 under $500,000	29,332	9,040	30.8%
$500,000 under $2,500,000	133,541	39,321	29.4%
$2,500,000 or more	957,085	204,808	21.4%
Totals	$ 1,258,483	$ 293,357	

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

Accessible Text for Appendix I: Management's Report on Internal Control over Financial Reporting

November 9, 2016

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 provisions of applicable laws, including those governing the use of budget authority, regulations, contracts, and grant agreements; noncompliance with which could have a 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, 2016, based on the criteria established under 31 U.S.C. 3512(c), (d) (commonly known as the Federal Managers' Financial Integrity Act).

Based on that evaluation, we conclude that, as of September 30, 2016, 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 modified assurance at as of September 30, 2016, the IRS's internal control over financial

John A. Koskinen Commissioner

Jeffrey J. Tribiano

Deputy Commissioner, Operations Support

Ursula S. Gillis

Chief Financial Officer

Accessible Text for Appendix II: Comments from the Internal Revenue Service

November 4, 2016

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 2016 and 2015 Financial Statements. We are pleased that the Internal Revenue Service (IRS received an unmodified opinion on the combined financial statements for the 1t consecutive year. The unmodified opinion demonstrates that the IRS accurately accounts for approximately $3.3 trillion in tax revenue receipts, $426 billion in tax refunds, and $11 billion in IRS appropriated funds.

We appreciate the Government Accountability Office (GAO) recognizing our continued focus on information systems security, protecting sensitive taxpayer and financial information, and unpaid assessments (UA). This year, our efforts included continued development on new financial system asset accounting and procurement modules, as well as progress on addressing the long-term UA action plan. The IRS is dedicated to continuing to improve its financial management, internal controls, and information technology security posture.

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