United States Government Accountability Office

Report to the Secretary of the Treasury

November 2017

FINANCIAL AUDIT

IRS's Fiscal Years 2017 and 2016 Financial Statements

GAO-18-165

GAO Highlights

Highlights of GAO-18-165, a report to the Secretary of the Treasury

November 2017

FINANCIAL AUDIT

IRS's Fiscal Years 2017 and 2016 Financial Statements

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-18-165. For more information, contact Cheryl E. Clark at (202) 512-3406 or clarkce@gao.gov.

What GAO Found

In GAO's opinion, the Internal Revenue Service's (IRS) fiscal years 2017 and 2016 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, 2017, 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 2017.

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 federal taxes receivable, compliance assessments, and write-offs, as necessary to determine reliable balances for financial reporting purposes. To compensate for these deficiencies, IRS applied a statistical estimation process to determine the amount of federal taxes receivable, net, which is the largest asset on IRS's balance sheet. Through this estimation process, IRS recorded a significant adjustment of $13 billion to the 2017 fiscal year-end gross federal 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 establishing a task force to improve unpaid assessments data quality. However, further enhancements to IRS's financial systems are needed to address the continuing issues with the accuracy of tax records, enable IRS to record reliable taxes receivable transaction detail, improve IRS's ability to effectively manage taxpayers' accounts, and reduce taxpayer burden.

During fiscal year 2017, 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 resources.

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Abbreviations

CFO	Chief Financial Officer
CMS	Centers for Medicare & Medicaid Services
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
PTC	premium tax credit
RSI	required supplementary information
W-2	Wage and Tax Statement

GAO U.S. GOVERNMENT ACCOUNTABILITY OFFICE

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

November 9, 2017

The Honorable Steven T. Mnuchin
Secretary of the Treasury

Dear Mr. Secretary:

The accompanying report presents the results of our audits of the fiscal years 2017 and 2016 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, 2017, and 2016, 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, 2017, because of a continuing material weakness[1] in internal control over unpaid assessments;[2] and
- no reportable noncompliance for fiscal year 2017 with provisions of applicable laws, regulations, contracts, and grant agreements we tested.

This report also provides a discussion of a continuing significant deficiency in IRS's internal control over financial reporting systems that we believe merits the attention of those charged with governance of IRS.[3] In addition, this report discusses ongoing financial management challenges that IRS faces related to (1) safeguarding taxpayer receipts

[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]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 § 1.34.1.2(138), *Definitions and Acronyms* (June 23, 2009).

[3]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 by those charged with governance.

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.

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

U.S. GOVERNMENT ACCOUNTABILITY OFFICE
441 G St. N.W.
Washington, DC 20548

Independent Auditor's Report

To the Commissioner of Internal Revenue

In our audits of the fiscal years 2017 and 2016 financial statements of the Internal Revenue Service (IRS), we found

- IRS's financial statements as of and for the fiscal years ended September 30, 2017, and 2016, 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, 2017; and
- no reportable noncompliance for fiscal year 2017 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] and other information included with the financial statements,[2] 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 compliance with laws, regulations, contracts, and grant agreements; and (3) agency comments.

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[1]The 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 the 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, 2017, and 2016; 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 also have audited IRS's internal control over financial reporting as of September 30, 2017, based on criteria established under 31 U.S.C. § 3512(c), (d), commonly known as the Federal Managers' Financial Integrity Act (FMFIA).

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

Management's Responsibility

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

[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). Pursuant to the authority of 31 U.S.C. § 3515, the Office of Management and Budget requires IRS to issue annual audited financial statements that are separate from those of the Department of the Treasury. Although the CFO Act designates the agency's inspector general, or where applicable, an independent external auditor, as the responsible auditor of an agency's financial statements, the act also gives GAO the authority to perform such audits at its discretion. Based on that authority, we audit IRS's financial statements because of the significance of IRS's tax collections to the consolidated financial statements of the U.S. government, which GAO is required to audit. See 31 U.S.C. § 331(e)(2).

effectiveness of internal control over financial reporting based on the criteria established under FMFIA; and (6) its assessment about the effectiveness of internal control over financial reporting as of September 30, 2017, 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 involves performing procedures to obtain evidence about whether a material weakness exists.[5] The procedures selected depend on the auditor's judgment, including the assessment of the risk that a material weakness exists. An

[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.

audit of internal control over financial reporting also includes obtaining an understanding of internal control over financial reporting, and evaluating and testing the design and operating effectiveness of internal control over financial reporting based on the assessed risk. Our audit of internal control also considered IRS'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.

Definition 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 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, 2017, and 2016, 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 unaudited 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 as the associated dollar amounts, is discussed in other information included with the financial statements.

Opinion on Internal Control over Financial Reporting

In our opinion, because of a material weakness in internal control over unpaid assessments,[8] IRS did not maintain, in all material respects, effective internal control over financial reporting as of September 30, 2017, 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 2017. However, the material weakness may adversely affect any decisions by IRS's management that are based, in whole or in part,

[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 code, such as special exclusions, exemptions, deductions, credits, deferrals, and tax rates.

[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 has been reduced in part or full by IRS). Internal Revenue Manual § 1.34.1.2 (138), *Definitions and Acronyms* (June 23, 2009).

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 2017 (1) FMFIA assurance statement to the Department of the Treasury[9] and (2) Management's Report on Internal Control over Financial Reporting.

In addition, our fiscal year 2017 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 in internal control in fiscal year 2017.[10] This significant deficiency is discussed in more detail below.

We considered the material weakness and significant deficiency in determining the nature, timing, and extent of our audit procedures on IRS's fiscal year 2017 financial statements.

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

Material Weakness in Internal Control over Unpaid Assessments

System limitations in IRS's subsidiary ledger and the supporting financial systems it uses to account for federal taxes receivable and other unpaid assessment balances, as well as other control deficiencies that led to errors in taxpayer accounts, continued to exist during fiscal year 2017. Because of these deficiencies, IRS's financial systems currently do not provide the timely, reliable, and complete transaction-level financial information necessary to enable IRS to classify and report unpaid

[9] 31 U.S.C. § 3512(d)(2)-(3) requires the head of each executive agency to prepare and sign a statement on whether the systems of the agency comply with certain FMFIA criteria and submit that statement to the President and Congress.

[10] A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit the attention by those charged with governance.

assessment balances in accordance with federal accounting standards,[11] and to effectively manage these amounts on a daily basis throughout the year.

As in prior years,[12] for fiscal year 2017, IRS's balance for federal taxes receivable, net, which comprised over 86 percent of total assets reported on IRS's fiscal year 2017 balance sheet, was produced from a statistical estimation process,[13] instead of through the summation of individual taxpayer account transaction data in its general ledger.[14] IRS applied a statistical estimation process to compensate for limitations in its financial systems that render the systems unable to readily distinguish between federal taxes receivable, compliance assessments, and write-offs in order to accurately classify unpaid assessments in the proper categories 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

[11]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.

[12]GAO, *Financial Audit: IRS's Fiscal Years 2016 and 2015 Financial Statements*, GAO-17-140 (Washington, D.C.: Nov. 10, 2016).

[13]This estimation 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) federal taxes receivable in its financial statements and the RSI and (2) compliance assessments and write-offs in the RSI.

[14]For financial reporting, IRS records an adjusting journal entry to change the gross taxes receivable amount produced by its systems to reflect the results of its statistical estimate, and then reduces this adjusted gross taxes receivable amount by an estimated allowance for uncollectible taxes receivable to report the amount of net federal taxes receivable on its balance sheet.

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 2017, similar to what we have reported in prior years,[15] 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 balances of federal 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 statistical sampling and estimation process, IRS recorded a significant adjustment of $13 billion to the 2017 fiscal year-end gross federal 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 the reported gross receivable balance from its general ledger to detailed supporting records maintained in its subsidiary ledger. This lack of traceability leaves IRS unable to identify which taxpayers owe the tax debts summarized in the gross federal taxes receivable balance or how much each one owes. However, absent the use of this statistical estimation process, the various unpaid assessment balances reported in its general 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 the material weakness and the associated system deficiencies that existed during fiscal year 2017, IRS's financial management systems did not substantially comply with two of the three requirements of the Federal Financial Management

[15]See GAO-17-140.

Improvement Act of 1996, based on criteria established under 31 U.S.C. § 3512.[16]

These issues affecting federal taxes receivable and other unpaid assessments are of particular concern because of the significant amount of federal taxes receivable due from taxpayers, which IRS estimated to be $52 billion, net, as of September 30, 2017. IRS's tax collection efforts play a critical role in funding government operations and public services. Given the heightened attention to federal deficits, IRS is under increased pressure to enforce taxpayer compliance and reduce the tax gap. However, inaccurate tax records adversely affect IRS's ability to effectively enforce compliance and collect on taxes owed and also create taxpayer burden.

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 establishing in 2017 a task force to enhance unpaid assessments data quality. However, further enhancements to IRS's financial systems are needed to address the continuing issues with the accuracy of tax records, enable IRS to record reliable taxes receivable transaction detail, improve IRS's ability to effectively manage taxpayers' accounts, and reduce taxpayer burden.

Significant Deficiency in Internal Control over Financial Reporting Systems

During fiscal year 2017, IRS made progress in addressing previously reported control deficiencies related to its financial reporting systems. Key actions included addressing certain access control deficiencies by enforcing password complexity requirements for accounts supporting key systems, implementing improvements to the access controls over its mainframe databases, and enforcing strong encryption authentication on

[16]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-related 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.

certain systems.[17] However, control deficiencies in IRS's information security program that we identified in prior audits continued to exist. Specifically, we continued to find control deficiencies in (1) monitoring activities to reasonably assure compliance with security policies and procedures (monitoring), (2) limiting or preventing unnecessary access and unauthorized changes to systems (access controls), (3) change controls over tax and financial management processing on the mainframe, (4) segregating incompatible duties, (5) reasonably assuring that software was supported by the vendor and updated to protect against known vulnerabilities, and (6) developing and implementing effective policies and procedures as part of IRS's security management program.[18] These control deficiencies limit IRS's effectiveness in protecting the confidentiality, integrity, and availability of sensitive taxpayer data and financial information.[19]

During fiscal year 2017, IRS corrected deficiencies related to monitoring the use of sensitive database commands. However, our audit identified continuing and additional monitoring control deficiencies involving certain key financial reporting systems. For example, IRS's monitoring processes had not identified user account control settings that were not in compliance with its policy. In addition, IRS was unable to detect changes made to its mainframe systems, including changes made in a nonproduction test environment that affected controls in the mainframe production system. These deficiencies limit IRS's ability to detect and respond to unauthorized access or unusual activity affecting its financial reporting systems.

In fiscal year 2017, deficiencies also persisted in access controls, change controls, and segregation of duties. For example, authorizing officials did

[17] 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.

[18] 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.

[19] We have previously reported deficiencies in these control areas and made recommendations to address them, and reported on IRS's associated corrective actions, in various reports to IRS concerning its information security. See, for example, GAO, *Information Security: Control Deficiencies Continue to Limit IRS's Effectiveness in Protecting Sensitive Financial and Taxpayer Data*, GAO-17-395 (Washington, D.C.: July 26, 2017).

not review and appropriately restrict access to several IRS user and service accounts per its policy. IRS did not consistently implement its policies for controlling access on the servers supporting several key financial systems. In addition, change control procedures were not properly enforced on systems that process tax and financial management data. Further, IRS did not correct a previously identified control deficiency concerning segregation of duties, where certain IRS employees continued to have both security and nonsecurity access roles to a key financial system. Because of these control deficiencies, IRS has limited assurance that its information resources are being protected from unauthorized access, alteration, and disclosure.

Although IRS took steps to mitigate risks by applying software updates for known vulnerabilities, control deficiencies persisted during fiscal year 2017. Specifically, IRS did not apply vendor-supported software updates on certain databases, servers, and network equipment that support its financial systems. Such control deficiencies increase the risk that unauthorized personnel can leverage known information security vulnerabilities and gain access to key systems and network equipment. In addition, we identified control deficiencies in aspects of IRS's security management of its information systems. Specifically, in fiscal year 2017, system security plans for key IRS systems had not been updated to reflect the current system environment. Further, many of the system security plans for the systems we reviewed still referenced IRS's rescinded policy on information technology logging security controls.

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, 2017. 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 the RSI be presented to supplement the financial statements. Although the RSI is not a part of the financial statements, FASAB considers this information to be an essential part of financial reporting for placing the financial statements in appropriate operational, economic, or historical context. We have applied certain limited procedures to the RSI in accordance with U.S. generally accepted government auditing standards, which consisted of inquiries of management about the methods of preparing the RSI and comparing the information for consistency with management's responses to the auditor's inquiries, the financial statements, and other knowledge we obtained during the audit of the financial statements, in order to report omissions or material departures from FASAB guidelines, if any, identified by these limited procedures. We did not audit and we do not express an opinion or provide any assurance on the RSI because the limited procedures we applied do not provide sufficient evidence to express an opinion or provide any assurance.

Other Information

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

Other Financial Management Challenges

In addition to the challenge of addressing its internal control deficiencies, IRS also faces other significant ongoing 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-related 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 resources.[20]

Safeguarding Taxpayer Receipts and Associated Information

Although levels of electronic filing of tax returns and related payments 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 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.[21] 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. In our previous audits of IRS, we have made numerous recommendations to address these issues, to which IRS has been responsive.[22] However, several deficiencies related to issues that we reported in prior years reemerged during this year's audit. Specifically, our tests during this year's audit identified reemerging control deficiencies relating to the lack of policies and procedures and ineffective implementation and monitoring of certain controls designed to safeguard and prevent unauthorized access to IRS facilities and hard

[20]IRS's appropriations have declined approximately $580 million from fiscal years 2012 through 2017, and according to IRS, its staffing has declined by about 13,000 full-time equivalents during this period. Consolidated Appropriations Act, 2017, Pub. L. No. 115-31, div. E, § 1, 129 Stat. 197-200 (May 5, 2017). Consolidated Appropriations Act, 2012, Pub. L. No. 112-74, div. C, § 1, 125 Stat. 887-89 (Dec. 23, 2011).

[21]26 U.S.C. § 6103 states that all returns and return information shall be confidential subject to certain limited exceptions enumerated in the statute.

[22]We have reported these control deficiencies and made recommendations to address them, and reported on IRS's associated corrective actions, in various management 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-17-454R (Washington, D.C.: May 17, 2017).

copy taxpayer receipts and related sensitive information. As IRS continues to respond to deficiencies identified during our audits, it is critical that IRS undertake a global approach 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.

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 is a persistent and evolving threat that burdens taxpayers who are victims of the crime.[23] IRS and Congress have taken steps to address this challenge. IRS has deployed new tools and increased resources dedicated to identifying and combating IDT tax refund fraud, including establishing the Identity Theft Tax Refund Fraud Information Sharing and Analysis Center that allows IRS, representatives of the tax preparation and software industries, and state tax administrators to share information for combating IDT tax refund fraud. In addition, to further enhance IRS's ability to detect IDT tax refund fraud, in December 2015 Congress passed the Protecting Americans from Tax Hikes Act of 2015, which accelerated Wage and Tax Statement (W-2) filing deadlines to January 31, allowing IRS to verify wage and withholding information reported on tax returns before issuing refunds, potentially preventing billions of dollars in fraudulent tax refunds.[24]

IRS does not yet know the full effect of its W-2 systemic verification process on the number of IDT fraudulent tax refunds for which it has been able to prevent payment. However, in its first year of implementation, IRS

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[23]Given current and emerging risks, in 2015, GAO expanded the enforcement of the tax laws high-risk area to include IRS's efforts to address tax refund fraud based on IDT. See GAO, *High-Risk Series: Progress on Many High-Risk Areas, While Substantial Efforts Needed on Others*, GAO-17-317 (Washington, D.C.: Feb. 15, 2017).

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

is facing challenges related to the availability and timing of the W-2s.[25] 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. It is important that IRS continues to explore available options to effectively identify, design, and implement the most effective systems, processes, and internal controls for preventing and detecting IDT tax refund fraud and thereby minimizing the effects on taxpayers and the associated losses to the federal government.

Implementing Patient Protection and Affordable Care Act Tax-Related Provisions

IRS continues to face management challenges as it implements the complex tax-related provisions of PPACA.[26] Among these challenges is the extensive coordination, not only within IRS but also with multiple agencies and other entities tasked with responsibilities under the act.[27] 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 and maintain information systems that can share data among IRS, CMS, and other agencies.[28] Since IRS is responsible for managing and administering payments to health plans and the financial reporting of PPACA-related payment transactions, IRS must work closely with CMS, which administers the programs that process, approve, and calculate advance premium tax

[25]See GAO, *2017 Filing Season: New Wage Verification Process Holds Promise but IRS Faced Implementation Challenges*, GAO-17-525T (Washington, D.C.: Apr. 26, 2017), for additional information on challenges IRS faced in its first year of implementing the W-2 verification process.

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

[27]PPACA's provisions involve major health care stakeholders, including federal and state governments, employers, issuers of qualified health plans (issuers), and health care providers. IRS is one of several agencies accountable for implementing the legislation.

[28]CMS is responsible for overseeing 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, and is responsible for creating a federally facilitated marketplace in each state that did not establish its own.

credit (PTC) and other PPACA-related monthly payments.[29] IRS must also rely on individuals to report information on household income and family size, employers and government-sponsored programs to report health care coverage information to IRS, and health care marketplaces to determine individuals' eligibility to receive PTC that IRS processes on tax returns.[30]

IRS has developed a strategic approach to implementing the PPACA-related payments; however, it has continued to face ongoing management challenges and risks. Because IRS relies on CMS for payment information, deficiencies in CMS's controls over the integrity of payment information could adversely affect the validity of the amounts reported on IRS's financial statements. Therefore, IRS must continually monitor CMS's controls and develop procedures to mitigate the risks to IRS's financial reporting. IRS also faces challenges related to the timeliness and availability of key data for verifying taxpayers' PTC claims. For example, employers and government-sponsored programs are not required to report health care coverage information to IRS until the end of March, which impedes its ability to verify PTC calculations prior to issuing tax refunds. IRS also faces challenges in validating eligibility criteria, such as income and citizenship requirements, and in validating information provided by individuals because, according to IRS, many potential sources for determining PTC amounts contain information that is incomplete, out-of-date, or otherwise unsuitable for use in tax administration.[31] Without sufficient information and timely access to

[29]To help pay the cost of insurance premiums for taxpayers and their dependents, PPACA provides PTC to individuals who meet certain income and other requirements. Individuals can have the federal government pay PTC to their issuers in advance on their behalf, known as advance PTC, which lowers their monthly premium payments. Taxpayers who choose to have advance PTC must reconcile the amount of advance PTC paid to issuers on their behalf with PTC they are eligible for on their income tax returns. See 26 U.S.C. § 36B(a)-(c).

[30]To be eligible to enroll in a qualified health plan offered through a marketplace, an individual must be a U.S. citizen or national, or otherwise lawfully present in the United States; reside in the marketplace service area; and not be incarcerated (unless incarcerated while awaiting disposition of charges). See 42 U.S.C. § 18032(f).

[31]IRS relies on the state and federal marketplaces to determine whether the individuals met citizenship or lawful presence eligibility requirements and relies on individuals to report income. If IRS receives enrollment information from the state or federal marketplaces, IRS presumes that individuals met citizenship or lawful presence requirements. IRS has not established a mechanism to identify that individuals claiming PTC meet these key PTC eligibility requirements. Further, according to IRS officials, they are in the process of assessing the feasibility of obtaining such information from the marketplaces and incorporating such information into IRS's processes.

necessary data, IRS is at increased risk of making improper payments of PTC to individuals.[32] It is important for IRS to continue to work closely with the agencies and other entities involved in carrying out its responsibilities in order to improve the timeliness and accuracy of the information provided by those entities, and to continue to design and implement effective systems and processes to reasonably assure that valid and accurate PPACA-related payment amounts are processed and reported.[33]

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 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.

[32]See GAO, *Improper Payments: Improvements Needed in CMS and IRS Controls over Health Insurance Premium Tax Credit*, GAO-17-467 (Washington, D.C.: July 13, 2017), for a more detailed discussion on the challenges IRS faces concerning the processing of PTC.

[33]Several recent executive actions could affect IRS's responsibilities under PPACA in the future. An executive order issued in January 2017 directs federal agencies to exercise all authority and discretion available to them to reduce the potential burden of PPACA. Executive Order No.13765, 82 Fed. Reg. 8351 (Jan. 24, 2017). In addition, on October 13, 2017, the administration announced that it would cease making cost-sharing reduction payments to issuers because of the lack of an appropriation for the payments. PPACA requires issuers to reduce cost-sharing amounts for eligible individuals, and IRS had previously made cost-sharing reduction payments to issuers to offset the cost of these reductions. See 42 U.S.C. § 18071.

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 2017 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. 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 8, 2017

Management's Discussion and Analysis

MANAGEMENT'S DISCUSSION AND ANALYSIS

CONTENTS

Mission and Organizational Structure

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.

Vision

The IRS will uphold the integrity of the nation’s tax system and preserve the public trust through the IRS’s talented workforce, innovative technology and collaborative partnerships.

Values

- Honesty and Integrity
- Respect
- Continuous Improvement
- Inclusion
- Openness and Collaboration
- Personal Accountability

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).

Location

The IRS headquarters is located at 1111 Constitution Ave., NW, Washington, DC 20224. There are also 542 offices in all states and territories as well as in a few U.S. embassies and consulates.

Internet

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

Tax Statistics

FY 2017 Tax Statistics Highlights	
Total Returns Processed	201 million
Total Returns and Other Forms Processed	246 million
Total Revenue Collected	$3.4 trillion
Enforcement Revenue Collected	$56.9 billion
Total Refunds and Outlays	$437 billion
Average Individual Refund	$2,862
E-File Rate – Individual	86.9%
E-File Rate – Business	52.9%
IRS.gov Page Views	2.2 billion
Where’s My Refund? Usage	278 million
IRS.gov Downloads	124.6 million

Organization

The IRS organizational structure (Appendix A) closely resembles the private sector model of organizing around customers with similar needs. The scope of IRS operations includes collection of individual and corporate taxes, examination of returns, taxpayer assistance, and tax-exempt organizations, as well as multiple refundable tax credit and other specialized programs.

The IRS structure consists of two primary organizations: The Deputy Commissioner for Services and Enforcement and the Deputy Commissioner for Operations Support.

The Deputy Commissioner for Services and Enforcement (DCSE), the largest organization, oversees the four primary operating divisions responsible for the major customer segments, as well as other taxpayer-facing functions. The functions under DCSE include:

- **Wage and Investment** - serves more than 123 million customers, including those who file jointly, with wage and investment income only.

- **Small Business/Self-Employed** - serves about 57 million small businesses and self-employed individuals operating as sole proprietorships, small corporations or flow-through entities. The division is also responsible for estate, gift, fiduciary, excise, and most employment tax returns and is responsible for the collection of all unpaid federal tax accounts.
- **Large Business and International** - serves about 250,000 corporations, subchapter S corporations, and partnerships with assets greater than $10 million. Also, serves U.S. citizens and residents with offshore activities and non-residents with U.S. activities.
- **Tax Exempt and Government Entities** - serves about three million customers across three distinct taxpayer segments - Employee Plans, Exempt Organizations, and Government Entities.
- **Criminal Investigation** - investigates potential criminal violations of the Internal Revenue Code and related financial crimes in a manner that fosters confidence in the tax system.
- **Office of Professional Responsibility** - administers the laws and regulations governing the practice of tax professionals before the Department of the Treasury and the Internal Revenue Service.
- **Whistleblower Office** - assesses and analyzes incoming tips received from individuals who spot tax problems in their workplace or day-to-day business.
- **Return Preparer Office** - seeks to improve taxpayer compliance by providing comprehensive oversight and support of tax professionals.
- **Office of Online Services** - delivers strategy, policy, and initiatives to strengthen the IRS online services experience.
- **Affordable Care Act (ACA) Office** - supports the administration of the tax provisions of the ACA through collaboration with government agencies and other stakeholders.

The Deputy Commissioner for Operations Support oversees the IRS's integrated support functions, facilitating economy of scale efficiencies and better business practices. The functions under the DCOS include:

- **Information Technology** - manages and secures Servicewide information resources and technology. IT establishes the IRS's long-range objectives and strategies for improving tax administration through modernizing tax administration systems.
- **Chief Financial Officer** - manages a portfolio of corporate activities including strategic planning, performance measurement, budget formulation, budget execution, accounting, financial management, internal controls, and facilitates the processes and outcomes of audits by IRS oversight offices (Government Accountability Office (GAO) and Treasury Inspector General for Tax Administration (TIGTA)).
- **Agency-Wide Shared Services** - provides professional services in the areas of real estate and facilities management and physical security and emergency preparedness to all organizational entities within the IRS.
- **Human Capital Office** - provides human capital strategies and tools for recruiting, hiring, developing, and retaining a highly skilled and high performing workforce to support IRS mission accomplishments.
- **Office of Equity, Diversity and Inclusion** - provides strategic planning, management, direction, and execution of the full range of activities related to EEO, diversity, and inclusion.

- **Office of Procurement** - provides acquisition services for all operating divisions of the IRS and other bureaus and offices within Treasury.

- **Privacy, Governmental Liaison and Disclosure** - safeguards and protects sensitive taxpayer and employee information while promoting government transparency and accountability through better access to government information.

- **Office of the Chief Risk Officer** - oversees the Enterprise Risk Management program, which provides an agency-wide approach to risk management through education, awareness, and mitigation approaches.

Certain key functions report directly to the IRS Commissioner to maintain their independence from the operating units. These offices are:

- **Chief Counsel** - provides advice to the IRS Commissioner on all matters pertaining to the interpretation, administration and enforcement of the Internal Revenue laws, represents the IRS in litigation, and provides all other legal support needed by the IRS to carry out its mission of serving America's taxpayers. In carrying out these responsibilities, Counsel must interpret the law with complete impartiality so that the American public will have confidence that the tax law is being applied with integrity and fairness. Counsel reports to the Commissioner of Internal Revenue on tax matters and reports to the Treasury General Counsel on other matters.

- **Appeals** - resolves tax controversies without litigation on a basis that is fair and impartial to both the taxpayer and the Government.

- **Taxpayer Advocate Service** - helps taxpayers resolve problems with the IRS and recommends systemic changes.

Certain offices with specialized focus report to the Commissioner. These offices include:

- **Research, Applied Analytics and Statistics** - provides leading research, analytical, statistical, and technology services to improve tax administration.

- **Communications and Liaison** - focuses on outreach, education and communication services for taxpayers, business and professional partners, legislative and governmental offices, and IRS employees in support of the IRS mission and goals.

Strategic and Performance Goals

The IRS's Fiscal Year (FY) 2014-2017 Strategic Plan provides a central direction for the attainment of the IRS mission and vision. Its two primary strategic goals align to the service and enforcement areas. Each goal is outcome-based and is supported by several objectives, which are in turn supported by executable strategies.

The first goal is to deliver high quality and timely service to reduce taxpayer burden and encourage voluntary compliance. The IRS works hard to incorporate taxpayer perspectives, expedite resolution of taxpayer issues, provide timely guidance to help taxpayers navigate the tax system and deploy digital options that compliment traditional service channels.

The second and equally important goal is to enforce the tax law to ensure compliance with tax responsibilities and to combat fraud. The IRS aims to be timely in its enforcement actions while seeking innovative solutions to make compliance easier.

The IRS strategic foundation for organizational excellence supplements the two strategic goals and describes the internal initiatives required to support its taxpayer-facing actions. IRS employees are its most valuable asset in effective tax administration. Without a high quality and dedicated workforce, the IRS cannot tackle the risks posed by an increasingly complex external environment. To ensure that it can meet the challenges of tax administration, the IRS must provide its employees with excellent technology systems, processes, and tools. It also must encourage and embrace innovative thinking and foster a culture of continuous improvement. Finally, the IRS must have a strong enterprise-risk management (ERM) system that enables the organization to identify, assess, manage, and monitor risks. The ERM Program must facilitate the processes that provide IRS leadership the information necessary to make decisions, with risk being one of the core considerations of the decision-making framework.

See the performance measures associated with these strategic goals in Appendices B through D.

The Department of the Treasury is in the process of developing a new strategic plan for fiscal years 2018 – 2022 in accordance with the Government Performance and Results Act (GPRA) Modernization Act of 2010. The IRS plans to publish its FY 2018 - FY 2022 Strategic Plan by June 2018.

Major Trends

In meeting its responsibilities each year, the IRS faces major policy, legislative, economic, socio-demographic, and technological challenges that affect the environment in which it operates. The IRS will continue to embrace these challenges and the opportunities they provide to improve the taxpayer experience and to enforce the tax law effectively.

Identity Theft

In recent years, the IRS has seen a significant increase in the types of refund fraud schemes and identity theft. The IRS is committed to stopping this threat to tax administration, protecting the government's revenue, and safeguarding the identity of all taxpayers. The IRS has increased its efforts to prevent refund fraud and identity theft before they happen. A major component of this involves the Security Summit initiative, a public-private sector partnership started in 2015 between the IRS, state revenue departments, software developers, tax professionals, and financial services groups. This effort led to a sharp decline in identity theft and related refund fraud by 2017, with several indicators dropping by more than 50 percent since the Summit began.

Cybersecurity

Protecting taxpayer information and the IRS's electronic systems, services, and data from internal and external cyber security-related threats 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 continues to build robust programs in these areas and has defended its networks against attacks successfully, including instances where third-party systems and data were compromised, affecting IRS's tax administration activities.

The IRS is focusing on enhancing the security of its networks via the use of cyber-threat forensics, implementation of a comprehensive patch management system, and the adoption of government-wide information security continuous monitoring tools as part of a layered defense. In addition, the IRS is instituting multiple layers of electronic authentication at the time of filing. Investments and activities in this area help combat stolen identity refund fraud and include detection and prevention assistance to victims and law enforcement.

Increasing Demand for Online Services

The growth of the Internet over the past decade has changed consumer expectations as they become more accustomed to using the web for anything from ordering services to conducting transactions with financial institutions by using traditional online and mobile devices. More and more, customers show a preference for internet-based service before trying other service channels such as phones, correspondence, or in-person. The primary focus for the IRS over the past two decades has been to offer taxpayers more electronic filing and most recently, web self-service options. The shift to additional digital service channels creates challenges in safeguarding data and ensuring cyber security. The prevalence of malicious websites poses one such challenge. Looking forward, the IRS is committed to expanding the portfolio of digital service offerings to meet customer expectations while continuing to keep taxpayer data secure. The IRS's investment in innovative technology is essential to accelerating the move to a "web first" organization that provides the electronic services that taxpayers desire, the tools that employees need, and the mission-critical security that the IRS requires.

Core Responsibilities

Administering the Tax System

Effective tax administration is the IRS's core responsibility. Providing efficient taxpayer services and enforcing the tax laws are the IRS's primary focuses. In recent years, the volume and complexity of legislative changes to the Tax Code have been a challenge. Often, the IRS must implement these legislative changes within limited timeframes that strain resources and disrupt workload planning; for example, the IRS must quickly implement operational changes to processes and information technology systems in support of taxpayers when new tax laws are passed close to the start of tax filing season. The IRS remains responsible for delivering an effective and timely tax-filing season while ensuring compliance with the tax laws, regardless of the changes to or increases in the complexity of the Tax Code. The IRS will continue to be highly responsive to changes in the Tax Code throughout the coming years by strategically allocating its resources, ensuring its IT systems are agile, and providing its workforce with necessary training and support.

Taxpayer Service

Taxpayer Services entails providing customers with top quality service by helping them understand and comply with applicable tax laws and protecting the public interest by applying the tax law with integrity and fairness to all. This includes producing forms and publications, processing tax returns and related documents, offering filing and account services, ensuring the availability of taxpayer assistance, and providing taxpayer advocacy services.

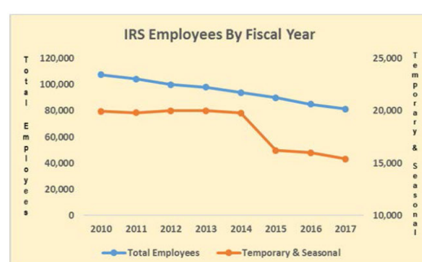
Enforcing Tax Laws

IRS enforcement activities ensure compliance with the tax laws. Compliance includes:

- Examination of tax returns (both domestic and international),
- Administrative and judicial settlement of taxpayer appeals of examination findings,
- Technical rulings,
- Monitoring employee pension plans,
- Determination of qualifications of organizations seeking tax-exempt status,
- Examination of tax returns of exempt organizations,
- Enforcement of statutes relating to detection and investigation of criminal violations of the internal revenue laws,
- Identification of underreporting of tax obligations,
- Securing of unfiled tax returns, and
- Collection of unpaid accounts.

State of the IRS Workforce

In FY 2017, the IRS employed, on average, about 81,310 employees, including more than 15,400 temporary and seasonal staff. The IRS has lost about 21,000 full time positions through attrition from FY 2010 to FY 2017.



The IRS forecasts it will lose, through attrition and retirement, nearly 4,600 full-time, permanent employees in the next year. In addition, the IRS expects 34.9 percent of its workforce will be eligible to retire by 2020, creating a significant risk of lost knowledge and experience without the ability to fill the gap. With a workforce of about 81,310 employees, only 1,073 are of age 25 or younger. Current resource constraints present challenges in hiring and maintaining a multi-generational staff.

IRS EMPLOYEES (By Age Group)

Age Group	Total
0-25	1,073
26-35	9,862
36-45	16,291
46-55	27,077
56-65	22,265
66+	4,742
All	**81,310**

If IRS staffing levels remain the same or continue to decline, then the ability to attract, develop, lead and retain employees will be compromised, taxpayers will be affected, and the IRS will have inadequate staff to execute its mission.

Preparing for the Future

Future State Overview and Discussion

The IRS continues the process begun in 2014 to develop and deliver its envisioned Future State. The IRS is moving toward a more proactive and interactive relationship between taxpayers and IRS employees to improve taxpayer service, enforcement and operations. The Future State provides the context for transformational change through a series of iterative improvements to achieve a more timely and transparent relationship with taxpayers and their representatives. These efforts will improve the IRS's understanding of taxpayer needs, preferences and behaviors, expand the range of service delivery options, and accelerate the ability to deter, detect, and resolve non-compliant behavior.

The Future State is an ongoing effort to keep pace with the changing environment. The IRS will strive to stay atop of evolving technologies and communication methods to improve both the taxpayer and employee experience. Through the Future State, the IRS will seek to:

- 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 the highest value work using data analytics and a robust feedback loop; and
- Drive more agility, efficiency, and effectiveness in IRS operations.

Mapping and Managing Risks to Anticipate Future Needs and Developments

The IRS's Enterprise Risk Management (ERM) Program facilitates the identification and assessment of risks to the IRS's objectives to provide senior leadership with information to enable sound decision-making and risk response. The ERM Program provides guidance and assistance for operationalizing risk management within the business units, leveraging existing risk management processes and structures. As part of its ERM efforts, the IRS conducts an annual enterprise risk assessment to identify and assess the most significant risks to the IRS's objectives. This provides a forward-looking view of events that could occur and might negatively affect the IRS's ability to achieve its mission. The IRS Executive Risk Committee (ERC) identifies the most significant enterprise risks based on analyses performed by the Risk Working Group (RWG), determines additional actions to be taken, assigns accountable parties for implementing those actions, and monitors enterprise risks The IRS uses the enterprise risk information as an input to the planning and budget decision-making processes.

Because of the IRS's ERM efforts, senior leadership has greater transparency into the top risks facing the IRS, as reflected in the IRS's enterprise risk profile. Over the past several years, the IRS has operated with reduced funding and a declining workforce as workloads and responsibilities have increased. Since FY 2011, the IRS has had to operate through an exception-only hiring policy, which has inhibited its ability to replace most of the employees lost through attrition. The IRS has also received unfunded legislative mandates expanding the IRS's responsibilities and requiring the diversion of resources from its core tax administration responsibilities. These expansions to the IRS's responsibilities include:

- Affordable Care Act (ACA)
- Foreign Account Tax Compliance Act (FATCA)
- Achieving a Better Life Experience (ABLE) Act
- Retroactive extension of the Health Coverage Tax Credit (HCTC)

The reduced funding, expanded responsibilities, and loss of staffing have compounded risks in some areas while also reducing the IRS's options for responding to risks. The challenges of the IRS's future environment manifest themselves in many ways and are reflected in the IRS's five most significant enterprise risks:

1. **Aging Technology Infrastructure** – The risk that the large and increasing amount of infrastructure (i.e., hardware, software, and middleware) that has aged significantly beyond industry standards combined with the fact that components of the infrastructure and systems are interrelated and interdependent, may cause a ripple effect making outages/failures unpredictable and widespread, inhibiting the IRS's ability to conduct daily operations and perform its core tax administration responsibilities.

2. **Cyber and Data Security** – The risk that the increased complexity and sophistication of cyber threats, including insider threats, social engineering and unauthorized access to sensitive information, may result in data loss, refund fraud, identity theft, ransomware, or denial of service.

3. **Critical Staffing Shortages** – The risk that increased attrition and continued constraints in hiring and retaining employees with needed skills and expertise may result in critical business failures and over-reliance on contractors.

4. **Secure Access to IRS Services** – The risk that the IRS does not have an effective authentication and authorization protocol that reduces identity theft, refund fraud, and business fraud, protects taxpayer data, and allows legitimate taxpayers to access IRS services.

5. **Data Breaches at External Entities** – The risk that data breaches at external entities compromise access to tax related data elements which may result in increased refund fraud, taxpayer burden, lost revenue, and decreased public confidence.

Major Accomplishments

Filing Season

Thousands of employees spend months planning, communicating, testing, and training to administer a successful filing season. For the public, filing season typically runs from mid-January through mid-April; however, before the activities for one filing season end, preparation for the next one is well underway. Each year, the Filing Season Readiness Executive Steering Committee (FSR ESC), which includes every IRS function and business unit, provides assurance that the IRS operations are ready for the upcoming filing season. The FSR ESC meets from June through January to plan for programming changes to tax systems, updates to forms and instructions, training, and return processing.

The FSR ESC works to find and elevate risks to operational readiness as well as issues that may hinder the filing season. This kind of planning allows the IRS to adjust quickly and manage potential risks.

The IRS delivers successful filing seasons through the hard work and dedication of its workforce. The focus for the 2017 filing season was on ensuring that necessary changes to the IRS's information technology systems were completed as quickly as possible, addressing fraud prevention, security safeguards, and implementing new legislation.

The IRS's information technology systems play a major role in filing season readiness by providing and maintaining the electronic tax processing computing infrastructure. The infrastructure includes the applications and equipment to process tax returns securely, ensure network connectivity, secure taxpayer self-service tools, and provide the technology required to respond to customer service requests.

When Congress enacts late legislation, it often introduces significant new work and may require changes to decisions and system updates made in earlier lifecycle phases, creating a strain on the limited resources already working to meet tight delivery schedules.

The 2017 filing season opened on January 23, 2017. During this filing season, the IRS received about 136 million individual tax returns, and issued more than 97 million refunds totaling more than $268 billion. Taxpayers filed more than 90 percent of individual returns electronically. The IRS.gov web site was visited more than 312 million times and taxpayers used the *Where's My Refund?* tool more than 278 million times. Filing season Level of Service (LOS) reached 79.1 percent, its highest level since 2007. Assistors answered nearly 10 million calls, and addressed another 18 million calls through automated systems.

The IRS believes these results are attributable largely to three factors:

- Additional funding Congress provided to improve service to taxpayers, as well as to strengthen cybersecurity and to expand the IRS's ability to address identity theft;
- Stability of the tax laws in 2016, which reduced the number of taxpayers calling with questions; and,
- Adequate time to prepare taxpayers for the Protecting Americans from Tax Hikes (PATH) Act of 2015 changes, which the IRS believes reduced the burden on taxpayers needing to call for additional assistance.

Outreach and Education

It is important that taxpayers understand their rights and responsibilities with respect to tax administration, so the IRS continues to improve and expand its outreach and educational services through partnerships with state taxing authorities, volunteer groups, and other organizations.

The IRS launched a campaign using traditional communication methods and social media to help taxpayers prepare for filing season. In addition to many news releases and Tax Tips, the IRS used Thunderclap, a crowd-speaking social media platform, to rally IRS partners and stakeholders in spreading the "Get Ready" message. The IRS also added a "Get Ready" section to IRS.gov that provided tax filing preparedness information to raise taxpayer awareness about the filing season and recent changes to tax law. For those taxpayers who are not comfortable with use of the web, the IRS developed Publication 5273*, Take Steps Now for Tax Filing Season*, which provided steps taxpayers could take to get ready to file tax year 2016 federal tax returns.

Each year, the IRS and its partners provide free tax assistance to the elderly, disabled, and limited English proficiency individuals and families at Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) sites. The VITA/TCE programs prepared almost 4 million federal returns at nearly 11,500 sites. More than 180,000 returns were prepared through the VITA/TCE programs' Facilitated Self-Assistance process, which allows taxpayers to use free tax preparation software with virtual assistance from a certified VITA/TCE volunteer from the convenience of their home. This year, about 97 percent of taxpayers filed their VITA/TCE returns electronically. Accuracy of returns prepared by the VITA/TCE volunteers was at 92.7 percent, which exceeded the FY 2017 goal. In addition, more than 2.4 million state tax returns were prepared by the VITA/TCE sites.

The IRS continued to educate taxpayers about new tax scams that emerge, including the pervasive IRS impersonation phone scam. The IRS increased awareness about the phone scam and phishing by featuring them in news releases as a part of its *Dirty Dozen* tax scams series this year. When new scams are reported, the IRS assesses the magnitude of the scam and, working with Security Summit partners, issues a national news release about the scam. During the year, the IRS issued more than a dozen news releases and tax tips advising taxpayers and tax professionals about the scams.

The IRS held its eleventh annual Earned Income Tax Credit (EITC) Awareness Day on January 27, 2017. To support EITC outreach efforts, IRS stakeholders, along with national and local partners, collaborated to promote events. This year, there were 169 EITC Awareness Day outreach events. The IRS shared promotional information with partners that included useful links, local statistics, key messages, fast facts, newsletter and web articles, tips for running an EITC campaign, and other basic marketing and communication materials. This day marked the kickoff of a multilingual communication effort to increase awareness of EITC eligibility and to encourage participation and the filing of accurate returns.

As part of the IRS's EITC customer service efforts, the IRS took steps to ensure that returns claiming EITC were as accurate as possible. The EITC Return Preparer Strategy is designed to increase the accuracy of EITC returns by focusing on return preparers who are not exercising due diligence when preparing taxpayers' returns claiming EITC. Interventions for EITC preparers before and during the filing season included monitoring nearly 25,000 preparers. The IRS conducted nearly 800 pre-filing season due-diligence visits and closed 744 with nearly $20 million in proposed penalties asserted on 629 preparers.

The IRS revised more than 675 tax products to assist taxpayers in complying with their tax responsibilities. Additionally, the IRS released its 100th eBook. The IRS eBooks effort, which began two years ago, offers an easy way to read and review some of the most commonly used IRS tax products. Through eBooks, taxpayers may view Form 1040, *U.S. Individual Income Tax Return*, instructions; Publication 17, *Your Federal Income Tax (For Individuals)*; and other frequently used tax publications via mobile devices, such as smart phones, tablets, and eReaders. Thus, the number of eBook downloads increased 12.3 percent during the 2017 filing season.

IRS Web Services

The IRS has been working very hard to provide taxpayers with the types of products they need online. The IRS continually looks for ways to improve tax products and the services provided to taxpayers to make the return filing process a positive experience.

Taxpayers who have downloaded the *IRS2Go* mobile app, which is available in English and Spanish, may check the status of their refund, make a payment, find a free tax preparation site, and subscribe to helpful tax updates. To meet demand from the growth in the mobile marketplace, the IRS recognized the need to provide a means for taxpayers to file their taxes using mobile devices. Thus, the IRS added *Free File* as another 'take action' option in the *IRS2Go* app. For the first time, taxpayers could enter and file their tax returns on the go.

Taxpayers can find a wealth of helpful tax information and products on IRS.gov. IRS.gov increasingly provides information online in

Spanish, Chinese, Korean, Vietnamese and Russian—almost 4,000 pages of content.

IRS Web Services Infrastructure continues to support IRS.gov, which has maintained 100 percent availability for public access and use since 2012. In FY 2017, IRS.gov received nearly 493.5 million website visits and almost 2.2 billion page views.

IRS.gov supports tax preparer submissions and reduces paper and person-to-person delays between the IRS and the public to complete a tax transaction. Millions of taxpayers use IRS web services, such as *Get Transcript* on-line services (1.9 million users) and *IRS2Go* application downloads (five million users); and there were nearly 124.6 million downloads of tax forms, publications and other items. The popular *Where's My Refund?* tool recorded 278 million completions (web and phone).

In addition, the IRS has developed and deployed several other tools for taxpayers. For example, the Online Account (OLA) application is a mobile-friendly online tool that provides tax account balances, payment history, the ability to make payments or set up payment agreements, and access to tax transcripts and records. The IRS first released OLA to the public in November 2016 and since then has seen more than 2.1 million visits. It allows taxpayers to view their cumulative tax account balance and amount owed by year and has allowed taxpayers to submit about 184,000 payments worth more than $478 million using their bank account via *IRS Direct Pay*.

Taxpayers who cannot pay their balances in full have several payment options, and the IRS has continued to use online tools to help taxpayers make use of these options. This year taxpayers established more than 39,000 payment plans by using a link in the OLA to access the Online Payment Agreement (OPA) application. The OPA application is an easy, safe, and secure tool that reduces taxpayer burden by providing qualified taxpayers, or their authorized 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 is 10 minutes. In FY 2017, OPA accounted for about 21 percent of all Installment Agreements established, with almost 600,000 total completions. The IRS focused on improving opportunities to increase the usage of the OPA tool by expanding the eligibility business rules. Compared to FY 2016, there has been a 57 percent increase in the use of the web-based OPA.

Digital service offerings provide taxpayers with the ability to:

- *Find answers to tax law questions*
- *File their tax return*
- *Check on their refund*
- *Check the status of an amended return*
- *Make a payment*
- *Apply for a payment agreement*
- *Get a transcript*
- *Find a tax preparer*
- *Locate a VITA or TCE site offering free volunteer tax preparation assistance*
- *Search for a charity*
- *Find out whether they are eligible for EITC*
- *Figure their tax withholding, and much more.*

One of the challenges faced by the IRS is how to interact with taxpayers securely in an online environment when impersonation scams are so prevalent. Part of the strategy for accomplishing this is the IRS's Taxpayer Digital Communications (TDC) program. Technical implementation began in March 2016, making online Secure Messaging, Text Chat, Video Chat, and Co-Browse (i.e. screen sharing) capabilities available to the IRS. Pilot operations began in December 2016, offering an online alternative for taxpayers selected for examinations of Schedule A (Form 1040), *Itemized Deductions*, which are traditionally conducted by correspondence. The TDC program offered taxpayers the option to communicate with the IRS through a secure electronic channel, where they can send and receive messages and upload documents. Later releases, also using Secure Messaging, supported the ACA compliance processes and Levy and EITC cases at the Taxpayer Advocate Service. These releases were significant as they introduced several innovations, including the first IRS use of an externally-hosted, federally-certified solution for the handling of taxpayer information and the use of federated credentials, allowing IRS login and password information to be used outside of the IRS in a secure electronic channel. Of the taxpayers offered the online Secure Messaging option for correspondence, almost half attempted to use it. Follow-up correspondence submitted digitally resulted in fewer phone calls and less duplicate correspondence.

In FY 2017, the IRS developed additional TDC capabilities, such as the configuration of Text Chat to aid taxpayers who receive an IRS letter advising them of taxes owed and for taxpayers needing assistance with the OPA application. These Text Chat options will become available online in early FY 2018.

The IRS continues to improve authentication for other online taxpayer services as well by adding more applications behind Secure Access - a tool that enhances security while providing greater access for legitimate taxpayers and improving the customer experience. The IRS stood up the Secure Access e-Authentication capability to protect the *Get Transcript* Online application in June 2016. Since then, the IRS has added several applications behind Secure Access, including Identity Protection Personal Identification Number (IP PIN), the Taxpayer Digital Communications pilot, Qualified Intermediary Registration and Management, and Online Account with functions such as *See Balance Due* and a link to *Make a Payment*.

Traditional Services

The IRS continues to improve face to face interactions with taxpayers. For example, following the successful pilot of the Taxpayer Assistance Center (TAC) Appointment Service, the IRS implemented the appointment service nationwide saving time for the taxpayer and allowing the IRS to provide more efficient service. By screening taxpayer questions and service needs in advance of visiting a TAC, the IRS and the taxpayer could resolve minor issues that did not require an appointment. This allows the IRS to spend more time with taxpayers with more complex service needs that are better served face-to-face. This positive change is attributable to phone assistors being able to resolve many taxpayer service needs so the taxpayer does not require an appointment. Assistors on the appointment line answered more than 3.5 million calls, with only 1.7 million resulting in an appointment. Furthermore, the appointment service practically eliminated the long lines of taxpayers waiting for service seen in past years. Although the IRS continues to serve taxpayers without appointments who come in for payments, return drop offs, form pick-ups, and when TAC capacity permits accepting walk-ins, nearly 94 percent of customers waited less than 30 minutes for service. This is a 28 percent improvement compared to last year.

In addition, beginning January 2017, the IRS collaborated with the Social Security Administration (SSA) to allow IRS employees to work in SSA offices. The IRS employees conduct normal TAC operations from their SSA site, including meeting with taxpayers using the appointment system. The SSA facilitates taxpayer access to the employees through their customer management system and provides signage to assist taxpayers. This allowed the IRS to reduce space demands in smaller TACs and builds on inter-governmental partnerships to provide services to taxpayers.

Quality is at an all-time high at 95 percent, indicating that TAC employees continue to focus on providing accurate responses to taxpayers. In January 2017, the IRS was bestowed the President's Award for Customer Service in recognition of its effective implementation of the appointment service model that is now practiced in all IRS TACs throughout the country.

The IRS recognizes that there is still a segment of the population uncomfortable with online services or unable to visit a TAC site, so virtual technology will be used to ensure face-to-face service is available in remote locations where staffing is a challenge. The IRS's Virtual Service Delivery (VSD) offers most of the services offered in a normal brick and mortar TAC through video communication equipment, which allows the taxpayer to talk face-to-face to an assistor in another city or state. This filing season, taxpayers could schedule an appointment and receive assistance at 28 video terminals located in external community partner sites. Plans are underway to add additional locations and to explore the use of a new cloud-based conferencing system that gives users the ability to communicate in much the same fashion as a live in-person meeting, and to share information through any computer or mobile device. This allows taxpayers and employees to communicate at any time and from anywhere.

FY 2017 Compliance Activity

The IRS continues to intensify efforts to enhance voluntary compliance by focusing on approaches to tax administration that are more proactive, accessible, and interactive. The IRS is committed to delivering programs and services that educate and assist taxpayers to understand and comply with the tax law. Whether the IRS is addressing non-compliance through enforcement efforts or providing service through education, outreach, or taxpayer burden reduction, the fundamental aim is to help taxpayers comply with the tax laws and ensure that these laws are applied fairly to all.

The IRS has worked to improve the selection of the most egregious returns for examination while balancing available resources and strategic priorities. Data analytics models have enhanced enforcement efforts by improving the IRS's ability to predict the likelihood of deliberate non-compliance activity. This allows the IRS to prioritize the most egregious non-filer cases and to identify effective approaches to resolve issues and secure the proper amount of tax due. In FY 2017, the IRS analyzed data to improve the return selection process for partnership returns as well as the Employment Tax National Research Program (NRP). The IRS also initiated a Discriminant Index Function (DIF) Score pilot on claims to evaluate the feasibility of selecting and assigning returns based on DIF scores. Similarly, the Automated Underreporter (AUR) program analyzed return preparer data on preparers who had the highest volume of tax returns with AUR discrepancies to identify potential non-compliant return preparers for further enforcement action.

Achievements

- *Conducted 94,913 high-income audits*
- *Completed 44,017 small business audits (assets <$10 million)*
- *Completed 8,979 large corporate audits (including partnership and flow-through returns)*
- *Completed 934,597 individual audits*
- *Closed about 2.4 million collection cases*
- *Closed almost 3.3 million automated underreporter contact closures*
- *Completed 31,884 tax-exempt and government entities compliance contacts*

The Return Review Program (RRP) is the IRS's primary fraud detection system. When it flags an individual tax return as potentially fraudulent, the IRS delays the associated refund while the analysis and verification is completed. In processing year 2017, RRP selected about 1,035,000 potentially fraudulent tax returns with a refund value of $12.8 billion. The RRP protected more than $3.7 billion in revenue.

The IRS undertook an Early Interaction Initiative to expand and enhance the IRS Federal Tax Deposit Alert program. The IRS issues alerts when it appears an employer is behind in depositing withheld payroll taxes. Earlier contact with non-compliant employers improves the likelihood that these employers will meet their payroll tax depositing requirements. Face-to-face meetings with an IRS expert improve employers' understanding of their filing and payment requirements and the potential consequences of non-compliance. Through the Early Interaction Initiative, the IRS estimates an annual increase in net payments of $360 million and a decrease in penalties and interest of $47 million.

Identity Theft

The IRS intensified its communication efforts to increase awareness of identity theft by both taxpayers and tax professionals. The IRS issued 28 news releases and two fact sheets discussing identity theft, 22 Tax Tips, which included 12 Tax Tips issued as a part of the *Taxes.Security.Together.* public awareness campaign, and eight Tax Tips issued as part of the *Protect Your Clients; Protect Yourself* security awareness campaign for tax professionals. The IRS also held several press events, including the first National Security Awareness Week conducted from December 5-9, 2016. This was a collaborative effort with the Security Summit, and other external partners whose focus is to enhance cybersecurity and combat identity theft refund fraud and to increase awareness among taxpayers and tax professionals about the need for greater vigilance to protect against refund fraud and identity theft.

For the 2017 filing season, the IRS initiated an Identity Theft Tax Refund Fraud Information Sharing and Analysis Center (ISAC) pilot. The ISAC serves as an improved early warning system for spotting emerging identity theft schemes and quickly sharing that information with Security Summit partners so that all participants can enact safeguards. There are 20 States with full membership, 17 states with pending membership, and 14 Tax Industry and three Financial Sector members of the ISAC. Five organizations from the tax industry and state tax administrator organizations endorsed the ISAC, and more than 1.9 million leads and 61 alerts have been produced. The IRS can identify potential anomalies faster and stop potentially fraudulent refunds based on ISAC information. The IRS expects to continue the pilot in future filing seasons, as the ISAC appears to have the potential to be a very powerful tool for combatting identity theft tax fraud.

In addition, this year the IRS began notifying taxpayers if it appeared that their SSN was being used to report wages that were earned by someone else to obtain or maintain employment. The intent of this proactive notification was to inform the taxpayer that they might be the victim of identity theft so that they might take preventative measures to avoid misuse of their SSN. To date, the IRS has notified about 135,000 taxpayers that they might be a victim of employment-related identity theft.

At the same time, the IRS's Security Summit partners took additional actions to identify and stop fraudulent identity theft returns by adding and expanding features to protect taxpayers and the tax system. For example, the tax industry expanded the identity theft protections available to business and individual filers by agreeing to share with the IRS and states additional data elements not included on business tax returns (Forms 1120, *U.S. Corporation Income Tax Return*, 1065, *U.S. Return of Partnership Income*, and 1041, *U.S. Income Tax Return for Estates and Trusts*). In addition, software providers added additional pre-filing safeguards by enhancing software password requirements for individual and tax professional users, and by expanding the Form W-2 Verification Code initiative to 47 million forms in 2017 from two million in 2016. This initiative requires individuals and tax professionals to enter the verification code when prompted by tax software to validate the information on the Form W-2.

Eleven states are also working with the financial services industry to flag suspicious refunds and return those funds. The IRS coordinated efforts with these states and the financial industry to update the Automated Clearing House (ACH) naming convention to enable recognition of a state tax refund deposit. In addition, private sector partners are enhancing efforts to identify the "ultimate bank account." The ultimate bank account will assist the IRS, states, and industry in identifying the destination of refunds.

Communications are underway for this year's Security Summit awareness campaign. The IRS has been developing media releases, tax tips, talking points, feature articles for partner use, web updates, and other materials. This year's campaign*, Don't Take the Bait*, educates tax professionals, businesses, and taxpayers on ways to protect themselves and their clients/customers from data breaches, identity theft, and other web-based attacks.

Because of the collaborative Security Summit workgroup efforts, the IRS is preventing more identity theft than it did last year and is seeing fewer fraudulent refund claim attempts. In 2016, the number of victim reports was 376,000, reflecting a drop of 46 percent from the prior year. This year through August, about 189,000 taxpayers filed victim reports, which was an additional drop of about 40 percent from the same period last year.

Identity theft and related refund fraud continue to be one of the IRS's main areas of investigative concentration. The IRS collaborated with federal law enforcement agencies and private sector entities to ensure an effective approach to deterring this type of fraud. In FY 2017, the IRS leveraged both existing programs and new initiatives to combat identity theft. For example, the IRS's Identify Theft Clearinghouse (ITC), currently in its sixth year, continues to detect and refer identity theft refund fraud schemes to the IRS for investigation. In FY 2017, the ITC received 275 identity theft related refund fraud leads that were associated with 97,111 tax returns requesting more than $403 million in refund claims.

Combatting identity theft also requires the help of the IRS's partners. The Law Enforcement Assistance Program (LEAP) helps state and local law enforcement lawfully obtain federal tax return data vital to their local efforts in investigating and prosecuting specific cases of identity theft. In FY 2017, 117 state and local law enforcement agencies from 32 states participated in the program and the IRS received 368 requests from state or local law enforcement to obtain federal tax return data vital to their local efforts in investigating and prosecuting specific cases of identity theft. At the same time, identity theft outreach events designed to educate private sector entities and law enforcement partners focused on theft from tax preparation and payroll services businesses. The IRS participated in 167 outreach presentations.

Cybersecurity

In FY 2017, the IRS detected and mitigated 1,305 phishing and malware sites. During this time, the IRS identified and responded to 542 cyber incidents of which 128 incidents (about 24 percent) involved common threats of removable media, email, and web-based activity. The IRS also implemented 1,876 content filtering restrictions to mitigate Internet content deemed a security risk to IRS information systems. Despite these incidents, IRS systems remain secure.

The IRS Cyber Crimes unit identifies and pursues criminal investigations where there is reason to believe the subject is committing a tax or other financial crime while using the Internet. Use of the internet gives perpetrators the means to commit the crime, remain anonymous, and elude law enforcement, as well as conceal financial transactions, ownership of assets, or other evidence. The IRS Cyber Crimes unit also collaborates with other federal law enforcement agencies to identify the movement of criminally-derived profits utilizing virtual currency.

The IRS also recently established a cyber-security working group called the Cyber Fusion Team to identify and address the most egregious cyber threats affecting tax administration. The group is comprised of multiple functions within the IRS that collaborate to rebuff attempts to circumvent existing IRS system safeguards or engage in unauthorized use of personally identifiable information for illicit purposes.

Implementing Legislation

Protecting Americans from Tax Hikes (PATH) Act of 2015

The IRS successfully implemented the PATH Act, which included several sections affecting taxpayers for the 2017 filing season. The IRS delivered these changes successfully in part because Congress made them effective about a year after enactment, which gave the IRS sufficient lead-time to update its systems and to prepare taxpayers and tax practitioners for the changes. Further, the lead time meant that the IRS had sufficient time to work extensively with its partner groups through press releases, social media, speeches, and the annual IRS Nationwide Tax Forums so that taxpayers would understand what the changes would mean for them. This reduced the need for taxpayers to call or write with questions.

One significant change resulting from the PATH Act is that certain information returns (Forms W-2 or 1099) must be filed by January 31. Through collaboration with SSA, the IRS received electronically-filed wage/withholding data within days of receipt at the SSA, providing the IRS with more data at the point of filing to assist with the detection of refund fraud and identity theft. Through mid-February, the IRS processed about 216 million Forms W-2; an increase of 125 percent compared to the same time the previous year.

Another significant change prevented the IRS from issuing a credit or refund of an overpayment for a previous taxable year before February 15, 2017, if the taxpayer claimed the EITC or Additional Child Tax Credit (ACTC) on their return. Before the filing season started, the IRS prepared to hold these refunds until February 15. On February 16, 2017, the IRS released 10 million returns claiming EITC or ACTC with refunds totaling $51 billion.

In addition, the PATH Act prohibited retroactive claims of the EITC, Child Tax Credit (CTC), or American Opportunity Tax Credit (AOTC) for a tax year in which the taxpayer or the qualifying child did not have a Social Security Number (SSN), Individual Taxpayer Identification Number (ITIN), or Adoption Taxpayer Identification Number (ATIN) issued before the return due date for the taxable year involved. The IRS developed and executed an extensive communication strategy to educate and inform partners and taxpayers about the new refund process, including the timing of the refund release.

The PATH Act also modified certain rules related to the ITIN application process and added rules regarding the term and deactivation of new and existing ITINs. The first annual deactivation process was completed in early January, and resulted in the expiration of 12.4 million ITINs. Recognizing some taxpayers may file a return with an expired ITIN, resulting in the disallowance of exemptions and/or credits, the IRS developed a new process that proactively corrected the math disallowance of the exemptions and/or credits, assuming the ITIN was renewed. This new process resulted in the taxpayer receiving a refund or a corrected balance due notice without having to contact the IRS a second time.

Finally, to reduce improper payments, the IRS implemented PATH Act provisions that expanded the paid preparer due diligence requirements (and related non-compliance penalties) to the CTC and the AOTC. The IRS published temporary due diligence regulations in December 2016 with an immediate effective date. In January 2017, the IRS delivered two 90-minute web conferences, *Understanding PATH Act Due Diligence Requirements – It's More Than Just EITC*, to more than 3,000 tax professionals. The presentation included a comprehensive overview of the expanded due diligence requirements and forms resulting from the PATH Act.

In April 2017, the IRS issued its *Report to Congress on the Effectiveness of Tax Return Preparer Due Diligence Requirements for Claiming the Earned Income Credit under Section 32 of the Internal Revenue Code*. Additionally, the IRS updated websites and online training tools such as the Due Diligence

Training Module for Continuing Professional Education to reflect all PATH Act changes.

Health Coverage Tax Credit (HCTC) – Implementation

After a lapse of two years, Congress reauthorized the HCTC in June 2015, allowing a refundable tax credit of 72.5 percent of qualified health insurance premiums for eligible taxpayers either through their annual filing or through an advance monthly payment (AMP). The IRS began processing amended returns within six months of reauthorization for retroactive credits and annual return processing began seven months after reauthorization. The IRS developed a full systemic AMP process in January 2017 that eliminated 52 percent of the processes used in the former program and required 53 percent fewer resources. To further streamline the program, the IRS eliminated 85 percent of the letters and half of the forms used in the previous program. The IRS provided detailed guidance and forms on the IRS.gov/HCTC website and established a dedicated toll-free line to provide additional customer service. The IRS accepted more than 45,000 Forms 1040 with attached Forms 8885, *Health Coverage Tax Credit*, covering more than 21,700 participants and a total distribution of $37.5 million.

Affordable Care Act (ACA)

During the 2017 ACA open enrollment period, the IRS saw both the highest volume of combined Income and Family Size Verification (IFSV) and Advance Premium Tax Credit (APTC) transaction requests as well as the highest number of those transactions successfully processed of any Open Enrollment season. From November 1, 2016, to January 31, 2017, the IRS processed more than 49 million combined IFSV and APTC transactions and averaged less than half a second response time per transaction for the entire Open Enrollment period, well below the IRS's Service Level Agreement with Health and Human Services/Centers for Medicare & Medicaid Services (CMS).

Since the beginning of fiscal year 2017, the IRS completed information technology system upgrades related to ACA that improved both the stability and capacity of the processing systems. The improvements enhanced the IRS's ability to handle data from the insurance marketplaces, allowing the IRS to process more than two times the number of bulk files as in prior years, resulting in increased responsiveness to the CMS and state exchanges.

Passport Denial and Revocation

The Fixing America's Service Transportation (FAST) Act generally prohibits the State Department from issuing or renewing a passport to a taxpayer with federal tax debt greater than $50,000. The IRS is working with the State Department to implement this provision of the law. Once implemented, the IRS will notify the State Department of taxpayers with seriously delinquent tax debts. The IRS regularly works with taxpayers who have tax issues and offers several options to help people who cannot pay their tax bill.

Private Debt Collection (PDC)

The FAST Act also requires the IRS to use private debt collection agencies for the collection of outstanding inactive taxes receivables. The IRS is committed to protecting the security and integrity of taxpayer data. To ensure these protections, the IRS initiated a controlled launch of the Private Debt Collection program in April 2017 when it contracted with four private collection agencies (PCAs) to initiate the private collection of certain overdue federal tax debts. The IRS incrementally assigned to PCAs 128,000 individual delinquent tax accounts with balances ranging from $500 to $50,000 and 529 cases with balances of more than $50,000. By implementing the program incrementally, the IRS increases the likelihood that the program will work effectively while at the same time ensuring the protection and security of taxpayer data.

The IRS understands that the use of PCAs may increase the risk to taxpayers of impersonation scams, since the program will involve contact with taxpayers by non-IRS employees on behalf of the government. The IRS urges taxpayers to be on the lookout for unexpected scam phone calls from anyone claiming to be collecting on behalf of the IRS. With the ongoing threat of scams, IRS public announcements throughout FY 2017 highlighted the facts of the Private Debt Collection program and what taxpayers should do to protect themselves. The IRS issued a news release in April and maintains a social media presence (Twitter and YouTube) that includes these messages:

- Taxpayers should not receive unexpected phone calls from the IRS or private collection agencies.
- Prior to phone contact, both the IRS and the assigned private collection agency will send letters to taxpayers.
- Private collection agencies will not ask for payment on prepaid debit, iTunes, or gift cards.
- If writing a check, make the check payable to the U.S. Treasury and mail payments directly to the IRS.

The IRS encourages taxpayers to visit IRS.gov to verify the private collection agency before calling a number received on a letter.

Foreign Account Tax Compliance Act (FATCA)

FATCA was enacted to increase the income tax compliance of U.S. taxpayers holding foreign accounts and assets. FATCA introduced new reporting requirements for both U.S. taxpayers and foreign financial institutions (FFIs) and imposed a 30 percent withholding tax on certain payments of U.S. connected income. These complementary provisions created a web of accountability to allow the IRS to gather and analyze information from multiple sources.

In FY 2017, the IRS deployed additional FATCA information technology capabilities in support of legislative mandates. The new functionality improves FATCA forms, reporting features, and overall interfaces. For the first time, new technology allows entities to enter an agreement with the IRS to become a Qualified Intermediary (QI), Withholding Foreign Partnership (WP), or a Withholding Foreign Trust (WT) via an electronic system. This release allows QI/WP/WTs to maintain account information, as well as apply, renew, or terminate agreements with the IRS electronically, thus replacing the existing paper process. It also provides IRS users with an interface to manage and monitor applications. Doing this electronically is far more resource-efficient, as it reduces storage needs and provides timely reporting in support of either new or existing compliance efforts. The application provides electronic notifications to end users informing them of any changes in the status of their application, reminders of upcoming renewal deadlines, and any other updates to their accounts. This will eliminate the need in many cases for users to contact the IRS directly. As of the September 30, 2017 due date for renewals, nearly 4,600 QIs, WPs and WTs had used the new application to renew their agreements.

In addition, about 290,000 FFIs registered with the IRS and received a global intermediary identification number (GIIN) via the FFI Registration application. More than 6,500 financial institutions and 97 host country tax authorities enrolled in the International Data Exchange Service (IDES) to submit FATCA information returns to the IRS, and more than 550 QIs completed their online application via the QI application.

Ongoing and Future Challenges

Information Technology

Insufficient budgetary resources over several years have resulted in inadequate investment in IT infrastructure.

The IRS's growing inventory of aged infrastructure is increasing inefficiencies, security vulnerabilities, and operational risks. The likelihood of a catastrophic system failure increases as the IRS's infrastructure continues to age.

The IRS focused its limited resources on the most critical security investments. Emerging cyber threats have increased the potential for unauthorized access to sensitive information, refund fraud, identity theft, and data loss. While several initiatives are underway to enhance or develop capabilities to detect and respond to cybersecurity threats, the IRS needs continued investment in technology, tools, and processes to strengthen information technology capabilities and its capacity to defend against expanding threats.

The exception-only hiring freeze and budget constraints also have had a significant effect on the IRS's ability to recruit, train, and retain the next generation of IRS information technology professionals. The number of information technology employees declined from 7,385 in October 2011 to 6,691 in September 2017. About 22 percent of information technology employees are eligible to retire by the end of FY 2017 and about 34 percent will be retirement eligible by the end of FY 2019. With single points of dependency in several key programs, loss of knowledge due to retirements threatens the IRS's ability to deliver necessary changes to legacy IT systems and to modernization efforts.

Legislative mandates requiring significant information technology development without funding have come at a cost to the IRS and are inhibiting investments in information technology operations and the future state. Annual spending on new unfunded mandates has averaged $334 million from FY 2013 to FY 2017, reducing the availability of operational tax administration funding by nearly $1.7 billion dollars. This deficit represents 15 percent of overall IT annual spending.

The IRS also has limited resources to make changes to tax forms as well as to complete the programming changes that must accompany those form changes. Changes related to legislation take priority, leaving few resources for non-legislative form changes. Thus, it can take years to secure an update to a form, or such an update may be impossible to attain given the competing form and programming needs.

Changes to existing forms are beneficial to both the IRS and taxpayers because they give the IRS the opportunity to modernize tax forms in a way that improves taxpayers' understanding of the tax law and reporting requirements, thereby increasing the likelihood of voluntary compliance. In addition, changes to forms help the IRS to identify returns that present compliance risks. If the IRS can identify such returns, it can redirect resources currently spent examining compliant taxpayers to returns presenting greater compliance risk.

Staffing Shortfalls and Attrition

Many IRS functions face challenges due to the growing need for additional experienced and talented staff. In FY 2017, IRS hiring was constrained by both its exception-only hiring freeze (in effect since December 2010 due to budget limitations) and the government-wide hiring freeze. The IRS's current hiring plans constrain hiring to critical positions approved on a case-by-case basis.

The IRS's Mission Critical Occupations (MCO) population declined about 21 percent since FY 2010. The number of retirement eligible MCO employees is about 20 percent and trends show that about 19 percent of those eligible to retire do so at their first opportunity. Although the overall attrition rate for this population has remained steady at nine percent, the increasing number of retirement-eligible staff coupled with an inability to carry out significant attrition replacement hiring will exacerbate knowledge and resource gaps in the future.

Since FY 2010, staffing has declined in two of the primary positions that are the face of the IRS's enforcement, information technology, and taxpayer service programs, threatening the IRS's ability to carry out its mission. Additional funding received in FY 2016 and FY 2017 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" enabled the IRS to increase the number of information technology specialists and customer service representatives.

Primary MCO Positions		
Position Type	**FY 2010**	**FY 2017**
Revenue Officers	5,383	3,016
Revenue Agents	13,385	8,636
Information Technology Specialists	4,589	5,260
Customer Service Representatives	14,090	14,898
Total	**37,447**	**31,810**

The reductions in the IRS budget have led to reductions in IRS staffing, especially affecting compliance employees who conduct audits of individual taxpayers, small businesses, and large corporations. These reductions have limited the IRS's ability to expand enforcement activities in the increasingly complex global financial environment.

From 2010 to 2016, return filings for corporations, S corporations, and partnerships increased 31 percent from 242,000 to 317,000. Additionally, there have been significant changes in the tax law during that time, including implementation of the FATCA and the Bipartisan Budget Act (BBA) of 2015, and repeal of the Tax Equity and Fiscal Responsibility Act (TEFRA) Partnership Audit Rules. To address these challenges, the IRS realigned organizations and staffing, conducted training, and revised procedures to gain efficiencies. However, the staffing and hiring limitations and staffing losses are affecting mission delivery.

The IRS Criminal Investigation division is the only federal law enforcement organization with jurisdiction over the investigation of federal tax crimes, including tax related cybercrime and stolen identity theft refund fraud (SIRF). Tax fraud, cybercrime, employment tax, offshore compliance, and identity theft violations are some of the current and significant threats to the U.S. tax administration system. The most effective way of countering these threats is with a visible and sustained law enforcement response. However, years of decreased staffing has left the IRS with investigative resources that are stretched beyond capacity. The IRS Criminal Investigations total staffing levels decreased by 25.3 percent since FY 2011. Furthermore, about 28 percent of Special Agents and 47 percent of professional staff will be eligible to retire by 2021.

The exception-only hiring freeze has enabled the IRS to hire about 380 Special Agents since FY 2011; however, this is not enough to offset attrition losses. The average attrition rate for special agents has been about seven percent, with an average loss of 140 agents each year, which equates to a total loss of more than 980 special agents since FY 2011.

Furthermore, although the IRS made significant advances in improving the taxpayer's online experience and expanding digital customer service offerings, budgetary limitations have a direct effect on the ability to communicate effectively to the tax community through electronic channels.

To support current and future online service initiatives, the IRS requires additional web producers and web content strategists. Without additional new hires, this work is at risk, and the IRS's ability to communicate effectively via electronic channels during filing season 2018 and beyond may diminish. Key pages and design-related services on applications such as IRS.gov, *IRS2Go*, and Online Payment Agreement will continue to have issues displaying on mobile devices, and content upgrades and improved search functionality will be limited. The IRS may experience lower customer satisfaction and compliance, resulting in the use of higher cost channels.

Financial Management Highlights

Financial Resources

The IRS's FY 2017 appropriated level was $11.2 billion, the same as the FY 2016 enacted level. An administrative provision in the *Consolidated Appropriations Act of 2017*, Internal Revenue Service Administrative Provisions Section (§) 113 provided the same additional funding of $290 million to the IRS as it did in FY 2016. Again, this increase was specifically for 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.

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 to $12.4 billion.

Unfortunately, the IRS continues to face resource challenges. The enacted level did not cover the cost of labor and non-labor inflationary increases of about $200 million. About $45 million more 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 infrastructure refreshment development, modernization and enhancement of IT systems, facilities projects, and by continuing its exception-only hiring policy; resulting in further staffing level declines. The IRS had about 21,000 fewer permanent staff at the end of 2017 than it did at the end of 2010.

The IRS expects more than 30 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. 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 in five to ten years.

The IRS has shouldered these losses across the agency. The IRS full-time permanent workforce lost since 2010 includes more than 7,500 key enforcement personnel. These employees include revenue agents and revenue officers who audit returns and perform collection activities, Special Agents in the IRS's 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 seven years.

Last year, the IRS completed the fewest audits in a decade and the audit coverage rate in 2016 was the lowest since 2005. 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 $10 billion a year in enforcement revenue to achieve budget savings of a few hundred million dollars. For every $100 the government collects in taxes, the IRS spends only 35 cents. This makes the IRS one of the most efficient tax administrators in the world according to the Organisation for Economic Co-operation and Development (OECD). Similarly, additional investments in Compliance help to address the tax gap (the difference between the amount owed to the government in taxes and the amount paid in time), currently estimated at $458 billion. In addition to weakening compliance programs, these budget reductions 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. This has reduced the IRS's capacity to address other operational areas, including maintenance for newly deployed IT infrastructure. Since 2013, the IRS has incurred more than $96.6 million in increased annual requirements due to business systems modernization (BSM) deployments but has not received funding in the

Operations Support appropriation to support these deployments. Ultimately, continued underfunding of the IRS threatens to erode its effectiveness and ability to be efficient.

Funding by Appropriation ($ thousands)

Taxpayer Services *[$2,365,754, includes §113 allocation of $209,200]* funds staffing for the processing of tax returns and related documents, and assistance for taxpayers in filing returns and paying taxes due.

Enforcement *[$4,860,000]* funds staffing for the examination of tax returns, collection of balances due, the administrative and judicial settlement of taxpayer appeals of examination findings, and provides resources for strengthening enforcement to reduce invalid claims and erroneous filings associated with the EITC program as well as other refundable tax credits.

Operations Support *[$3,719,246, includes §113 allocation of $80,800]* funds 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 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]* funds capital asset acquisitions of information technology to modernize key tax administration systems.

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

Other Resources: User Fees [$393,352] from payment for services provided and [$244,769] from prior year balances brought forward October 1, **Offsetting Collections Resources** [$168,568], **Unobligated Balance Transferred In (50% Carryover)** [$30,150], and **Unobligated Balances** [$352,207] brought forward October 1.

In FY 2017, the IRS transferred, with Congressional approval, $220 million from the Enforcement account -- $90 million to the Taxpayer Services account and $130 million to the Operations Support account. These late-in-the-year funds transfers reflect an imbalance of appropriated resources between these appropriations that has been growing since FY 2013. Thus, yearly transfers have been critical to provide the necessary information technology infrastructure for IRS personnel to carry out their duties and to support customer service programs.

Use of Resources

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

Taxpayer Assistance and Education activities [4%] include taxpayer education and outreach, tax publication issuance and distribution.

Filing and Account Services activities *[34%]* include filing tax returns, maintaining customer accounts, processing taxpayer information, providing service to taxpayers, and resolving issues.

Compliance activities *[61%]* include pre-filing agreements, document matching, examination, collection, and criminal investigation activities.

Administration of Tax Credit Programs *[1%]* 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 several other refundable and non-refundable tax credit programs. The IRS Financial Statements reflect those tax credits and the associated costs.

Use of Resources ($ thousands)		
Program	**FY 2016**	**FY 2017**
Taxpayer Assistance and Education	$539,685	$544,719
Filing and Account Services	$3,938,665	$4,333,587
Compliance	$7,868,447	$7,700,759
Administration of Tax Credit Programs	$141,480	$138,259

Overview of Revenue and Administrative Accounts

Stewardship Information Analysis

The IRS financial statements and footnotes have received an unmodified audit opinion for 17 consecutive years.

Administrative accounts reflect resources used and expenses incurred in administering the tax laws. Revenue accounts reflect net taxes receivable and taxes collected to support the federal government.

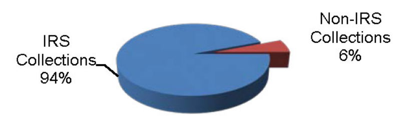
The Balance Sheet reports total assets of $60.26 billion. Of these assets, approximately 86 percent are federal taxes receivable. These receivables are expected to be collected from past due accounts. The increase in assets of $3.02 billion is primarily attributable to an increase in federal tax receivables. Almost 91 percent of the liabilities consist of amounts due to Treasury and are offset by federal taxes receivable.

The Statement of Net Cost consists of four major programs with a net cost of $12.15 billion. Total net cost of operations includes $12.71 billion in gross cost and $0.57 billion in exchange revenue. The overall increase in net cost of one percent is primarily from an increase in agreements with the Federal Emergency Management Agency (FEMA) and installment agreements.

New obligations and upward adjustments consist of $11.75 billion, which represents a one percent decrease. This is comprised of $11.59 billion in direct obligations and $0.15 billion in reimbursable obligations.

The Statement of Custodial Activity reports collection of taxes resulting in $3.42 trillion of gross federal receipts before tax refunds. The IRS collections total 94 percent of Federal Government receipts.

Total Federal Receipts (Percent)



Revenue and Refund Trend Information

FY 2017 revenue receipts collected by the IRS totaled $3.4 trillion, representing an increase from $3.3 trillion in FY 2016. Federal tax revenues are collected through six major classifications: individual income and FICA/SECA, corporate income, excise taxes, estate and gift taxes, railroad retirement, and federal unemployment taxes.

FY 2017 tax refund and outlay activity totaled $437 billion, representing an increase from $426 billion in FY 2016. 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

Trust Fund	Fiscal Year	
	2015	2016
Airport & Airway Trust Fund	$14,201,025,456	$14,462,292,055
Black Lung Disability Trust Fund	$540,950,252	$434,942,559
Highway Trust Fund	$41,364,513,585	$41,410,628,686
Total	**$56,106,489,293**	**$56,307,863,300**

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 2014 through September 2016. 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

Unpaid Assessments in 2017	
(Dollars in Billions)	
Taxes Receivable (including outstanding branded prescription drug fees)	$197
Uncollectible	*$145*
Potentially Collectible	*$ 52*

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 2017 Financial Statements, the unpaid assessment balance was $380 billion plus $2 billion in outstanding branded prescription drug fees as of September 30, 2017. Of the total unpaid assessment balance, $197 billion (52 percent) consists of interest and penalties. Also, 48 percent of the total outstanding balance of IRS unpaid assessments is largely uncollectible because it is composed 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.

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 $111 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.

Internal Control and Legal Compliance

The IRS continued to enhance financial management and other 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 Enterprise Risk Management and 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 of these evaluations are discussed below.

Federal Managers' Financial Integrity Act (FMFIA)

In light of the existing material weakness in internal control over financial reporting related to unpaid assessments, and given that the IRS financial management systems do not substantially comply with FFMIA, the IRS provides a modified statement of assurance that its internal controls and financial management systems meet the objectives relative to FMFIA Sections 2 and 4. In addition, the IRS continues to be in non-compliance with the Improper Payments Information Act (IPIA), as amended by the Improper Payments Elimination and Recovery Act (IPERA) of 2010, and the Improper Payments Elimination and Recovery Improvement Act (IPERIA) of 2012.

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

The IRS conducted the required Treasury evaluation of the effectiveness of the IRS's internal control over financial reporting in accordance with OMB Circular A-123, Appendix A, *Internal Control Over Reporting*. Based on the results of this evaluation, the IRS identified one material weakness in internal control over financial reporting related to unpaid assessments. Other than this exception, the IRS provides reasonable assurance that its internal controls were operating effectively as of September 30, 2017, and no other material weaknesses were found in the design or operation of the internal control over financial reporting.

The FY 2017 OMB Circular A-123 testing included the following activities:

- Tested internal control sets for 17 transaction processes identified by the Department of the Treasury that are material to its Consolidated Financial Statements. The tests included six administrative processes covering material portions of the $11.2 billion in annual administrative transactions, seven information system processes, and four custodial processes covering material portions of the more than $3.4 trillion in tax revenue receipts through September 30, 2017;
- Performed supplemental testing of the FY 2017 transactions during the fourth quarter, except for internal controls over financial reporting relative to unpaid assessments, and verified controls remained effective throughout the year;
- Reviewed controls over IRS financial reporting, specifically Treasury Information Executive Repository (TIER) reporting;
- Reviewed and documented ACA related controls over the procedures and processes for recording beginning of year funding into the general ledger, the monthly journaling and reconciliation of CMS payments of APTC, the Premium Tax Credit (PTC) to APTC reconciliation based on tax returns, the Individual Income Tax Credit (IITC) report, and the pre-and post-refund error resolutions related to PTC error codes;
- Reviewed the FATCA process, including controls related to the following components: Online and Paper

Registration, Withholding Refunds, International Data Exchange Services (IDES), and International Compliance Management Model (ICMM);
- Conducted a self-assessment of the internal control environment using GAO's Internal Control Evaluation Checklist and GAO's Green Book that includes brief, written statements in support of the assessments;
- Reviewed IRS compliance with applicable laws and regulatory requirements regarding financial reporting and internal control; and
- Reviewed GAO and TIGTA audit reports and findings during the test plan development stage and at the end of the A-123 reporting period.

Integration of Enterprise Risk Management and Internal Controls

Internal Revenue Service executives and managers were responsible for establishing goals and objectives around IRS operating environments, ensuring compliance with relevant laws and regulations, and managing both expected and unexpected or unanticipated events. IRS executives and managers were responsible for implementing management practices that identify, assess, respond, and report on risks. Risk management practices were considered when designing internal controls and assessing their effectiveness. In accordance with OMB Circular A-123, the IRS developed a risk profile in coordination with its Office of the Chief Risk Officer.

Internal Control over Operations and Compliance

The IRS conducted its assessment of internal control over the effectiveness and efficiency of operations and compliance with applicable laws and regulations in accordance with OMB Circular A 123. Based on the results of this assessment, the IRS provides reasonable assurance that internal control over operations and compliance with applicable laws and regulations was operating effectively as of September 30, 2017, and no material weaknesses were found in the design or execution of the internal control over operations and compliance.

The FY 2017 Quality Assurance (QA) Program conducted review testing. The reviews that were tested consisted of a random sample of quality assurance activities conducted by the IRS's operating and functional divisions to meet their performance and internal control goals and objectives. The QA program assessment activities included:

- Tested internal controls for 55 randomly selected reviews obtained from the 417 reviews on the FY 2017 Quality Assurance Review Listing. These reviews addressed 12 operating and functional divisions with risk ratings of high and medium, and ranges of daily to annual performance frequency. Specific test objectives included:
  - Assessing adherence to references, standard operating procedures, and/or authoritative directives;
  - Evaluating control activities;
  - Identifying risk factors, including audit recommendations from external and internal auditors;
  - Examining associated FMFIA Managers' Assessments for each selected review; and
  - Determining the review outcomes on accounting information recorded in the financial systems and/or the annual audited financial statements.
- Identified 11 FY 2017 findings with recommendations for process improvements in FY 2018 around control activities including physical security, password protection, internal use only and personally identifiable information, and elements of the control environment including adherence to and updating guidance.
- Examined the status of 16 open FY 2016 findings and recommendations, and confirmed that 15 were closed, with one scheduled for closure in FY 2018.
- Initiated a new procedure to validate 120 FMFIA Managers' Assessments with affirmative responses to specific QA-related questions, determining whether IRS

managers initiate and evaluate internal control reviews and rely on those results for annual certification.

While the QA testing identified 11 FY 2017 findings, the IRS found that all the QA tested reviews generally were effective.

Federal Financial Management Improvement Act (FFMIA)

In November 2014, the IRS approved a Customer Account Data Engine 2 (CADE 2) Transition State 2 (TS2) implementation plan to be deployed over seven releases, five affecting the unpaid assessments material weakness. That plan assumed that the IRS would have adequate resources to support this modernization effort beginning in FY 2015. However, IRS resources are further affected by the continuing budget shortfalls, competing priorities of delivering filing seasons successfully, and having to meet significant unfunded legislative requirements (e.g. ACA, FATCA, ABLE, reauthorization of the HCTC, PATH Act).

While the implementation of CADE 2 TS2 is essential for closing this material weakness, the IRS also is working to reduce it to a significant deficiency prior to full implementation of CADE 2 TS2. The actions taken include examining the feasibility of enhancing the IRS's financial systems and establishing a task force to improve the data within taxpayer accounts. The UA Data Quality Task Force will identify and document opportunities to improve the quality of data in tax administration activities and the IRS's financial systems, as well as conduct pre-posting data quality reviews, review data posted to taxpayer accounts, expand large dollar reviews, and address legislative requests and emerging issues. In addition, the Financial Systems Enhancement Tiger Team developed recommendations for financial system improvements outside of CADE 2. The progress of this team also depends upon funding availability.

The IRS added three initial actions to the FFMIA Remediation Plan that are scheduled for completion in FY 2018 and completed six actions in FY 2017. The long-term solution depends on funding for changes to the financial systems, the Business Masterfile, and operational processes.

Information Security Significant Deficiency

The IRS worked diligently during FY 2017 to continue to enhance its Information Technology (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. This 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 201 7, the IRS completed the following activities:

- Complied with Federal Information Security Management Act [amended by the Federal Information Security Modernization Act of 2014] (FISMA); Federal Manager' s Financial Integrity Act (FMFIA) Sections Two and Four; and OMB, National Institute of Standards and Technology (NIST), Department of the Treasury, and IRS security requirements.
- Performed security assessments in compliance with OMB Circular No. A-123, Appendix A, 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. It is important to note that controls require time to mature and show evidence of their effectiveness.
- Facilitated GAO's review of IRS's IT Security Controls, including Boundary Protection, Identification and Authentication, Authorization, Cryptography, Audit and Monitoring, Physical Security, Configuration Management, Segregation of Duties, Contingency Planning, Risk Assessments,

Policies and Procedures, Security Plans, Training, Testing and Evaluation, and Remedial Actions.

- Analyzed and prioritized 2017 activities based on the greatest effect on the financial statements, developed corrective actions to mitigate the risk and apply compensating controls, and communicated the strategy to key stakeholders.
- Tested and validated prior year GAO recommendations to prevent premature closure. The IRS Compliance Assessment and Validation (CAV) Team conducted 81 reviews of planned corrective actions and statement of facts findings and sent 63 to GAO during the 2017 financial statement audit for closure consideration.
- 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 documented adequately. During FY 2017, IRS completed 87 Contractor Security Assessments (CSAs): 24 associated with the Mission Essential Functions and Critical Business Processes (CBP) that support Processing of Remittances, Processing of Returns, and Processing of Refunds; 30 associated with contractor site assessments for environments collecting or maintaining IRS Sensitive But Unclassified (SBU) data on contractor-owned corporate IT environments and facilities supporting tax examination, customer surveys, identity theft initiatives, and other non-CBPs; 24 associated with security assessments to support the IRS's Private Debt Collection (PDC) programs, which are aligned with one CBP; and nine associated with contractor sites conducting printing activities.

Federal Information Security Management Act (FISMA)

In accordance with FISMA requirements and OMB Circular A-130, the IRS maintained a Servicewide 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. The IRS completed annual security control testing on these systems, 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 250 exercises and tests to determine that the plans were current and executable, backup data was readily available and readable, and Critical Infrastructure Protection systems had designated alternate processing sites that could be recovered within their defined Recovery Time Objective. If vulnerabilities were identified during testing, POA&Ms were created and are being enforced.

Improper Payments Elimination and Recovery Act (IPERA) of 2010

As of September 30, 2017, the IRS generally complied with applicable improper payments laws and regulations, except for the non-compliance with improper payments reporting related to reporting an overall EITC improper payment rate below ten percent. The IRS continues to face challenges to reduce the EITC error rate and plans to report on the actions being taken in the 2017 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. In December 2015, Congress enacted the PATH Act of 2015, which contains significant legislative changes intended to help reduce EITC, ACTC, and AOTC claims. Employers were required to file Form W-2 with the Social Security Administration by January 31, 2017. The earlier filing date for paper and electronic returns and statements gave the IRS more time to verify EITC and ACTC claims before it issued refunds; however, it did not expand the IRS's authority to systemically correct erroneous claims that are identified when tax returns are processed. The IRS included several legislative change proposals in the FY 2018 budget request to improve EITC compliance, including providing greater flexibility to address correctable errors to help the IRS deny certain erroneous EITC claims before refunds are paid, and increasing oversight of paid tax return preparers to promote high quality services and improve voluntary 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.

Digital Accountability and Transparency Act of 2014 (DATA Act) and USAspending.gov

In accordance with the requirements of the Digital Accountability and Transparency Act of 2014 (DATA Act), the IRS provides quarterly certification to the completeness, timeliness, and accuracy of the financial and award data to be published on USASpending.gov. The IRS reconciled the Appropriation Accounts file data, Award Financial file data, and Financial Assistance file data and established corrective action plans to address discrepancies for future resolution. Internal controls over spending data, agency source systems, and the DATA ACT submission on USASpending.gov are effective. Internal control assessments provide reasonable assurance that IRS adhered to the data standards established by OMB and Treasury for implementation of the DATA Act, and that the internal controls are designed, implemented, and operating effectively, except for the discrepancies noted in the second and third quarter submissions.

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. IRS updated charge card policies and procedures to mitigate the risk of repeating previously identified inappropriate use. In the TIGTA report (Reference #2017-10-060) dated July 26, 2017, TIGTA also reviewed the IRS's current charge card guidance and determined that policies and controls were established and designed to mitigate the risk of fraud and inappropriate government travel and purchase card practices, including controls that address centrally billed travel card accounts.

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: Progress on Many High-Risk Areas, While Substantial Efforts Needed on Others* (GAO-17-317), published on February 15, 2017. In addition, the GAO identified three significant financial management challenges in its report, *Financial Audit: IRS's Fiscal Years 2016 and 2015 Financial Statements* (GAO-17-140), published on November 10, 2016. 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 the tax-related provisions of the Patient Protection and Affordable Care Act (PPACA).

1. 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 2017, the IRS took the following actions to address the issues of unauthorized access to IRS facilities, hard copy taxpayer receipts, and related sensitive information:

- Concluded a study of contractor population variances; identifying the types of non-IRS contractors with unescorted access, their current contractual terms/obligations, and other pertinent data.
- Issued an updated standard operating procedure, *Clearing Other Federal Agency/Bureau Contractors for Unescorted Access to IRS Facilities/Data/Systems Work*, that outlines the processes and procedures for vetting other federal agency contractors (non-IRS) for unescorted access to IRS facilities.
- Updated the Enterprise Learning Management System (ELMS) Course, *Contracting Officer's Representative (COR's) Security Training,* to include COR's responsibilities as it relates to Physical, Personnel, and Data Security and held two classes.

Actions Planned or Underway for FY 2018 and Beyond:

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

- Implement a Memorandum of Understanding (MOU) between the IRS and Federal Protective Service (FPS) to address access requirement compliance for security guards contracted through FPS.
- Update facility access policy, focusing on business operations, with consideration of risk acceptance, if appropriate.
- Complete the online version of the *Contracting Officer's Representative Security Training* course and require CORs take the course upon assignment to a service contract.

2. 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 several initiatives related to the Security Summit, a collaborative effort between the IRS, state tax administrators and private-sector tax partners. In FY 2017, the IRS:

- Engaged with tax software industry members and received data elements from both individual and business tax returns to improve taxpayer authentication and identify possible identity theft scams as part of the Security Summit effort.
- Collaborated with the Security Summit team to develop a new process that would allow the IRS to post alerts into the Information Sharing & Analysis Center (ISAC) functionality.
- Collaborated with SSA and the Department of the Treasury to coordinate a data sharing method and subsequently received 10.4 million prisoner records. After excluding incomplete and duplicate records, the IRS produced two million usable records to include into the annual IRS prisoner database.

3. Implementing Patient Protection and Affordable Care Act Tax-Related Provisions

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 3: 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 3: 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 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, 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 2017, the top management and performance challenges, in order of significance, were:

1. Security Over Taxpayer Data and Protection of IRS Resources
2. Identity Theft and Impersonation Fraud
3. Implementing the Affordable Care Act and Other Tax Law Changes
4. Improving Tax Compliance
5. Reducing Fraudulent Claims and Improper Payments
6. Improving Tax Systems and Expanding Online Services
7. Providing Quality Taxpayer Service Operations
8. Impact of Global Economy on Tax Administration
9. Protecting Taxpayer Rights
10. Achieving Program Efficiencies and Cost Savings

The IRS addresses these issues through new and existing program activities. Measures of these program activities 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 2017.

1. Security Over Taxpayer Data and Protection of IRS Resources

Summary of Major Issues: Promote measures protecting the confidentiality of taxpayer information.

Actions Taken:

In FY 2017, the IRS engaged in several activities with external stakeholders to promote data protection:

- Began to implement the Enterprise Exchange Upgrade Project, which will allow the IRS to achieve full compliance with federal record retention requirements for e-mail.
- Established process improvements in the development of Interconnection Security Agreements (ISAs), which are connections between the IRS and external entities such as banks and improve the efficiency of financial data transactions for tax administration purposes.
- Updated the ISA standard operating procedures to clarify IRS policy on criteria for when an ISA is required and the need to provide notification when sharing IRS data externally.
- Continued updating and streamlining the Records Control Schedule to ensure compliance with the Office of Management and Budget (OMB), *Managing Government Records Directive,* (OMB Memorandum M-12-18) dated August 24, 2012. The Records Control Schedule consisted of updating retention schedules, conducting electronic recordkeeping content assessments, inventories, and updating files plans to develop disposition plans compliant with National Archives and Records Administration (NARA) electronic recordkeeping management practices.

Actions Planned or Underway for FY 2018 and Beyond:

To protect the safety and security of taxpayer data, the IRS will:

- Initiate an independent verification and validation process to assess compliance with NARA requirements and resolve or reconcile any problems or discrepancies.
- Update the ISA renewal process to describe steps needed to enforce the importance of timely renewals to avoid lapses in formal connection authorization.
- Continue to update the records control schedule, incrementally bringing plans into full compliance with the NARA electronic recordkeeping management practices by January 1, 2020.

2. **Identity Theft and Impersonation Fraud**

Summary of Major Issues: Detect and prevent fraudulent tax refunds resulting from identity theft.

Actions Taken:

Combatting fraud and identity theft continues to be a priority for the IRS. In FY 2017, the IRS:

- Continued work on the Security Summit effort with state revenue agencies, the private sector tax industry, tax professional groups and financial services partners.
- Completed programming for a new transaction code that locks a suspicious Employer Identification Number (EIN) entity and prevents anything from posting for that entity.
- Expanded pre-refund Business Master File (BMF) identity theft activities to include filters for Form 1120S, *U.S. Income Tax Return for an S Corporation*, and Form 1041, *U.S. Income Tax Return for Estates and Trusts*, and implemented BMF authentication schema data elements at the time of filing.
- Presented information on business identity theft and phishing schemes at Tax Forums and other outreach events.

Actions Planned or Underway for FY 2018 and Beyond:

In FY 2018, the IRS will continue to pursue opportunities to combat identity theft, detect fraudulent tax returns, and reduce improper payments. Planned activities include:

- Develop programming to lock dormant business entities systemically to protect them from possible takeover.
- Expand filters and models to identify business identity theft at the time of filing and use the BMF authentication data elements in the filters.

3. **Implementing the Affordable Care Act and Other Tax Law Changes**

Summary of Major Issues: Implementation of the Patient Protection and Affordable Care Act (ACA)

Actions Taken:

The IRS engaged with stakeholders to expand ACA information availability:

- Ensured information security safeguards were in place for an agency authorized to receive federal tax information.
- Notified new agencies being coordinated with for the first time and existing agencies of revisions to Publication 1075, *Tax Information Security Guidelines for Federal, State and Local Agencies*, using a variety of methods such as mass e-mails, conference calls, in-person presentations, as well as publication on IRS.gov.
- Analyzed results of the non-filer soft notice test and identified potential changes to instructions regarding the filing requirement of information returns and potential changes to classification selection criteria.

Actions Planned or Underway for FY 2018 and Beyond:

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

- Collaborating with new or existing agencies implementing tax information security requirements for FTI under new or proposed amendments to existing legislation.
- Implementing changes to the filter methodology to identify populations of non-filers and stop-filers and update selection criteria for case assignment after the data becomes available.

4. **Improving Tax Compliance**

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

Actions Taken:

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

- Analyzed Form 1023-EZ, *Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, rejection data and expanded the ineligibility criteria to include organizations that are currently or previously were exempt under another subsection of §501(c).
- Commenced identifying the population of amended plan submissions that could be considered for determination reviews by studying compliance trends of determination applications received in previous years.
- Completed an analysis of partnership data to assess how the Bipartisan Budget Act (BBA) of 2015 proposed tax law changes would affect partnership structures and determined there is a need for new training and policy for IRS Field and Campus employees.
- Began analyzing the results of the "contact and no contact" Federal Tax Deposit Soft Letter Notices sent to taxpayers using specific data elements.
- Initiated the Field Inventory Process Improvement Team pilot to explore opportunities to increase revenue officers' productivity by evaluating several variables, including emerging issues, communication strategies, and queue inventories.
- Established a team to conduct an analysis of the backup withholding process, identify gaps or inconsistencies and to make recommendations for improvements and oversight/ ownership.
- Implemented a plan to retain data on current Refund Hold taxpayers, track their future filing compliance for five years into the future, and monitor the progress of the UWR as it moves forward.

Actions Planned or Underway for FY 2018 and Beyond:

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

- Revising Form 1023-EZ, *Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, and its instructions to require a filing organization to describe its activities and attest that it is not a school, hospital or a church.
- Engaging a contractor to conduct an independent assessment to provide insight into the need for additional changes to Form 1023-EZ, *Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, its processing, and the post-application compliance program.
- Gathering compliance issue ideas and developing top focus areas as a precursor to creating a strategy to address issues of substantial non-compliance in the tax exempt and government entities arena.
- Exploring and analyzing external and internal data sources to test indicators of non-compliance with exempt organizations, employee plans, and tax-advantaged bonds.
- Developing processes and procedures to reject Form 990 series returns if the submitted form is incomplete or incorrect.
- Developing additional training to address the effect on partnership structures subject to the Bipartisan Budget Act (BBA) of 2015.

- Evaluating the results of the Field Inventory Process Improvement Team project pilot program to determine whether there are increases in efficiencies and cost savings allowing full implementation.
- Developing an implementation plan and a resource needs estimate for the backup withholding processes.

5. **Reducing Fraudulent Claims and Improper Payments**

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:

Addressing improper payments, identity theft, and fraud continues to be a priority. In FY 2017, the IRS:

- Increased the use of the W-2 Verification Code (VC) pilot for tax year 2016 to 47 million Forms W-2, which included three additional payroll service providers.
- Revised the Refundable Credits Preparer Strategy to include the AOTC, Child Tax Credit (CTC), and the ACTC in accordance with the PATH Act.
- Conducted Knock and Talk site visits, called practitioners, and issued educational letters to practitioners about the AOTC and ACTC credits prior to the start of filing season.
- Penalized preparers who received a warning notification but continued to fail to attach the Form 8867, *Paid Preparer's Due Diligence Checklist*, to tax year 2015 client returns.

Actions Planned or Underway for FY 2018 and Beyond:

In FY 2018, the IRS will continue to pursue opportunities to combat identity theft, detect fraudulent tax returns, and reduce improper payments. Planned activities include:

- Continue to expand filters and models used to identify identity theft BMF filing at the time of filing, which includes leveraging the BMF authentication data elements in these filters.
- Increase the number of Forms W-2 included in the W-2 Verification Code (VC) pilot for tax year 2017 to about 66 million forms, which will include subsidiary payroll service providers and a large federal payroll provider.
- Analyze lead individual and business data elements to determine effectiveness in identifying potential identity theft and enhance lead data elements, if necessary.
- Continue to perfect the use of prisoner data to assist with fraud detection by combining the annual IRS prisoner file and usable data from Treasury data to update theft filters bi-monthly.

6. **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 2017, the IRS:

- Demonstrated the financial integrity of the CADE 2 Database through deployment to production in Parallel Validation of the Financial Recap Reports Project, which allows IRS business units to view and monitor the accuracy of financial reports created by the CADE 2 system.

- Enhanced the ability of the CADE 2 Operational Data Store, which allows business units to create ad hoc reports using CADE 2 data and to deliver historical and up-to-date taxpayer data for use by multiple organizations across the IRS.
- Continued work to generate critical financial reports from CADE 2 that will feed into IRS financial statements and the GAO financial audit and continued work on an interface to enable generation of refund data to support transmission of refunds from the Department of the Treasury.
- Deployed the Data Services Framework (DSF) into operations and maintenance to enable IRS organizations to generate and extract reports for projects that require data from the CADE 2 database.
- Enhanced the capability to detect and block fraud in real-time by integrating other web-facing applications, including the Federal Investigative Service Tax Check Service. The IRS included additional applications under eAuthentication protection including FATCA Qualified Intermediary & Taxpayer Digital Communications and added eServices applications behind eAuthentication.
- Completed initial translation of Individual Master File (IMF) code that will allow data posting, settlement, and analysis to be accessible in Java-based programs. This promotes greater transparency into IMF functionality and data, and empowers IRS developers, designers, and architects to more easily understand and maintain the IMF code.
- Completed development of a prototype to integrate legacy and Java code to support testing of IMF posting, and continued to analyze and record IMF business logic that will support the establishment of a modernized individual tax-processing engine.
- Launched the Online Account for Individual Taxpayers, which allows taxpayers to access their balance due, see details about tax years where there is a balance, and link into electronic payment options (Direct Pay, Pay by Credit or Debit Card, and Online Payment Agreement). Additionally, taxpayers can see 18 months of payments made to the IRS, and can see a snapshot of commonly requested elements from the most recent tax filing. Taxpayers can link into Get Transcript to download a full detailed transcript, if needed.

Actions Planned or Underway for FY 2018 and Beyond:

In FY 2018, the IRS will continue to improve system performance and integrity. For example, the IRS will:

- Leverage the CADE 2 Database to enable generation of refund data to support transmission of refunds from the Treasury and modernize a subset of reports to help establish CADE 2 as the authoritative data source for financial reporting.
- Revise the CADE 2 release plan to determine a schedule for restarting projects that were strategically paused in response to the President's FY 2018 budget, including those that enabled the leveraging of CADE 2 data for transcript generation to support financial reporting and legal counsel, making CADE 2 the data source for the IRS's Integrated Data Retrieval System (IDRS).
- Continue to leverage the Data Services Framework (DSF) database to generate and extract reports for projects that require data retrieval from the CADE 2 database.
- Include additional applications under eAuthentication protection, and review and plan for changes required by the National Institute of Standards and Technology (NIST) Special Publication 800-63 Revision 3, *Digital Identity Guidelines*.
- Reengineer core IMF posting, settlement, and analysis functions into Java-based programs, and analyze and record IMF business logic, which supports establishment of a modernized individual tax-processing engine.
- Identify new features for Online Account and pilot projects for expanding Taxpayer Digital Communications (TDC).

7. **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 2017, the IRS:

- Used an automated script to inform taxpayers on hold on IRS phone lines of optional automated electronic services, including checking the status of a refund, making a payment, or getting answers to tax law questions by using IRS.gov, *IRS2Go*, Direct Pay, or Interactive Tax Assistance.
- Launched a campaign using both traditional communication methods and social media to help taxpayers become aware of important changes before the start of the filing season. In addition to numerous news releases, Tax Tips, and IRS.gov, the IRS used Thunderclap, a crowd-speaking social media platform, to rally IRS partners and stakeholders in spreading a "Get Ready" message that provided information to raise taxpayer awareness about actions they needed to take to be prepared for the 2017 filing season.
- Posted signage and visual communications in TACs alerting taxpayers of evolving IRS business models, the appointment service, the future state of the organization, and online and toll-free services.
- Converted all TACs and Virtual Service Sites to appointment service as of November 2016 and identified a new appointment scheduling tool for use in FY 2018 to improve phone assistors' ability to see appointment vacancies and better identify resolutions to the customer's inquiry.
- Optimized resources to deliver taxpayer service through effective communication, training, and virtual technology.
- Utilized virtual communication tools to reach larger stakeholder audiences at less cost and reduced travel time and expense by developing and delivering virtual training sessions to more than 2,300 participants, including National Site Coordinators.
- Conducted more than 1,200 remote site reviews across geographic boundaries to maintain oversight of VITA and TCE sites.
- Shared information with partners on the PATH Act, IRS Online Tools, and Identity Theft so that they would be better equipped to assist taxpayers in satisfying their tax responsibilities.

Actions Planned or Underway for FY 2018 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:

- Developing a communications strategy to support all key initiatives and implementing a "Get Ready" campaign for filing season 2018, which will encourage taxpayers to use online services and the appointment service tool.
- Expanding the IRS's local geographic presence to reach taxpayers in remote and underserved communities through virtual assistance. For example, VSD allows taxpayers in remote locations to interact face-to-face with an assistor in a TAC. Virtual assistance alleviates staffing issues, balances workload, improves service, and makes voluntary compliance easier for taxpayers. For FY2017, the IRS collaborated with 30 community partners to host VSD terminals at their offices. Testing is underway for a new, more efficient virtual service platform to replace VSD and allow the ability to share information through any computer or mobile device.

8. **Impact of Global Economy on Tax Administration**

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 2017, the IRS:

- Educated employees on fraud related to counter-terrorism financing.
- Worked with Federal Bureau of Investigation (FBI) Terrorist Financing Operations Section (TFOS) to respond to all leads on charitable organizations.
- Deployed FATCA release 5.0.2 and release 5.0.3:
  - Release 5.0.2 provided Qualified Intermediaries (QIs), Withholding Foreign Partnerships (WPs), and Withholding Foreign Trusts (WTs) with an electronic tool for requesting renewal of their agreements with the IRS. Electronic functionality was also provided in release 5.0.2 for enabled entities to apply for QI/WP/WT status, and for authorized IRS users to review and process QI/WP/WT applications and renewal requests.
  - Release 5.0.3 provided electronic functionality for Foreign Financial Institutions (FFIs) to renew their FATCA agreement. Release 5.0.3 also provided functionality to send notifications to each FFI Responsible Officer informing them that renewal functionality was available, and included the capability for the IRS to remove FFIs who do not renew from the FFI list on IRS.gov.
- Provided project management support to the Organisation for Economic Cooperation and Development (OECD) Secretariat for the deployment of the Common Transmission System (CTS).
- Created Form 8975, *Country-by-Country (CbC) Report*, and an accompanying schedule to enable the IRS to track large multi-national enterprises' (MNEs) efforts to shift profits and assets offshore to reduce their tax obligations.

Actions Planned or Underway for FY 2018 and Beyond:

In FY 2018, the IRS will continue to address global third-party compliance and tax administration. Planned actions include:

- Exhaust any leads or referrals to investigate tax-exempt entities related to counterterrorism matters and, if applicable, move those referrals into the larger national security arena.
- Educate employees on fraud relating to charities and non-governmental organizations (NGOs).
- Continue to work with TFOS and ensure efficient and effective use of limited resources in the counterterrorism arena with a focus on the use and abuse of charities by foreign terrorist organizations.
- Deploy FATCA program releases with certification functionalities:
  - Release 6.2 will provide electronic functionality for Foreign Financial Institutions to submit a certification of pre-existing accounts and periodic certifications (every three years) and allow authorized IRS users to view certification submissions.
  - Release 6.3 will provide electronic functionality for Qualified Intermediaries, Withholding Foreign Partnerships, and Withholding Foreign Trusts to submit periodic certifications (every three years) and allow authorized IRS users to review and process certification submissions.

- Provide Project Management support to the OECD Global Forum Secretariat after deployment of the CTS, and help troubleshoot issues for the vendor team and the jurisdictions that use the system.
- Revise the Country-by-Country (CbC) web pages as needed with updates to the Jurisdiction Status Table and new FAQs as they become available.

9. Taxpayer Protection and Rights

Summary of Major Issues: Apply the tax laws fairly

Actions Taken:

In FY 2017, the IRS engaged in several activities with external stakeholders to promote data protection and updated its internal processes and policies to minimize the potential mistreatment of taxpayers:

- Tested address verification research procedures for effectiveness and updated IRM 5.19.6.17.4, *Undeliverable Notice of Federal Tax Lien*, to address/clarify procedures when the lien notice envelope shows multiple reasons for return.
- Worked with the Tax Software Industry to determine the necessary data elements required to transmit with returns and the best methods for sharing them.
- Developed a process for the input of IRS alerts into the Information Sharing and Analysis Center (ISAC).

Actions Planned or Underway for FY 2018 and Beyond:

To protect the safety and security of taxpayer data, the IRS will:

- Review and update procedures for IRM 5.19.6, *Liability Collection,* as necessary.
- Analyze individual and corporate tax returns to determine whether the data elements they contain are useful in identifying potential identity theft, and use the results of that analysis to improve identity theft protection efforts for 2018.
- Explore opportunities for information sharing with IRS partners. The Security Summit team will work to continue the feedback/communication process with states and industry to improve existing and develop new authentication data elements.

10. 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 2017, the IRS improved efficiency in the following IT-related and operational activities:

- Developed Risk Management Refresher Training, which is available online for all employees, but is mandatory for all managers and management officials. The training covers the following topics: Importance of Risk Management at the IRS, Building a Culture of Trust and Openness, and Risk Management Roles and Responsibilities.
- Continued efforts to implement an effective Software Asset Management (SAM) program and established regular license inventory reporting and reconciliation capabilities. Ongoing SAM efforts have identified more than $15 million in savings.
- Worked with the Program Governance Office on the final integration of the Enterprise Software Governance activities into the Infrastructure Executive Steering Committee to continue to track accountability of software asset and license management across the IRS.

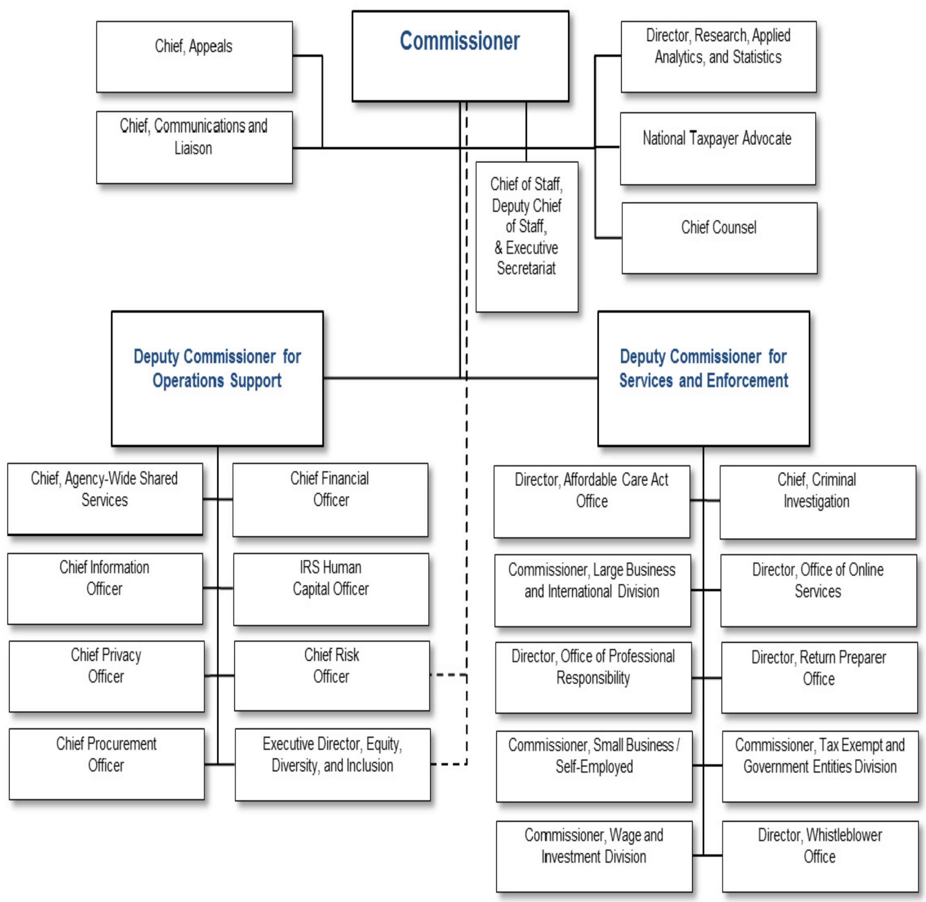
- Implemented military retirement payments into the Federal Payment Levy Program (FPLP).

Actions Planned or Underway for FY 2018 and Beyond:

In FY 2018, the IRS will continue efforts to achieve program operational and cost savings efforts by:

- Developing and delivering Enterprise Risk Management (ERM)-related communications to all IRS employees.
- Implementing automated tools, which will allow full compliance with FISMA, the Federal Information Technology Acquisition Reform Act (FITARA), and the Making Electronic Government Accountable By Yielding Tangible Efficiencies (MEGABYTE) Act of 2016 mandates. The ability to more quickly determine license positions and optimize license deployment and utilization will result in more effective cost control measures and the reduction of duplicate purchases and unused/underused licenses.
- Utilizing governance boards to manage software asset tracking and license management, and maintaining an enterprise solution across the IRS in accordance with TIGTA recommendations and other legislative mandates.

Appendix A
IRS Organization Chart



Appendix B
Performance Measures Descriptions

Strategic Foundation: Invest in the IRS's workforce and the foundational capabilities necessary to achieve the IRS's mission and deliver high performance for taxpayers and stakeholders	
Percent of Major IT Investments within +/- 10% Cost Variance at the Investment Level[1]	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 at the Investment Level[1]	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.
Rentable Square Feet per Person (new for FY 2017)[2]	The amount of rentable square feet the IRS maintains per person requiring space. The IRS will use this as an indicator for FY 2017.
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 (Revised in FY 2017)[3]	The number of Customer Contacts resolved in relation to staff years expended. The IRS will baseline this measure in FY 2017.
Customer Accuracy – Tax Law Phones	The percentage of correct answers given by a live assistor on Toll-free tax law inquiries.
Customer Accuracy – 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 many filers to prepare a complete and accurate tax return) available to the public in a timely fashion.
Timeliness of Critical TE/GE and 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.
Enterprise Self-Assistance Participation Rate (revised for FY 2017)[4]	The percentage of taxpayer assistance requests resolved using self-assisted automated services. The IRS will use this data as an indicator for FY 2017.
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 (TE/GE) and Large Business and International (LB&I) 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 the LB&I Quality Measurement System (LQMS). Case scores are based on the percentage of elements passed within each of the four auditing standards.

Appendix B
Performance Measures Descriptions (Continued)

Enforcement: Effectively enforce the law to ensure compliance with tax responsibilities and combat fraud (Continued)	
Examination Coverage – Business (Assets >$10M)	The number of LB&I returns (C and S Corporations with assets more than $10 million and all partnerships) examined and closed by LB&I during the current fiscal year divided by the number of filings for the preceding calendar year.
Examination Efficiency – Individual (1040)	The sum of all individual 1040 returns closed by SB/SE, W&I, TE/GE and LB&I (Field Exam and Correspondence Exam programs) divided by the total Full-Time Equivalent (FTE) expended in relation to those individual returns.
Automated Underreporter (AUR) Efficiency	The total number of W&I and SB/SE contact closures (a closure resulting from a case where the IRS made contact) divided by the total FTE, including overtime.
Automated Underreporter (AUR) Coverage	A percentage representing the total number of W&I and SB/SE contact closures (a closure resulting from a case where SB/SE 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.
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.

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

[2] A new measure was added to support the Operations Support Budget Appropriation. This indicator will help the IRS better manage rental costs.

[3] Due to the modifications made to the Taxpayer Self-Assistance Rate measure for FY 2017, several components of the Customer Contacts Resolved Per Staff Year measure changed including: the way the IRS counts transcripts from "requested" to now counting "delivered", the addition of Get Transcript (Online & Mail), and the discontinuation of Electronic Interactions.

[4] Starting in FY 2017, the IRS modified the Taxpayer Self Assistance Rate measures to include additional self-assistance applications, including Get Transcript and payment applications, such as Direct Pay and Online Payment Agreements. As new self-assistance applications are provided to the public, they will be added to the methodology.

Appendix C
Performance Measurement Data

	2014	2015	2016	2017	
				Target	Actual
Strategic Foundation: Invest in the IRS's workforce and the foundational capabilities necessary to achieve the IRS's mission and deliver high performance for taxpayers and stakeholders					
Percent of Major IT Investments within +/- 10% Cost Variance at the Investment Level	66.7%	73.7%	76.2%	90.0%	50.0%
Percent of Major IT Investments within +/- 10% Schedule Variance at the Investment Level	100.0%	89.5%	85.7%	90.0%	88.9%
Rentable Square Feet per Person (new for FY 2017)	N/A	N/A	N/A	Indicator	297
Taxpayer Service: Deliver high quality and timely service to reduce taxpayer burden and encourage voluntary compliance					
Customer Service Representative (CSR) Level of Service	64.4%	38.1%	53.4%	64.0%	77.1%
Customer Contacts Resolved per Staff Year (revised for FY 2017)	21,018	26,245	28,497	Baseline	25,535
Customer Accuracy – Tax Law Phones	95.0%	95.0%	96.4%	95.0%	96.7%
Customer Accuracy – Customer Accounts (Phones)	96.2%	95.5%	96.1%	95.0%	96.0%
Timeliness of Critical Filing Season Tax Products to the Public	99.1%	89.0%	92.5%	89.0%	93.1%
Timeliness of Critical TE/GE and Business Tax Products to the Public	98.7%	92.6%	98.0%	91.0%	96.7%
Percent Individual Returns Processed Electronically	84.1%	85.3%	86.4%	87.0%	86.9%
Percent Business Returns Processed Electronically	43.1%	47.0%	50.0%	51.0%	52.9%
Refund Timeliness – Individual (Paper)	98.7%	98.8%	98.7%	97.0%	98.4%
Enterprise Self-Assistance Participation Rate (revised for FY 2017)	84.7%	88.7%	89.0%	Indicator	79.0%
Enforcement: Effectively enforce the law to ensure compliance with tax responsibilities and combat fraud					
Examination Coverage – Individual	0.9%	0.8%	0.7%	0.6%	0.6%
Field Examination National Quality Review Score	88.4%	86.7%	86.8%	86.7%	85.0%
Office Examination National Quality Review Score	90.6%	88.3%	88.4%	86.7%	87.9%
Examination Quality – Large Business	83.0%	86.0%	83.0%	90.0%	78.0%
Examination Coverage – Business (Assets >$10M)	4.3%	3.9%	3.0%	2.7%	2.5%
Examination Efficiency – Individual (1040)	138	148	143	118	121
Automated Underreporter (AUR) Efficiency	1,935	2,209	2,196	2,133	2,188
Automated Underreporter (AUR) Coverage	2.6%	2.3%	2.3%	2.0%	2.2%
Collection Coverage	45.9%	46.3%	43.4%	37.5%	42.2%
Collection Efficiency	2,051	2,448	2,266	2,117	2,135
Field Collection National Quality Review Score	81.6%	79.2%	79.2%	79.7%	76.7%
Automated Collection System (ACS) Accuracy	95.2%	95.3%	95.4%	95.0%	94.7%
Criminal Investigations Completed	4,606	4,486	3,721	3,100	3,089
Number of Convictions	3.110	2,879	2,672	2,100	2,300
Conviction Rate	93.4%	93.2%	92.1%	92.0%	91.5%
TE/GE Determination Case Closures	136,746	111,940	99,973	95,791	102,749

* These are annual coverage measures based on a full year of data. Through 3rd quarter FY 2017, these measures are on plan and are projected to meet the year-end target.

Appendix D
Explanation of Shortfalls

Percent of Major IT Investments within +/- 10 percent Cost Variance at the Investment Level: Nine of 18 major investments (50 percent) were within the cost variance threshold at the close of the fourth quarter and below the 90 percent target.

1) **Affordable Care Act Administration (ACA)** had a much lower actual cost versus planned cost associated with milestone 4B.4.
2) **Customer Account Data Engine 2 (CADE 2)** cost underrun is due to project activities associated with release 4 and 5 being stopped due to budgetary constraints.
3) **e-Services (e-SVS)** had lower than expected cost due to fewer than expected legislative changes.
4) **Enterprise Case Management (ECM)** shows a variance because the ECM governance board approved halting the development efforts for ECM fraud case management.
5) **Integrated Financial System/CORE Financial System (IFS)** shows a cost overrun due to a software acquisition expense that was planned in milestones 1 and 2 but didn't happen until milestones 3 and 4a due to procurement competition that took longer than planned.
6) **IRS Mainframes and Servers Services and Support (MSSS)** displays a cost underrun due to activities being closed out or put on hold due to budgetary constraints.
7) **IRS Telecommunications Systems and Support (TSS)** had a cost underrun due to several activities costing less than planned.
8) **Return Review Program (RRP)** is showing a cost underrun due to the reporting portion of the Reporting and Transaction Processing (RTP) functionality being deferred to a future release.
9) **Web Applications** is showing over budget due to the baseline not reflecting the funded budget (funded higher than baseline).

Percent of Major IT Investments within +/- 10 percent Schedule Variance at the Investment Level: Sixteen of 18 major investments (88.9 percent) were within the schedule variance threshold at the close of the fourth quarter.

1) **Individual Master File (IMF)** is ahead of schedule due to filing season activities being completed before their projected timeframes.
2) **IRS Mainframes and Servers Services and Support (MSSS)** displays a schedule variance due to activities being closed out or put on hold due to budgetary constraints.

Percent Individual Returns Processed Electronically: Exceeded actual prior year performance but fell slightly short of the annual target for individual returns processed electronically. W&I will continue to process individual returns as efficiently as possible to meet the FY 2018 plan.

Field Exam National Quality Review Score: The loss of experienced employees, cases transferred from examiner to examiner when employees leave their position, and the inability to hire permanent front-line managers are all factors that contributed to Field and Office Exam not fully achieving the FY 2017 quality target.

To facilitate improvement in FY 2018, Exam is forming a joint quality team to analyze quality data trends and the influence of organization changes on quality scores. FY 2018 commitments proposed for Territory and Group Managers include refresher training on both Exam Technical Time Reports and Exam Process Reviews, as well as focused exam quality narratives on the lowest scoring attributes. SBSE also plans to implement an area-wide risk assessment to determine appropriate actions (i.e. close/reassign) upon case reassignment. It is expected that developing and communicating guidance at the group level will positively affect quality and customer satisfaction.

Examination Quality – Large Business: LB&I Quality Review and Analysis (QRA) established a core team to develop and implement an action plan to assist the field examination operations in preparing quality case work in accordance with the Internal Revenue Manual (IRM). Many the actions in the plan have already been implemented, including briefing all Directors of Field Operations (DFOs) on scoring methodology and areas to focus on for improvement; preparing a Fiscal Year Quality kick off memo from the LB&I Commissioner to

Appendix D

Explanation of Shortfalls (Continued)

emphasize the importance of quality review; drafting performance commitments for the DFO, territory manager, and frontline

managers that incorporates case quality improvements; and providing briefings and educational presentations at field level meetings. Several other activities are underway, including a collaboration with statisticians from Research, Applied Analytics and Statistics (RAAS) to review and update the sampling methodology to improve accuracy.

Exam Coverage – Business: Two factors combined to cause the coverage rate shortfall of 0.2 percent. The actual number of return filings used in the denominator of the coverage rate calculation increased by 17,566 returns from original projections. This 6 percent increase in filings accounts for a decrease of 0.1 percent in the coverage rate. Actual filings are outside the control of LB&I. The actual number of closed large business returns used in the numerator of the coverage rate calculation was 122 returns less than projected. This 1.5 percent shortfall in closures accounts for the remaining decrease of 0.1 percent in the coverage rate. A decline in closures of the largest corporations were the primary cause of this decrease.

Field Collection National Quality Review Score (NQRS): The shortfall in this measure 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 NQRS and improve performance, Field Collection (FC) held consistency review meetings with HQ NQRS staff and workgroup meetings with HQ NQRS staff to better identify quality review trends and issues and better inform managers in the EQ/NQ process. Focused communication and training materials were developed to drive improvements in casework. FC also worked in FY 2017 to clarify EQ/NQ documentation and IRM sections that may have created confusion and negatively affected quality results, many of which have been fully implemented, with additional changes coming in early FY 2018.

Automated Collection System Accuracy: Periodic performance reviews were conducted on the campus program and communicated to the sites. The top drivers of Customer Accuracy errors were analyzed and other quality issues were discussed with the Quality staff at the sites each month and this practice will continue. Additionally, training opportunities are recommended through top errors received and served as the basis for topics for FY 2017 Continuing Professional Education.

Criminal Investigations Completed: Year-end results are 99.6 percent of year-end target (3,100) and reflect a 17.0 percent decrease compared to FY 2016. Overall performance in FY 2017 continued to be effected by a steady decrease in the number of special agents available to work cases (due to attrition and limited hiring) as well as CI's focus on existing judicial process inventory and traditional tax case programs, which tend to have a higher cycle time. Cases of Legal, Illegal and Narcotics nature completed through the 4th quarter decreased (22.5 percent, 13.2 percent and 12.3 percent respectively) compared to the same period in FY 2016.

Conviction Rate: Year-end rate is 0.6 percent lower than FY 2016 and just 0.5 percent below the year-end target (92 percent). The average number of Acquittals and Dismissals remained consistent compared to previous years while the overall number of Convictions decreased 13.9 percent from FY 2016, thereby contributing to a slight drop in the Conviction Rate. Appropriate case selection and effective field performance continue to positively affect the number of cases resulting in convictions. Since CI does not prosecute its own cases, it must depend on the ability of DOJ to accept its cases for prosecution and move such cases through the courts.

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 2017 and 2016 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, 2017 and 2016

(In Millions)

	2017	2016
Assets		
Intragovernmental		
Fund balance with Treasury (Note 2)	$ 2,603	$ 2,580
Due from Treasury (Note 6)	3,061	2,974
Other assets (Note 3)	16	10
Total intragovernmental	**5,680**	**5,564**
Cash and other monetary assets (Notes 4, 6)	493	671
Federal taxes receivable, net (Notes 5, 6)	52,000	49,000
General property and equipment, net (Note 7)	2,078	1,996
Other assets (Note 3)	13	14
Total assets	**$ 60,264**	**$ 57,245**
Liabilities		
Intragovernmental		
Due to Treasury (Note 5)	$ 52,000	$ 49,000
Other liabilities (Note 8)	173	175
Total intragovernmental	**52,173**	**49,175**
Federal tax refunds payable	3,062	2,974
Other liabilities (Note 8)	1,898	2,104
Total liabilities	**57,133**	**54,253**
Net position		
Unexpended appropriations	1,513	1,587
Cumulative results of operations	1,618	1,405
Total net position	**3,131**	**2,992**
Total liabilities and net position	**$ 60,264**	**$ 57,245**

The accompanying notes are an integral part of these statements.

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Internal Revenue Service
Statement of Net Cost
For the Years Ended September 30, 2017 and 2016

(In Millions)

	2017	2016
Program		
Taxpayer Assistance and Education		
Gross cost	$ 544	$ 540
Earned revenue	(2)	(2)
Net cost of program	**542**	**538**
Filing and Account Services		
Gross cost	4,334	3,939
Earned revenue	(149)	(114)
Net cost of program	**4,185**	**3,825**
Compliance		
Gross cost	7,701	7,868
Earned revenue	(418)	(387)
Net cost of program	**7,283**	**7,481**
Administration of Tax Credit Programs		
Gross cost	138	141
Earned revenue	-	-
Net cost of program	**138**	**141**
Net cost of operations (Note 11)	**$ 12,148**	**$ 11,985**

The accompanying notes are an integral part of these statements.

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Internal Revenue Service
Statement of Changes in Net Position
For the Years Ended September 30, 2017 and 2016

(In Millions)

	2017		2016	
	Cumulative Results of Operations	**Unexpended Appropriations**	**Cumulative Results of Operations**	**Unexpended Appropriations**
Beginning balances	**$ 1,405**	**$ 1,587**	**$ 1,145**	**$ 1,480**
Budgetary financing sources				
Appropriations received		11,235		11,235
Transfers in/out without reimbursement	18	-	18	(1)
Other adjustments		(104)		(94)
Appropriations used	11,205	(11,205)	11,033	(11,033)
Other financing sources				
Imputed financing	1,159		1,219	
Transfers in/out without reimbursement	-		-	
Transfers to general fund	(21)		(25)	
Total financing sources	**12,361**	**(74)**	**12,245**	**107**
Net cost of operations	**(12,148)**		**(11,985)**	
Net change	**213**	**(74)**	**260**	**107**
Ending balances	**$ 1,618**	**$ 1,513**	**$ 1,405**	**$ 1,587**

The accompanying notes are an integral part of these statements.

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Internal Revenue Service
Statement of Budgetary Resources
For the Years Ended September 30, 2017 and 2016

(In Millions)

	2017	2016
Budgetary resources		
Unobligated balance brought forward, October 1	$ 949	$ 1,018
Recoveries of prior year unpaid obligations	106	116
Other changes in unobligated balance	(48)	(63)
Unobligated balance from prior year budget authority, net	1,007	1,071
Appropriations (discretionary and mandatory)	11,631	11,614
Spending authority from offsetting collections (discretionary and mandatory)	165	123
Total budgetary resources	**$ 12,803**	**$ 12,808**
Status of budgetary resources		
New obligations and upward adjustments (total) (Note 12)	$ 11,745	$ 11,859
Unobligated balance, end of year		
Apportioned, unexpired accounts	530	467
Exempt from apportionment, unexpired accounts	7	7
Unapportioned, unexpired accounts	238	151
Unexpired unobligated balance, end of year	775	625
Expired unobligated balance, end of year	283	324
Unobligated balance, end of year (total)	1,058	949
Total budgetary resources	**$ 12,803**	**$ 12,808**
Change in obligated balance		
Unpaid obligations brought forward, October 1	$ 1,665	$ 1,382
New obligations and upward adjustments (Note 12)	11,745	11,859
Outlays (gross)	(11,727)	(11,460)
Recoveries of prior year unpaid obligations	(106)	(116)
Unpaid obligations, end of year	1,577	1,665
Uncollected payments, federal sources, brought forward, October 1	(30)	(24)
Change in uncollected payments, federal sources	1	(6)
Uncollected payments, federal sources, end of year	(29)	(30)
Memorandum (non-add) entries:		
Obligated balance, start of year	1,635	1,358
Obligated balance, end of year	**$ 1,548**	**$ 1,635**
Budget authority and outlays, net		
Budget authority, gross (discretionary and mandatory)	$ 11,796	$ 11,737
Actual offsetting collections (discretionary and mandatory)	(222)	(150)
Change in uncollected payments, federal sources (discretionary and mandatory)	1	(6)
Recoveries of prior year paid obligations (discretionary and mandatory)	56	33
Budget authority, net (total) (discretionary and mandatory)	**$ 11,631**	**$ 11,614**
Outlays, gross (discretionary and mandatory)	$ 11,727	$ 11,460
Actual offsetting collections (discretionary and mandatory)	(222)	(150)
Outlays, net (total) (discretionary and mandatory)	11,505	11,310
Distributed offsetting receipts	(362)	(348)
Agency outlays, net (discretionary and mandatory)	**$ 11,143**	**$ 10,962**

The accompanying notes are an integral part of these statements.

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Internal Revenue Service
Statement of Custodial Activity
For the Years Ended September 30, 2017 and 2016

(In Billions)

	2017	2016
Revenue activity		
Collections of federal tax revenue (Note 13)		
Individual income, FICA/SECA, and other	$ 2,976	$ 2,875
Corporate income	339	346
Excise	64	76
Estate and gift	24	22
Railroad retirement	6	6
Federal unemployment	8	8
Total collections of federal tax revenue	**3,417**	**3,333**
Increase in federal taxes receivable, net	3	8
Total federal tax revenue	**$ 3,420**	**$ 3,341**
Distribution of federal tax revenue to Treasury	**$ 3,417**	**$ 3,333**
Increase in amount due to Treasury	3	8
Total disposition of federal tax revenue	**3,420**	**3,341**
Net federal revenue activity	**$ -**	**$ -**
Federal tax refund and outlay activities		
Total refunds of federal taxes and outlays (Note 14)	$ 437	$ 426
Appropriations used for refund of federal taxes and outlays	(437)	(426)
Net federal tax refund and outlay activities	**$ -**	**$ -**

The accompanying notes are an integral part of these statements.

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INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2017 and 2016

Note 1. Summary of Significant Accounting Policies

A. Reporting Entity

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

Operating Divisions
The IRS has four operating divisions:

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

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

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

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

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

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

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

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

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INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2017 and 2016

B. Basis of Accounting and Presentation

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

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

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

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

C. Fund Balance with Treasury

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

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

D. Other Assets

Accounts receivable consist of amounts due to the IRS from the public and from federal agencies. Accounts receivable are recorded and reimbursable revenues are recognized as the services are performed and costs are incurred. The allowance for uncollectible accounts is based on an annual review of groups of accounts by age for accounts receivable balances older than one year. Receivables include an expenditure transfer receivable from the Treasury Forfeiture Fund for the repayment of costs incurred in criminal investigations related to seizure and forfeitures.

Advances to the public represent cash outlays for criminal investigations and employee travel.

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INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2017 and 2016

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

E. Cash and Other Monetary Assets

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

F. Federal Taxes Receivable, Net and Due to Treasury

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

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

Compliance assessments are unpaid assessments which neither the taxpayer nor a court has affirmed is owed to the Federal Government. Examples include assessments resulting from an IRS audit or examination in which the taxpayer does not agree with the results. Write-offs consist of unpaid assessments for which the IRS does not expect further collections due to factors such as taxpayers' bankruptcy, insolvency, or death. Compliance assessments and write-offs are not reported on the balance sheet. Statutory provisions authorize the IRS to collect on unpaid assessments for a specific statutory timeframe. In order to pursue collections and account for collection efforts, the IRS maintains unpaid assessment accounts in the financial records until the statute for collection expires.

Tax Assessments

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

Abatements

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

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2017 and 2016

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

G. General Property and Equipment

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

In FY 2017, the IRS changed its capitalization threshold for the asset categories of mainframes, servers, laptops, and desktops by implementing a threshold of $50,000 or greater. Prior to FY 2017, these categories were capitalized regardless of cost. In FY 2017, the IRS also modified its capitalization threshold for Non-ADP equipment to include a bulk threshold of $50,000 or greater and an individual cost threshold of $5,000 or greater. Prior to FY 2017, the capitalization threshold for Non-ADP equipment only included a bulk threshold of $50,000 or greater.

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

Asset Class	Capitalization Threshold
ADP equipment *	Mainframe, server, desktop, laptop and commercial off the shelf software assets with bulk cost of $50 thousand or greater. Telecom equipment is capitalized regardless of acquisition cost.
Non-ADP equipment	Assets with bulk cost of $50 thousand or greater and the individual cost is $5 thousand or greater.
Furniture	Capitalized regardless of acquisition cost
Investigative equipment	Assets with bulk cost of $50 thousand or greater
Vehicles	Capitalized regardless of acquisition cost
Major systems	Projects with costs of $20 million or greater
Internal use software	Major business systems modernization projects with an estimated cost of $10 million per year or $50 million over the life cycle.
Leasehold improvements	Improvements with bulk cost of $50 thousand or greater
Assets under capital lease	Assets with bulk cost of $50 thousand or greater

*Automated Data Processing (ADP)

Prior to the implementation of Statement of Federal Financial Accounting Standards (SFFAS) No. 10, *Accounting for Internal Use Software*, Major systems was an asset class established to account for large-scale computer systems. These assets are fully depreciated, but still used in the IRS's daily operations and are reported on the financial statements.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2017 and 2016

Internal use software captures the costs of major Business Systems Modernization (BSM) projects in accordance with SFFAS No. 10. It encompasses software design, development, and testing of projects adding significant new functionality and long-term benefits. Costs for developing internal use software are accumulated in work in process until final acceptance and testing are successfully completed. When the software is completed and placed into service, the costs are transferred to amortizable property.

H. Federal Tax Refunds Payable and Due from Treasury

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

I. Financing Sources and Revenues

Appropriations Received

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

Appropriations

The major budget accounts are:

- Taxpayer Services
- Enforcement
- Operations Support
- Other

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

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

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

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

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

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2017 and 2016

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

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

J. Program Costs

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

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

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

Administration of Tax Credit Programs primarily administers the EITC program, which works closely with internal and external stakeholders through expanded customer service and public outreach, enforcement, and research efforts to increase the number of eligible taxpayers who claim the EITC and to reduce the number of EITC claims paid in error. The EITC payments actually refunded to individuals or credited against tax liabilities are not included in program costs.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2017 and 2016

K. Custodial Activity

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

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

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

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

L. Funds from Dedicated Collections

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

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

Established under the *American Jobs Creation Act of 2004,* the Private Collection Agent Program (20X5510) ended in March 2009. The remaining unobligated funds were retained by the IRS. The *Fixing America's Surface Transportation Act*, P.L. 114-94, enacted in December 2015, amended Title 26 United States Code, Section 6306, requiring the IRS to contract with private collection agencies for the collection of delinquent taxes. The delinquent taxes have (1) been removed from the IRS's active inventory due to a lack of resources or inability to find the taxpayer; (2) passed more than one-third of the applicable limitation period and no IRS employee has been assigned to the debt; or (3) been assigned for collection, but more than a year has passed without interaction with the taxpayer for the purpose of increasing the probability of collection. The Private Collection Agent Program (20X5510) is allowed to expend retained funds for qualified tax collection contracts and collection enforcement activities. The Special Compliance Personnel Program Account (20X5622) requires the hiring, training, and employment of personnel in compliance with Section 6307.

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For the Years Ended September 30, 2017 and 2016

M. Allocation Transfers

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

N. Fiduciary Activities

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

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

O. Employee Compensation and Benefits

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

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

Federal Employees' Compensation Act
The Federal Employees' Compensation Act (FECA) provides income and medical cost protection to covered federal civilian employees injured on the job, to employees who have incurred work-related occupational diseases, and to beneficiaries of employees whose deaths were attributed to job-related

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For the Years Ended September 30, 2017 and 2016

injuries or occupational diseases. The FECA program is administered by the U.S. Department of Labor (DOL), which pays valid claims and subsequently seeks reimbursement for claims paid. Accrued FECA liability represents amounts due to the DOL for claims paid on behalf of the IRS. Actuarial FECA liability represents the liability for future workers' compensation benefits, which includes the expected liability for death, disability, medical, and miscellaneous costs for approved cases. The DOL estimates the liability for future payments as a result of past events.

Employee Pension Benefits

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

EMPLOYEE PENSION BENEFIT CONTRIBUTION RATES

	Category	Employee	Agency
CSRS Rates	Regular	7.0%	7.0%
	Law Enforcement Officers	7.5%	7.5%
FERS Rates	Regular	0.8%	13.7%
Hired prior to January 1, 2013	Law Enforcement Officers	1.3%	30.1%
FERS – Revised Annuity Rate	Regular	3.1%	11.9%
Hired January 1, 2013 - December 31, 2013	Law Enforcement Officers	3.6%	28.4%
FERS – Further Revised Annuity Rate	Regular	4.4%	11.9%
Hired January 1, 2014 or later	Law Enforcement Officers	4.9%	28.4%

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

P. Use of Estimates

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

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For the Years Ended September 30, 2017 and 2016

Note 2. Fund Balance with Treasury

(In Millions)	2017	2016
General funds	$ 2,185	$ 2,319
Special funds	411	253
Revolving funds	7	7
Other funds	-	1
Fund balance with Treasury	**$ 2,603**	**$ 2,580**

(In Millions)	2017	2016
Unobligated balances:		
Available	$ 537	$ 474
Unavailable	521	475
Obligated balance not yet disbursed	1,548	1,635
Non-budgetary FBWT	(3)	(4)
Status of fund balance with Treasury	**$ 2,603**	**$ 2,580**

Note 3. Other Assets

(In Millions)	2017		2016	
	Intra-governmental	With the Public	Intra-governmental	With the Public
Accounts receivable, net	$ 16	$ 7	$ 10	$ 6
Advances	-	6	-	7
Forfeited Property Held for Sale	-	-	-	1
Other assets	**$ 16**	**$ 13**	**$ 10**	**$ 14**

Note 4. Cash and Other Monetary Assets

(In Millions)	2017	2016
Imprest fund	$ 4	$ 5
Other monetary assets	489	666
Cash and other monetary assets	**$ 493**	**$ 671**

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Notes to the Financial Statements

For the Years Ended September 30, 2017 and 2016

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

(In Billions)	2017	2016
Federal taxes receivable	$ 197	$ 178
Allowance for uncollectible taxes receivable	(145)	(129)
Federal taxes receivable, net and due to Treasury	**$ 52**	**$ 49**

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

As of September 30, 2017, the Federal taxes receivable balance and Federal taxes receivable, net balance include $2 billion from uncollected Branded Prescription Drug fees. These fees are deemed fully collectible based upon collection history and the type of taxpayer. As of September 30, 2016, there was no Federal taxes receivable from uncollected Branded Prescription Drug fees.

Note 6. Non-entity Assets

(In Millions)	2017		2016	
	Intra-governmental	With the Public	Intra-governmental	With the Public
Due from Treasury	$ 3,061	$ -	$ 2,974	$ -
Federal taxes receivable, net	-	52,000	-	49,000
Other monetary assets	-	489	-	666
Non-entity assets	**$ 3,061**	**$ 52,489**	**$ 2,974**	**$ 49,666**

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

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Notes to the Financial Statements

For the Years Ended September 30, 2017 and 2016

Note 7. General Property and Equipment, Net

(In Millions)	Useful Life (Years)	Cost	Accumulated Depreciation	2017 Net Book Value	2016 Net Book Value
ADP assets	3 to 7	$ 1,262	$ (867)	$ 395	$ 345
Internal use software	2 to 15	2,788	(1,431)	1,357	1,143
Leasehold improvements	10	243	(148)	95	105
Major systems	7	221	(221)	-	-
Internal use software - work in process		165	-	165	325
Vehicles	5	4	(3)	1	1
Furniture and non-ADP equipment	8 and 10	166	(110)	56	72
Assets under capital lease	3.5 to 8	21	(12)	9	4
Investigative equipment	10	4	(4)	-	1
Property and equipment		**$ 4,874**	**$ (2,796)**	**$ 2,078**	**$ 1,996**

The Cost column represents the historical cost of property and equipment, net of disposals. The cost basis for FY 2017 and FY 2016 is $4,874 million and $4,561 million, respectively. Accumulated depreciation for FY 2017 and FY 2016 is $2,796 million and $2,565 million, respectively.

Internal use software projects (deployed and work in process) include:

- Account Management Services (AMS) provides the applications to monitor and interface with taxpayers, issue enhanced notices, and deliver improved customer support and functionality.
- Customer Account Data Engine 2 (CADE 2) is leveraging existing systems and new development to implement a single data-centric solution, which provides daily processing of individual taxpayer accounts.
- Enterprise Case Management (ECM) will provide an enterprise solution for performing case management functions using a common infrastructure platform and common services.
- Foreign Account Tax Compliance Act (FATCA) is being developed to enable foreign financial institutions to report information to the IRS about financial accounts held by U.S. taxpayers or foreign entities in which U.S. taxpayers hold a substantial ownership interest.
- Information Reporting and Document Matching (IRDM) is a business document matching program designed to increase voluntary compliance and accurate reporting of income through the use of third party information reporting data.
- Integrated Financial System (IFS) is the administrative financial system.
- Integrated Procurement System (IPS) is the re-engineered procurement system.
- Knowledge Incident/Problem Service Asset Management (KISAM) is the asset and problem management system.
- Modernized e-file (MeF) is an electronic filing system for tax returns.
- PPACA is the development and implementation of systems to support tax administration responsibilities.
- Return Review Program (RRP) is an automated system designed to maximize fraud detection at the time tax returns are filed.
- Web Applications (Web Apps) is a program to improve the taxpayer's online experience, provide secure digital communications, and add more interactive capabilities to existing web self-service products.

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For the Years Ended September 30, 2017 and 2016

Other deployed internal use software projects include:

- Customer Communications is a customer service telephone system.
- Custodial Detail Database (CDDB), the subsidiary ledger for Redesigned Revenue Accounting Control System (RRACS), provides the functionality needed for custodial financial management and reporting.
- E-Services is a system of web-based products and services for tax practitioners and the public.
- Enterprise Systems Management (ESM) is an infrastructure system allowing remote monitoring and network management.
- Internet Refund Fact of Filing allows taxpayers to review the status of their refund.
- RRACS adds enhancements to financial reporting of taxpayer receipts and adds traceability between summary records and the detailed subsidiary ledger (CDDB).
- Security and Technology Infrastructure Release (STIR) is the infrastructure for information technology security.

Deployed Internal Use Software

(In Millions)	Cost	Accumulated Depreciation	2017 Net Book Value	2016 Net Book Value
AMS	$ 78	$ (44)	$ 34	$ 39
CADE 2	340	(210)	130	102
FATCA	287	(76)	211	211
IRDM	59	(42)	17	25
IFS	167	(160)	7	10
IPS	8	(5)	3	4
KISAM	6	(6)	-	1
MeF	405	(343)	62	63
PPACA	996	(210)	786	644
RRP	110	(36)	74	43
Web Apps	36	(3)	33	-
Other	296	(296)	-	1
Deployed internal use software	**$ 2,788**	**$ (1,431)**	**$ 1,357**	**$ 1,143**

Work in Process Internal Use Software

(In Millions)	2017	2016
PPACA	$ -	$ 199
CADE 2	96	48
RRP	44	38
MeF	-	17
Web Apps	-	13
FATCA	7	9
ECM	18	1
Work in process internal use software	**$ 165**	**$ 325**

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Notes to the Financial Statements

For the Years Ended September 30, 2017 and 2016

Note 8. Liabilities

Other Liabilities

(In Millions)	2017 Current	2017 Non-Current	2017 Total
Intragovernmental:			
Accrued payroll and benefits	$ 72	$ -	$ 72
Accrued FECA liability	41	49	90
Accrued expenses	10	-	10
Capital lease liabilities	1	-	1
Other liabilities	**$ 124**	**$ 49**	**$ 173**
With the Public:			
Accrued annual leave	$ 475	$ -	$ 475
Actuarial FECA liability	-	466	466
Accrued payroll and benefits	242	-	242
Accrued expenses	218	-	218
Liability for deposit funds, clearing accounts and custodial liabilities	489	-	489
Accounts payable	3	-	3
Energy savings performance liability	1	4	5
Other liabilities	**$ 1,428**	**$ 470**	**$ 1,898**

(In Millions)	2016 Current	2016 Non-Current	2016 Total
Intragovernmental:			
Accrued payroll and benefits	$ 71	$ -	$ 71
Accrued FECA liability	41	51	92
Accrued expenses	10	-	10
Capital lease liabilities	1	1	2
Other liabilities	**$ 123**	**$ 52**	**$ 175**
With the Public:			
Accrued annual leave	$ 479	$ -	$ 479
Actuarial FECA liability	-	471	471
Accrued payroll and benefits	239	-	239
Accrued expenses	227	-	227
Liability for deposit funds, clearing accounts and custodial liabilities	667	-	667
Accounts payable	15	-	15
Energy savings performance liability	1	5	6
Other liabilities	**$ 1,628**	**$ 476**	**$ 2,104**

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Notes to the Financial Statements

For the Years Ended September 30, 2017 and 2016

Liabilities Not Covered by Budgetary Resources

(In Millions)	2017 Intra-governmental	2017 With the Public	2016 Intra-governmental	2016 With the Public
Accrued annual leave	$ -	$ 475	$ -	$ 479
Actuarial FECA liability	-	466	-	471
Accrued FECA liability	90	-	92	-
Capital lease liabilities	1	-	2	-
Energy savings performance liability	-	5	-	6
Liabilities not covered by budgetary resources	**$ 91**	**$ 946**	**$ 94**	**$ 956**

Liabilities not covered by budgetary resources result from the receipt of goods and services, or occurrence of eligible events in the current or prior periods, for which revenue to pay the liabilities has not been made available through appropriations of the IRS.

Note 9. Leases

Capital Leases

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

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

In 2017 the IRS leased multifunctional printing devices in a lease-to-own agreement. The final payment for the leased multifunctional printing devices has been accrued and will be made in early FY 2018.

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

(In Millions) Fiscal Year	Lease Payment
2018	$ 1
After 2018	-
Total future lease payments	**$ 1**

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Notes to the Financial Statements

For the Years Ended September 30, 2017 and 2016

Operating Leases

(In Millions)

Fiscal Year	Lease Payment
2018	$ 156
2019	141
2020	136
2021	129
2022	71
After 2022	385
Total future lease payments	**$ 1,018**

The IRS leases office space from GSA and commercial entities under non-cancelable operating leases with lease terms from 1 to 30 years. This includes all GSA occupancy agreements the IRS determined to be non-cancelable. Future lease payments under non-cancelable leases of office spaces are presented above.

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

Note 10. Commitments and Contingencies

The IRS is a party to legal actions whose outcome, if unfavorable, could materially affect the financial statements. As of September 30, 2017 and 2016, there were no estimated contingent liabilities arising from these actions.

For some of the legal actions to which the IRS is a party, management and legal counsel cannot determine the likelihood of an unfavorable outcome nor can any related loss be reasonably estimated. The IRS does not accrue for possible losses related to cases where the potential loss cannot be estimated or the likelihood of an unfavorable outcome is less than probable. As of September 30, 2017 and 2016, there are five cases and seven cases, respectively, for which management and legal counsel are unable to determine the likelihood of an unfavorable outcome or establish a range of potential losses. Additionally, for some of the legal actions, management and legal counsel have determined the likelihood of an unfavorable outcome is remote.

As of September 30, 2017 and 2016, the IRS does not have contractual commitments for payments on obligations related to canceled appropriations or contractual arrangements for which the IRS has not recognized liabilities for goods and services provided.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2017 and 2016

Note 11. Cost and Earned Revenue by Programs

(In Millions)	2017 Taxpayer Assistance and Education	Filing and Account Services	Compliance	Administration of Tax Credit Programs	Total
Intragovernmental gross cost	$ 113	$ 1,876	$ 2,242	$ 38	$ 4,269
Gross costs with the public	431	2,458	5,459	100	8,448
Program costs	544	4,334	7,701	138	12,717
Intragovernmental earned revenue	(2)	(86)	(65)	-	(153)
Earned revenue from the public	-	(63)	(353)	-	(416)
Program revenues	(2)	(149)	(418)	-	(569)
Net cost of operations	**$ 542**	**$ 4,185**	**$ 7,283**	**$ 138**	**$ 12,148**

(In Millions)	2016 Taxpayer Assistance and Education	Filing and Account Services	Compliance	Administration of Tax Credit Programs	Total
Intragovernmental gross cost	$ 129	$ 1,772	$ 2,432	$ 39	$ 4,372
Gross costs with the public	411	2,167	5,436	102	8,116
Program costs	540	3,939	7,868	141	12,488
Intragovernmental earned revenue	(2)	(48)	(49)	-	(99)
Earned revenue from the public	-	(66)	(338)	-	(404)
Program revenues	(2)	(114)	(387)	-	(503)
Net cost of operations	**$ 538**	**$ 3,825**	**$ 7,481**	**$ 141**	**$ 11,985**

Intragovernmental expenses relate to the source of goods and services purchased by the reporting entity and not to the classification of related revenue.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2017 and 2016

Note 12. Statement of Budgetary Resources (SBR)

New Obligations and Upward Adjustments

(In Millions)	2017	2016
Direct		
Category B	$ 11,593	$ 11,754
Exempt from apportionment, unexpired accounts	-	-
Total	11,593	11,754
Reimbursable		
Category B	152	105
Exempt from apportionment, unexpired accounts	-	-
Total	152	105
New obligations and upward adjustments	$ 11,745	$ 11,859

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

Explanation of Differences Between the FY 2016 SBR and the FY 2018 President's Budget

(In Millions)	Budgetary Resources	New Obligations and Upward Adjustments	Distributed Offsetting Receipts	Outlays, Net
Statement of Budgetary Resources (SBR)	$ 12,808	$ 11,859	$ 348	$ 11,310
Included in SBR, not in President's Budget				
Expired funds	(359)	-	-	-
Offsetting receipts	-	-	(348)	-
Other	(2)	2	-	(4)
Included in President's Budget, not on SBR				
Refundable tax credits, interest refunds to taxpayers, and other outlays	127,059	127,059	-	121,779
Informant Payments	42	42	-	42
Budget of the United States Government	$ 139,548	$ 138,962	$ -	$ 133,127

The *FY 2019 Budget of the United States Government* (President's Budget) presenting the actual amounts for the year ended September 30, 2017 has not been published as of the issue date of these financial statements. The FY 2019 President's Budget is scheduled for publication in February 2018. A reconciliation of the FY 2016 column on the SBR to the actual amounts for FY 2016 in the FY 2018 President's Budget for budgetary resources, new obligations and upward adjustments, distributed offsetting receipts, and outlays, net is presented above.

The President's Budget includes $127.1 billion in appropriations for refundable tax credits, interest refunds, informant payments, and other outlays. These appropriations primarily consist of EITC, Premium Tax Credit, and Child Tax Credit and are reported with refunds on the Statement of Custodial Activity and are not reported on the SBR.

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Notes to the Financial Statements

For the Years Ended September 30, 2017 and 2016

Undelivered Orders at the End of Period

Undelivered orders are the value of goods and services ordered and obligated, but not yet received. This amount includes any prepaid or advanced orders for which delivery or performance has not yet occurred. Undelivered orders were $1,037 million and $1,109 million for the periods ended September 30, 2017 and 2016, respectively.

Note 13. Collections of Federal Tax Revenue

(In Billions)	Tax Year 2017		Tax Year 2016	Tax Year 2015	Tax Year Prior Years	Collections Received FY 2017	Collections Received FY 2016
Individual income, FICA/SECA, and other	$ 1,930	*	$ 989	$ 32	$ 25	$ 2,976	$ 2,875
Corporate income	219	**	109	2	9	339	346
Excise	47		17	-	-	64	76
Estate and gift	-		21	1	2	24	22
Railroad retirement	5		1	-	-	6	6
Federal unemployment	4		4	-	-	8	8
Collections of federal tax revenue	**$ 2,205**		**$ 1,141**	**$ 35**	**$ 36**	**$ 3,417**	**$ 3,333**

* Includes other collections of $217 million.
** Includes tax year 2018 corporate income tax receipts of $9 billion.

Note 14. Federal Tax Refund and Outlay Activities

(In Billions)	Tax Year 2017	Tax Year 2016	Tax Year 2015	Tax Year Prior Years	Refunds and Outlays FY 2017	Refunds and Outlays FY 2016
Individual income, FICA/SECA, and other	$ 46	$ 306	$ 28	$ 9	$ 389	$ 373
Corporate income	5	14	8	18	45	51
Excise	-	1	-	1	2	1
Estate and gift	-	-	-	1	1	1
Federal tax refund and outlay activities	**$ 51**	**$ 321**	**$ 36**	**$ 29**	**$ 437**	**$ 426**

Federal tax refund and outlay activities include overpayments from taxpayers; payments for various refundable credits, including EITC and the Premium Tax Credit; and other payments, including the Cost Sharing Reduction and Basic Health Program pursuant to the PPACA.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

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Note 15. Fiduciary Activities

(In Millions)	2017 20X6737	20X6738	20X6740	20X6741	Total
Fiduciary net assets, beginning of year	$ -	$ 19	$ -	$ -	$ 19
Contributions	9	10	23	13	55
Disbursements to and on behalf of beneficiaries	(9)	(20)	(23)	(13)	(65)
Decrease in fiduciary net assets	-	(10)	-	-	(10)
Fiduciary net assets, end of year	**$ -**	**$ 9**	**$ -**	**$ -**	**$ 9**

(In Millions)	2016 20X6737	20X6738	20X6740	20X6741	Total
Fiduciary net assets, beginning of year	$ -	$ 13	$ -	$ -	$ 13
Contributions	9	16	32	11	68
Disbursements to and on behalf of beneficiaries	(9)	(10)	(32)	(11)	(62)
Increase in fiduciary net assets	-	6	-	-	6
Fiduciary net assets, end of year	**$ -**	**$ 19**	**$ -**	**$ -**	**$ 19**

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

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

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

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

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

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INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2017 and 2016

Note 16. Reconciliation of Net Cost of Operations to Budget

(In Millions)	2017	2016
Resources used to finance activities:		
New obligations and upward adjustments	$ 11,745	$ 11,859
Spending authority from offsetting collections and recoveries	(327)	(272)
Distributed offsetting receipts	(362)	(348)
Transfers to General Fund	(21)	(25)
Imputed financing	1,159	1,219
Transfers in/out without reimbursement	-	-
	12,194	12,433
Resources that do not fund net cost of operations:		
Changes in goods, services and benefits ordered but not yet received or provided	65	(206)
Costs capitalized on the balance sheet	(199)	(124)
Other	15	18
	(119)	(312)
Costs that do not require resources in current period:		
Depreciation and amortization	392	353
Decrease in unfunded liabilities	(13)	(29)
Revaluation of assets and liabilities	8	14
Other	(314)	(474)
	73	(136)
Net cost of operations	$ 12,148	$ 11,985

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

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INTERNAL REVENUE SERVICE

Required Supplementary Information - Unaudited

For the Years Ended September 30, 2017 and 2016

Schedule of Budgetary Resources by Major Budget Accounts

	2017				
(In Millions)	Taxpayer Services	Enforcement	Operations Support	Other	Total
Budgetary resources					
Unobligated balance brought forward, October 1	$ 63	$ 136	$ 298	$ 452	$ 949
Recoveries of prior year unpaid obligations	6	17	78	5	106
Other changes in unobligated balance	3	9	51	(111)	(48)
Unobligated balance from prior year budget authority, net	72	162	427	346	1,007
Appropriations (discretionary & mandatory)	2,460	4,640	3,942	589	11,631
Spending authority from offsetting collections (discretionary & mandatory)	62	47	55	1	165
Total budgetary resources	**$ 2,594**	**$ 4,849**	**$ 4,424**	**$ 936**	**$ 12,803**
Status of budgetary resources					
New obligations and upward adjustments (total)	$ 2,504	$ 4,754	$ 4,166	$ 321	$ 11,745
Unobligated balance, end of year					
Apportioned, unexpired accounts	49	29	90	362	530
Exempt from apportionment, unexpired accounts	-	-	-	7	7
Unapportioned, unexpired accounts	-	-	-	238	238
Unexpired unobligated balance, end of year	49	29	90	607	775
Expired unobligated balance, end of year	41	66	168	8	283
Unobligated balance, end of year (total)	90	95	258	615	1,058
Total budgetary resources	**$ 2,594**	**$ 4,849**	**$ 4,424**	**$ 936**	**$ 12,803**
Change in obligated balance					
Unpaid obligations brought forward, October 1	$ 153	$ 299	$ 999	$ 214	$ 1,665
New obligations and upward adjustments	2,504	4,754	4,166	321	11,745
Outlays (gross)	(2,482)	(4,715)	(4,102)	(428)	(11,727)
Recoveries of prior year unpaid obligations	(6)	(17)	(78)	(5)	(106)
Unpaid obligations, end of year	169	321	985	102	1,577
Uncollected payments, federal sources, brought forward, October 1	-	(26)	(4)	-	(30)
Changes in uncollected payments, federal sources	-	(2)	3	-	1
Uncollected payments, federal sources, end of year	-	(28)	(1)	-	(29)
Memorandum (non-add) entries:					
Obligated balance, start of year	153	273	995	214	1,635
Obligated balance, end of year	**$ 169**	**$ 293**	**$ 984**	**$ 102**	**$ 1,548**
Budget authority and outlays, net					
Budget authority, gross (discretionary & mandatory)	$ 2,522	$ 4,687	$ 3,997	$ 590	$ 11,796
Actual offsetting collections (discretionary & mandatory)	(82)	(73)	(66)	(1)	(222)
Change in uncollected payments, federal sources (discretionary & mandatory)	-	(2)	3	-	1
Recoveries of prior year paid obligations (discretionary & mandatory)	20	28	8	-	56
Budget authority, net (total) (discretionary & mandatory)	**$ 2,460**	**$ 4,640**	**$ 3,942**	**$ 589**	**$ 11,631**
Outlays, gross (discretionary & mandatory)	$ 2,482	$ 4,715	$ 4,102	$ 428	$ 11,727
Actual offsetting collections (discretionary & mandatory)	(82)	(73)	(66)	(1)	(222)
Outlays, net (total) (discretionary & mandatory)	2,400	4,642	4,036	427	11,505
Distributed offsetting receipts	-	-	-	(362)	(362)
Agency outlays, net (discretionary & mandatory)	**$ 2,400**	**$ 4,642**	**$ 4,036**	**$ 65**	**$ 11,143**

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Schedule of Budgetary Resources by Major Budget Accounts

(In Millions)	2016 Taxpayer Services	Enforcement	Operations Support	Other	Total
Budgetary resources					
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					
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, 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					
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**

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For the Years Ended September 30, 2017 and 2016

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) 2017, the total estimated payout (including principal and interest) for claims pending judicial review by the federal courts is $8.2 billion and by Appeals is $2.2 billion. In FY 2016, the total estimated payout (including principal and interest) for claims pending judicial review by the federal courts was $4.8 billion and by Appeals was $2.3 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)	2017	2016
Total unpaid assessments	$ 382	$ 391
Compliance assessments	(74)	(74)
Write-offs	(111)	(139)
Gross federal taxes receivables	197	178
Allowance for uncollectible taxes receivable	(145)	(129)
Federal taxes receivable, net	**$ 52**	**$ 49**

Total unpaid assessments include $2 billion of Branded Prescription Drug fees which were assessed at year end and deemed fully collectible. As of September 30, 2016, there was no Federal taxes receivable from uncollected Branded Prescription Drug fees.

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 as of September 30, 2017 and September 30, 2016, 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.

INTERNAL REVENUE SERVICE

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For the Years Ended September 30, 2017 and 2016

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*.

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For the Years Ended September 30, 2017 and 2016

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.

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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. This tax credit expired in 2016.

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.

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Other Outlays

Cost Sharing Reduction

In addition to receiving a premium tax credit, a person who obtained a Silver health care insurance policy through the Marketplace was able to receive a government subsidy of their deductibles, copayments, and coinsurance costs based 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.

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The following table summarizes refundable tax credits in excess of tax liabilities and other outlays paid in FY 2017 and FY 2016.

(In Millions)	2017	2016
Earned Income Tax Credit	$ 59,749	$ 60,579
Premium Tax Credit *	28,544	23,051
Additional Child Tax Credit	19,408	20,188
Build America and Recovery Zone Bonds	3,629	3,646
Qualified Zone Academy Bonds	52	58
Qualified School Construction Bonds	673	746
Qualified Energy Conservation Bonds	40	36
New Clean Renewable Energy Bonds	40	38
American Opportunity Tax Credit	3,469	3,993
Corporate Alternative Minimum Tax Credit	626	108
Health Coverage Tax Credit	25	12
Individual Alternative Minimum Tax Credit	-	2
Small Business Health Insurance Tax Credit	7	15
Cost Sharing Reduction	6,270	4,952
Basic Health Program	4,330	2,824
Interest on Tax Refunds	1,148	1,530
Refundable tax credits and other outlays	**$ 128,010**	**$ 121,778**

*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 2017 and FY 2016, total Premium Tax Credit advances disbursed by the Center for Medicare and Medicaid Services totaled $35,028 and $28,331, respectively. The FY 2017 and FY 2016 advanced amounts were adjusted downward based on tax return information.

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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 $127,200, and an employer matching amount of 6.2 percent, bringing the total rate to 12.4 percent for calendar year 2017. In calendar year 2016, 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 $127,200 and $118,500 for calendar years 2017 and 2016, respectively. Remaining benefits under FICA pertain to hospital benefits (referred to as "Medicare") and are funded by a separate 1.45 percent tax on all wages and tips (there is no wage limit) and the employer matching contribution of 1.45 percent, bringing the total rate to 2.9 percent. Self-employed individuals pay a Medicare tax of 2.9 percent on all self-employment income. Beginning in 2013, an additional Medicare tax of 0.9 percent was collected on earned individual income of more than $200,000 ($250,000 for married couples filing jointly). Social security taxes collected by the IRS were estimated to be approximately $859 billion and $818 billion in FY 2017 and FY 2016, respectively. Medicare taxes collected by the IRS were estimated to be approximately $257 billion and $248 billion in FY 2017 and FY 2016, 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

The Congressional Budget and Impoundment Control Act of 1974 (Public Law 93-344) defines tax expenditures as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." 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.

While the term "revenue losses" is used in the statutory definition, tax expenditures have traditionally been measured as reductions in federal tax revenues relative to normal baseline provisions of an individual and corporate income tax system, which were properly approved and authorized by the Congress to accomplish identified policy objectives, recognizing that federal tax revenues would be reduced.

In accordance with Statement of Federal Financial Accounting Standards 52, *Tax Expenditures*, narrative disclosures and information regarding tax expenditures are reported in the consolidated *Financial Report of the U.S. Government*. Such disclosures do not apply to the financial statements of component reporting entities such as the IRS. Tax expenditures also do not affect the reporting in the *Budget of the U.S. Government* or any other special purpose report.

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Tax Gap and Tax Burden

Tax Gap

The gross tax gap is the amount of true tax liability for a given tax year not paid voluntarily and/or timely. The most recent estimate of the gross tax gap is $458 billion. 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 years 2008 - 2010. This approach was selected as it provides more reliable tax gap estimates by category and source of noncompliance.

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

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 2015) and corporations (tax year 2014). 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.

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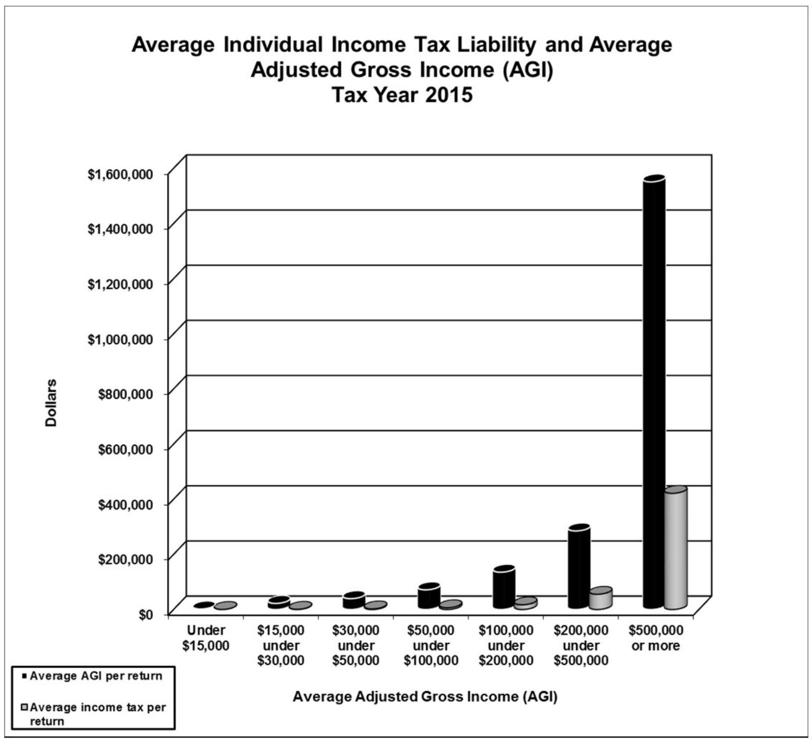

Adjusted gross income (AGI).	Number of taxable returns (in thousands)	AGI (in millions)	Total income tax (in millions)	Average AGI per return (in whole dollars)	Average income tax per return (in whole dollars)	Income tax as a percentage of AGI
Under $15,000	35,824	$ 61,630	$ 2,033	$ 1,720	$ 57	3.3%
$15,000 under $30,000	30,043	662,661	18,468	$ 22,057	$ 615	2.8%
$30,000 under $50,000	26,539	1,040,372	57,698	$ 39,202	$ 2,174	5.5%
$50,000 under $100,000	32,802	2,339,474	205,693	$ 71,321	$ 6,271	8.8%
$100,000 under $200,000	18,533	2,506,498	316,350	$ 135,245	$ 17,070	12.6%
$200,000 under $500,000	5,428	1,546,515	299,832	$ 284,914	$ 55,238	19.4%
$500,000 or more	1,324	2,053,160	557,817	$ 1,550,725	$ 421,312	27.2%
Totals	150,493	$ 10,210,310	$ 1,457,891			

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

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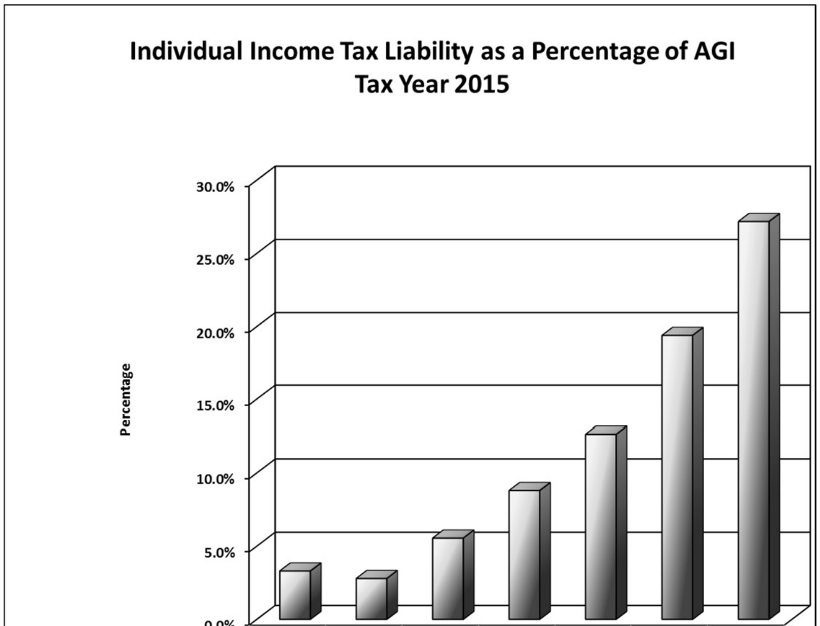

	Under $15,000	$15,000 under $30,000	$30,000 under $50,000	$50,000 under $100,000	$100,000 under $200,000	$200,000 under $500,000	$500,000 or more
Income tax as a percentage of AGI	3.3%	2.8%	5.5%	8.8%	12.6%	19.4%	27.2%

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

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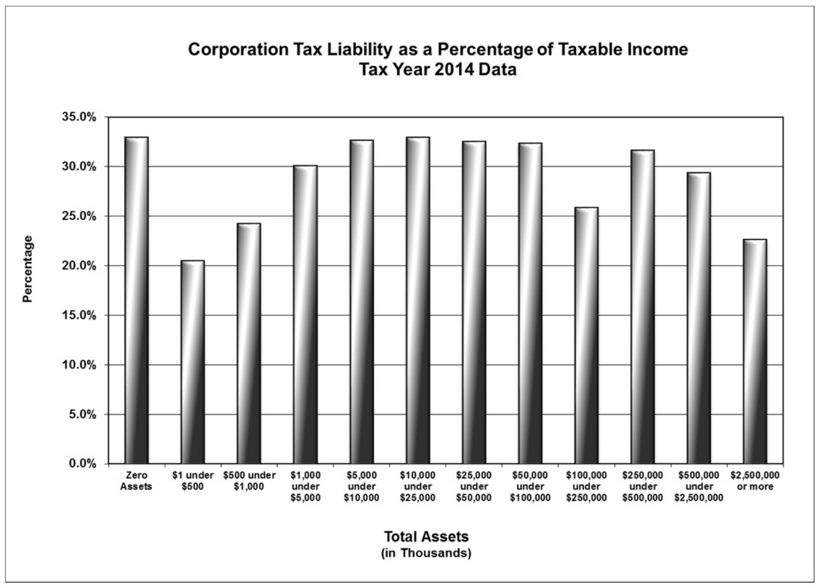
INTERNAL REVENUE SERVICE

Other Information - Unaudited

For the Years Ended September 30, 2017 and 2016



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	$ 16,236	$ 5,347	32.9%
$1 under $500	8,728	1,786	20.5%
$500 under $1,000	3,787	918	24.2%
$1,000 under $5,000	13,567	4,080	30.1%
$5,000 under $10,000	8,587	2,802	32.6%
$10,000 under $25,000	13,741	4,526	32.9%
$25,000 under $50,000	12,827	4,170	32.5%
$50,000 under $100,000	15,225	4,919	32.3%
$100,000 under $250,000	32,119	8,303	25.9%
$250,000 under $500,000	29,921	9,453	31.6%
$500,000 under $2,500,000	120,328	35,316	29.3%
$2,500,000 or more	1,126,109	254,458	22.6%
Totals	**$ 1,401,175**	**$ 336,078**	

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

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

COMMISSIONER

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

November 8, 2017

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 IRS's internal control over financial reporting as of September 30, 2017, 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, 2017, IRS has one material weakness in its internal control over financial reporting, specifically unpaid assessments. 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 that as of September 30, 2017, IRS's internal control over financial reporting was effective.

John A. Koskinen
Commissioner

November 8, 2017
Date

Jeffrey J. Tribiano
Deputy Commissioner, Operations Support

November 8, 2017
Date

Ursula S. Gillis
Chief Financial Officer

November 8, 2017
Date

Appendix II: Comments from the Internal Revenue Service

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

COMMISSIONER

November 3, 2017

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 2017 and 2016 Financial Statements. We are pleased that the Internal Revenue Service (IRS) received an unmodified opinion on its combined financial statements. The unmodified opinion demonstrates that the IRS accurately accounts for approximately $3.4 trillion in tax revenue receipts, $437 billion in tax refunds and $11 billion in IRS appropriated funds.

We appreciate the Government Accountability Office (GAO) recognizing our continuing efforts to mitigate the unpaid assessments (UA) material weakness, address identity theft challenges and implement the Affordable Care Act. This year we completed development of the asset accounting and procurement modules to eliminate related security deficiencies and improve the accuracy of reported balances. We also created a data quality task force and financial systems enhancement team to place additional focus on the UA material weakness. 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 produce accurate and reliable financial statements consistently. 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

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