# Audit Report

OIG-13-026

Audit of the Alcohol and Tobacco Tax and Trade Bureau's Fiscal Years 2012 and 2011 Financial Statements

December 18, 2012

# Office of Inspector General

DEPARTMENT OF THE TREASURY

The Alcohol and Tobacco Tax and Trade Bureau (TTB) is committed to making its Web Site accessible to all TTB customers and staff and creates its Web pages in accordance with the provisions of Section 508 of the Rehabilitation Act.

However, the attachment to our report, TTB's FY 2012 Annual Report, does not conform to the Standards of Section 508 of the Rehabilitation Act.

For a copy of TTB's FY 2012 Annual Report, see TTB's Annual Reports Web page and for problems with accessibility, please contact TTB at TTBWebmaster@ttb.gov.

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OFFICE OF
INSPECTOR GENERAL

**DEPARTMENT OF THE TREASURY**
**WASHINGTON, D.C. 20220**

December 18, 2012

**MEMORANDUM FOR JOHN J. MANFREDA, ADMINISTRATOR**
**ALCOHOL AND TOBACCO TAX AND TRADE BUREAU**

**FROM:** Michael Fitzgerald
Director, Financial Audits

**SUBJECT:** Audit of the Alcohol and Tobacco Tax and Trade Bureau's Fiscal Years 2012 and 2011 Financial Statements

I am pleased to transmit the attached audited Alcohol and Tobacco Tax and Trade Bureau (TTB) financial statements for fiscal years 2012 and 2011. Under a contract monitored by the Office of Inspector General, KPMG LLP, an independent certified public accounting firm, performed an audit of TTB's financial statements as of September 30, 2012 and 2011 and for the years then ended. The contract required that the audit be performed in accordance with generally accepted government auditing standards; applicable provisions of Office of Management and Budget Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended*;* and the *GAO/PCIE Financial Audit Manual*.

The following reports, prepared by KPMG LLP, are incorporated in the attachment:

- Independent Auditors' Report;
- Independent Auditors' Report on Internal Control Over Financial Reporting; and
- Independent Auditors' Report on Compliance and Other Matters

In its audit, KPMG LLP found:

- the financial statements were fairly presented, in all material respects, in conformity with U.S. generally accepted accounting principles;
- no deficiencies in internal control over financial reporting that are considered material weaknesses; and
- no instances of reportable noncompliance with laws and regulations tested.

In connection with the contract, we reviewed KPMG LLP's reports and related documentation and inquired of its representatives. Our review, as differentiated from an audit performed in accordance with generally accepted government auditing standards, was not intended to enable us to express, and we do not express, an opinion on TTB's financial statements or conclusions about the effectiveness of internal control or compliance with laws and regulations. KPMG LLP is responsible for the attached auditors' reports dated December 14, 2012 and the conclusions expressed in the reports. However, our review disclosed no instances where KPMG LLP did not comply, in all material respects, with generally accepted government auditing standards.

Should you have any questions, please contact me at (202) 927-5789, or a member of your staff may contact Catherine Yi, Manager, Financial Audits, at (202) 927-5591.

Attachment

Alcohol and Tobacco Tax and Trade Bureau

# FY 2012 Annual Report

# Table of Contents

# Introduction

Supporting the Nation's economic recovery and ongoing prosperity is at the core of the work performed by the Alcohol and Tobacco Tax and Trade Bureau (TTB). The Bureau's role in permitting and regulating the alcohol and tobacco industries ensures a fair marketplace, enhanced trade opportunities, and a level playing field for those engaged in the manufacture and trade of these commodities. As the Nation's excise tax authority on alcohol and tobacco products, TTB also ensures fair and effective tax administration and enforcement in a globalized marketplace.

As the country continues to recover from the global recession, TTB is focused on supporting the business community it serves by reducing the burden of compliance and addressing the illicit trade that undermines their legitimate operations. In the 10 years since TTB's inception, the industries that the Bureau regulates have continued to expand, evidenced by the 60 percent growth in the permit applications and registrations that TTB receives. Annual tax revenue from the alcohol, tobacco, firearms, and ammunition industries totals more than $23 billion annually, making TTB the third largest tax collection agency in the Federal government. The revenue that TTB collects on these products goes toward funding national priorities.

Maintaining a responsive and effective organization requires Government agencies to look at their business processes and operations anew. TTB, like the businesses its regulates, must continuously look for ways to effect its mandates more efficiently and effectively, leveraging limited resources in smarter and more innovative ways to ensure that the investments made in its mission show a return. Within its FY 2012 Annual Report, TTB combines program performance and financial data to demonstrate how effectively the Bureau translates its program dollars into quality service, responsible management practices, consumer protection, and increased tax revenue.

Each year, as part of the performance and budget cycle, TTB issues this report to inform its stakeholders of the Bureau's accomplishments and explain any challenges. The report defines the Bureau's mission, strategic goals, and major programs, and summarizes its progress in meeting its objectives, as stated in the TTB strategic plan. TTB also presents financial information that depicts how TTB expended its budget according to its major programs, and accounted for tax collections from the alcohol, tobacco, firearms, and ammunition industries.

This report presents this information in four parts:

**Part I – Management's Discussion and Analysis.** This section provides an overview of the Bureau including its mission and programs, highlights of program and financial operations, and a summary of TTB's program performance.

**Part II – Program Performance Results.** This section provides a discussion of results achieved for each performance measure related to the Collect the Revenue and Protect the Public strategic goals and an overview of the Bureau's accomplishments under its Management and Organizational Excellence goal.

**Part III – Financial Results, Position, Condition and Auditors' Reports.** In this section, TTB presents audited balance sheets, statements of net cost, changes in net position, budgetary resources, and custodial activity as of and for the years ending September 30, 2012, and September 30, 2011, and the Independent Auditors' Report on these financial statements. Also included is a report on the Bureau's internal control over financial reporting and a report on TTB's compliance with laws and regulations. This report section also includes a discussion of budget activities for each of the Bureau's seven major programs and supplemental information, such as a history of Federal excise tax collections for the past decade.

**Part IV – Appendices.** This section includes a listing of TTB principal officers, an organization chart, and strategic plan information that demonstrates the relationship between TTB's plan and the overall Department of the Treasury's mission and goals.

# Message from the Administrator

Formed by the Homeland Security Act of 2002, TTB has now completed a generation of its existence and, in that time, has distinguished itself as an innovative agency in the Federal government. Effective application of technology and responsive service to our customer and stakeholders were the hallmarks of our first generation as a Bureau. We will build on these foundations in our efforts to create TTB 2.0—a bureau with a leaner, smarter business model that is driven by data, informed by risk, and focused on improving mission results in both its revenue and trade facilitation roles.

As a tax agency, TTB plays an important role in supporting the financial security of the Nation. TTB has transformed its enforcement program in the past year, refining its approach through advanced risk modeling techniques and by breaking down organizational silos to draw on the complementary skill sets of not only TTB's auditors and investigators, but also our regulatory and trade specialists, chemists, and data scientists. Through the integration of expertise across the Bureau, TTB has improved its ability to identify illegal activity and efficiently pursue enforcement actions. As part of this approach, in FY 2012, TTB deployed joint forensic audit and investigation teams to detect and pursue fraudulent activity in the alcohol and tobacco trade. Working together with other TTB divisions, these teams pursue major cases with nationwide impact to augment our risk-based enforcement plan, enabling TTB to further focus our limited resources on high-risk areas for revenue loss. The TTB enforcement model produces one of the best returns of any tax collection agency, with the Bureau bringing in $449 for every $1 spent on tax collection. In FY 2012, TTB collections on alcohol, tobacco, and firearms products totaled $23.4 billion.

Enforcing the tax code also requires that TTB address tax evasion and the illicit trade in alcohol and tobacco products. The diversion of these products outside legal commercial channels not only represents potentially billions of dollars in revenue loss but also undermines the lawful business activity of taxpaying industry members and provides a well-established source of funding for criminal enterprises. The clandestine nature of this activity makes it difficult to accurately measure the loss in Federal tax receipts; however, in any case where the intrinsic value of a product is dwarfed by its tax value, there is incentive to evade the tax to gain an illegal profit. The recent tobacco tax rate increase, which tripled the tax on cigarettes, serves to enhance the potential for illegal gains.

Addressing this revenue threat requires a visible enforcement presence. In FY 2012, TTB continued its criminal enforcement program, using a $2 million annual appropriation from Congress to acquire and leverage existing law enforcement resources within the Department of the Treasury to enforce the Bureau's criminal jurisdiction. Contracting for agent services has ensured that the investment made by Congress in this criminal enforcement initiative was used to maximum effect, minimizing overhead costs and avoiding duplicative infrastructure.

In just 16 months of active investigations, TTB has opened 48 criminal cases that identified nearly $340 million in tax liabilities. We believe these results are artificially low, both because of the limitations placed on our investigations by the short-term spending authority, and because it does not account for the deterrent impact of our law enforcement presence. Looking ahead, TTB will continue to rely on the successful relationships we have established with law enforcement partners over the past two years to enforce our criminal jurisdiction in the coming year.

As part of its renewed strategic vision, TTB will continue to focus on improving its business results in two of its core service areas–permit and label applications–by enhancing the electronic filing capabilities for industry and evaluating proposals to streamline TTB's processing work without compromising our statutory mandates. Applications for permits continue to rise, increasing a staggering 33 percent in FY 2012, and TTB is making strategic investments in e-Gov solutions to avoid degradation to the level of service provided to the businesses applying for a Federal permit. Delays in issuing permits impede the Nation's economic recovery, as the new businesses that TTB authorizes to operate are predominantly small businesses that contribute to job opportunities locally and to America's competitiveness globally.

TTB is also pursuing long-term solutions to address the continued growth in alcohol beverage labeling applications, which are well above 150,000 annually. Technology enhancements alone will not entirely address the strain on TTB resources, which is why we are working with industry to assess opportunities to streamline this critical line of business to prevent costly delays in receiving TTB's approval. Such delays negatively impact businesses, which must have label approval prior to bottling or introducing their products into domestic commerce. This requires that we reshape our label approval program to facilitate the prompt introduction of products into commerce while maintaining our responsibility to ensure that consumers and industry competitors are protected from deceptive or other illegal labels. Part of our approach requires that we update existing regulations so that they are as clear as possible, and TTB plans to initiate rulemaking in this area in FY 2013.

TTB also plays an important role in the facilitation of the global alcohol trade. The trade in alcohol beverages continues to offer significant opportunities for U.S. businesses in overseas markets, with the export value of wine, spirits, and malt beverages totaling close to $3 billion in FY 2011, a 38 percent increase from 2007. TTB expanded our global network of alcohol and tobacco regulators in FY 2012 by signing a memorandum of understanding with Brazil's National Health Surveillance Agency, a vital ally in addressing the shared challenge of tobacco diversion. TTB continues to engage with regulators from Canada, China, the European Union, France, Italy, Mexico, and the new world wine producers of the World Wine Trade Group—all of which offer important export markets for U.S. producers—through its formal international agreements. These agreements ensure that markets remain open for opportunities for domestic businesses and that illegal activity in international trade is addressed promptly.

As shown in the pages that follow, we have made significant progress over the past year in implementing strategic changes that will improve the Bureau's efficiency without compromising mission results. The path we are on will help ensure that we are effective in accomplishing our mandates, meeting customer expectations, and ensuring that we maximize the dollars entrusted to us.

The Bureau has validated the accuracy, completeness, and reliability of the performance data contained in this report.

John J. Manfreda

John J. Manfreda
Administrator

# Vision, Mission, and Values

## Vision

Our vision is to maintain an organization of people who value each other and who treat each other and their customers with the respect that they deserve. We intend to uphold the laws, for which we are responsible, in a fair, equitable, and appropriate manner, affording all an opportunity to have their opinions heard without prejudice. We intend to carry out our mission without imposing inappropriate or undue burden on those from which TTB collects taxes and those TTB regulates.

## Mission

Collect the Federal excise taxes on alcohol, tobacco, firearms, and ammunition, and assure compliance with Federal tobacco permitting and alcohol permitting, labeling, and marketing requirements to protect consumers.

## Values

We value each other and those we serve. This Bureau:

- Upholds the highest standards of excellence and integrity;
- Provides quality service and promotes strong external partnerships;
- Develops a diverse, innovative, and well-trained workforce in order to achieve our goals; and
- Embraces learning and change in order to meet the challenges of the future.

# TTB Strategic Goals and Objectives

## Strategic Goal: Collect the Revenue

***Industry remits the proper Federal tax on alcohol, tobacco, firearms, and ammunition products***

***Tax Verification and Validation.*** Assure voluntary compliance in the timely and accurate remittance of tax payments

***Civil and Criminal Enforcement.*** Detect and address excise tax evasion and other criminal violations of the Internal Revenue Code in the industries TTB regulates

## Strategic Goal: Protect the Public

***Alcohol and tobacco industry operators meet permit qualifications, and alcohol beverage products comply with Federal production, labeling, and marketing requirements***

***Business Integrity.*** Assure that only qualified persons and business entities operate within the industries TTB regulates

***Product Integrity.*** Assure that alcohol beverage products comply with Federal production, labeling, and advertising requirements

***Market Integrity.*** Assure fair trade practices throughout the alcohol beverage marketplace

## Strategic Goal: Management and Organizational Excellence

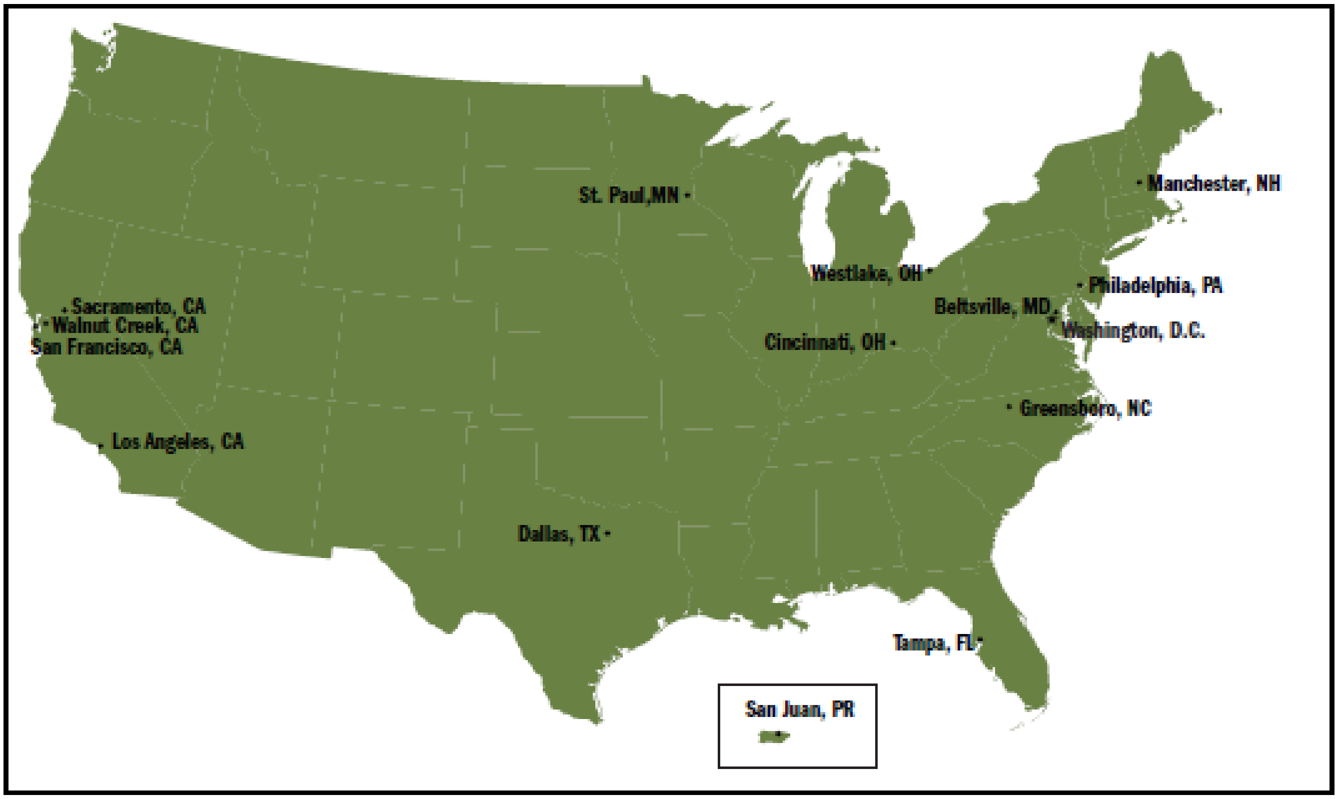
***Effectively managed resources and human capital for maximum performance, efficiency, and program results***

***Human Capital Management.*** Maintain a qualified, engaged, and satisfied workforce

***Technology Solutions.*** Deliver effective, streamlined, and flexible IT solutions that add value and support program performance

***Finance and Performance Results.*** Facilitate strategic management and financial accountability through the delivery of timely and reliable financial and performance information

# TTB Office Locations




| Industry at a Glance | |
|---|---|
| Total TTB Permittees | 61,684 |
| TTB Permittees by Industry Type | |
| *Alcohol* | 96.7% |
| *Tobacco* | 1.5% |
| *Firearms* | 1.8% |
| TTB Permittees Not Subject to Tax | 48,046 |
| TTB Permittees Subject to Tax | 13,643 |
| *TTB Permittes Who Filed and Paid Taxes* | 8,533 |

| TTB at a Glance | |
|---|---|
| Employees | 496 |
| Office Locations * | 17 |
| Budget Authority | $99.9 Million |
| Revenue Collected | $23.4 Billion |
| Original and Amended Permits Processed | 27,363 |
| Certificate of Label Applications Received | 152,741 |

*TTB has some offices co-located in larger cities.

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# PART I
# Management's Discussion and Analysis

## Profile of a Bureau

The mission of the Alcohol and Tobacco Tax and Trade Bureau (TTB) is to collect the Federal taxes on alcohol, tobacco, firearms, and ammunition products, protect consumers from unsafe or improperly labeled alcohol beverage products, and prevent unfair or unlawful trade of alcohol and tobacco products. TTB's diverse mission, and its position as a bureau of the Department of the Treasury, means that TTB must strike a balance between its tax and regulatory functions and its role in facilitating fair and robust economic activity in the alcohol and tobacco trades.

TTB is staffed with approximately 500 employees, most of whom report to either the headquarters office in Washington, D.C., or the National Revenue Center in Cincinnati, Ohio. For its auditors, investigators, and agents to most effectively operate in the field, TTB also has 10 offices in cities across the U.S., as well as Puerto Rico. In recent years, TTB has reduced its physical footprint by converting its auditors and investigators to full-time telework positions; however, the small, strategically located offices that TTB has maintained place the Bureau in close proximity to centers of trade and industry activity, and provide effective launch points for TTB's investigative teams. Additionally, the Bureau has two laboratory facilities in Walnut Creek, California and Beltsville, Maryland. See Part IV of this report for a chart outlining the TTB organizational structure.

The Bureau was formed in January 2003, under the Homeland Security Act of 2002, but its history began more than 200 years ago as one of the earliest Federal tax collection agencies. Today, TTB operates under the authorities of the Internal Revenue Code of 1986 (IRC)[1] and the Federal Alcohol Administration Act (FAA Act),[2] including the Alcoholic Beverage Labeling Act of 1988 (ABLA)[3] and the Webb-Kenyon Act.[4] These laws put in place strict requirements and controls related to alcohol and tobacco products and place restrictions on who can make, sell, and distribute these commodities.

In essence, TTB administers its jurisdiction according to two core mission areas—"Collect the Revenue" and "Protect the Public"—both of which serve to support the Nation's economic recovery by ensuring that the Federal government has the cash resources needed to fund the Nation's priorities and that lawful U.S. businesses are competitive and thriving in the global marketplace.

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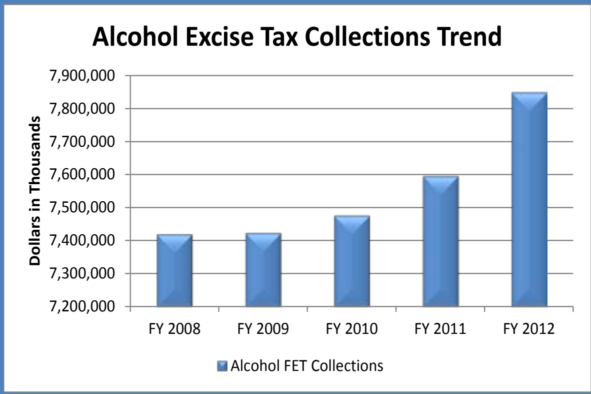
[1] Chapters 51 and 52 of the IRC provide for excise taxation and authorize operations of alcohol and tobacco producers and related industries, and IRC sections 4181 and 4182 provide for excise taxes for firearms and ammunition.

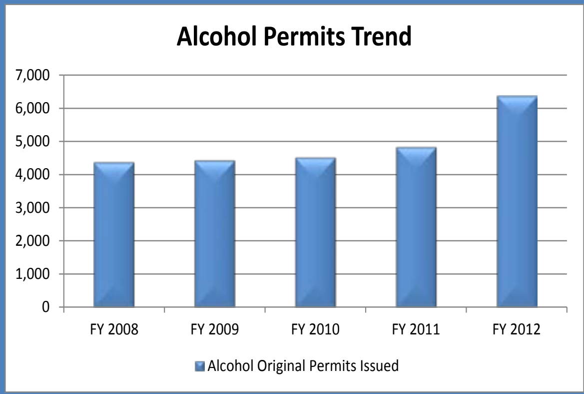
[2] The FAA Act provides for regulation of those engaged in the alcohol beverage industry and for protection of consumers through certain requirements regarding the labeling and advertising of alcohol beverages. The FAA Act also includes provisions to preclude unfair trade practices that serve as barriers to competition and trade in the U.S. marketplace.

[3] The ABLA mandates that a Government warning statement appear on all alcohol beverages offered for sale or distribution in the United States.

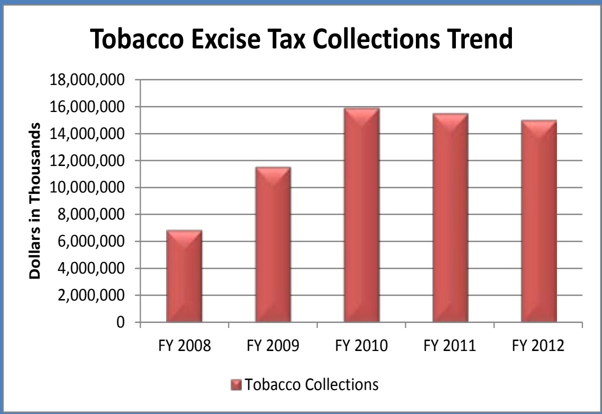
[4] The Webb-Kenyon Act prohibits the shipment of alcohol beverages into a State in violation of the receiving State's laws.

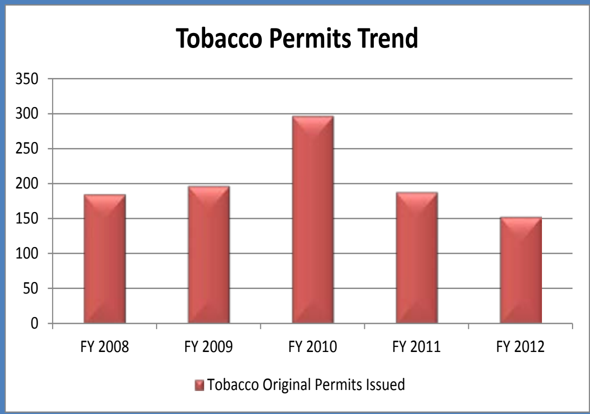
## Alcohol Industry Snapshot



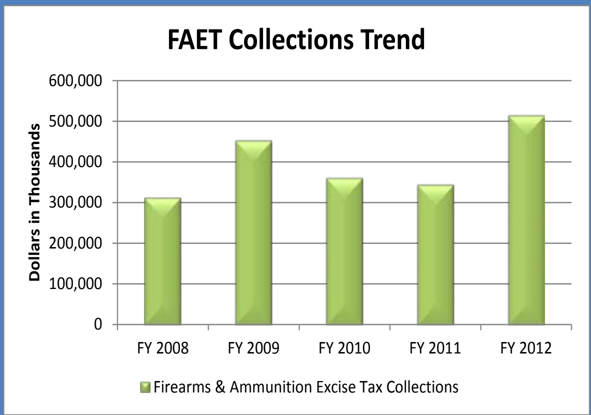



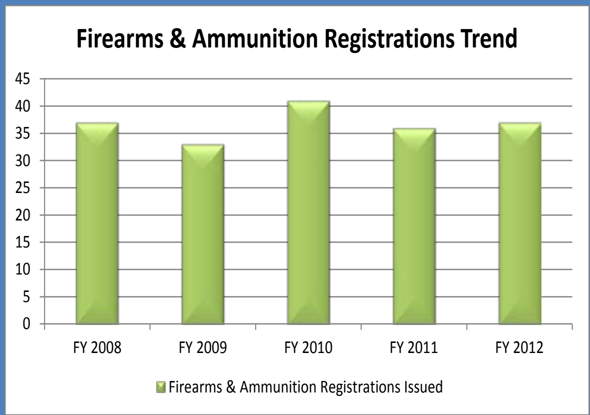

## Tobacco Industry Snapshot



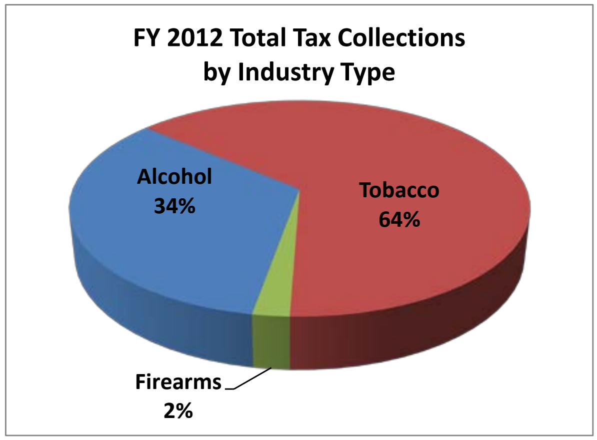

## Firearms & Ammunition Industry Snapshot



## Collect the Revenue

TTB is the third largest tax collection agency in the U.S. Government, behind the Internal Revenue Service (IRS) and U.S. Customs and Border Protection (CBP). In FY 2012, TTB collected $23.4 billion in alcohol, tobacco, firearms and ammunition excise taxes—a decrease of less than a half of 1 percent compared to FY 2011. Prior to 2008, TTB and its predecessor—the Bureau of Alcohol, Tobacco and Firearms (ATF)—collected between $14 - $15 billion in excise taxes annually. Now, for the fourth consecutive year, TTB tax collections have exceeded $23 billion.




TTB excise tax collections reached an historic high of $23.8 billion in FY 2010, principally due to increased receipts from the tobacco industry. With the passage of the Children's Health Insurance Program Reauthorization Act (CHIPRA) in February 2009, Congress imposed significantly increased tax rates on cigarettes and other tobacco products. This legislation provided for a tax increase on all tobacco products (except large cigars), and cigarette papers and cigarette tubes, effective April 1, 2009. In FY 2012, TTB tobacco excise tax collections totaled $15 billion, a decline of 3 percent compared to the prior year. In forecasting tobacco revenues, Federal collections are expected to decline after peaking at $15.9 billion in FY 2010. Higher prices on tobacco products have historically resulted in decreased consumption and increased illicit trade, which combined would indicate declining tax revenues in the out years. TTB efforts in enforcing both its civil and criminal tax jurisdiction support voluntary tax compliance and act to deter illicit trade, and TTB will continue to act to address the revenue threat posed by the diversion of alcohol and tobacco products to ensure the collection of the taxes due.

The alcohol beverage industry in the United States paid $7.9 billion in Federal excise taxes in FY 2012. The Federal excise taxes collected on alcohol beverage products increased 3 percent over the prior year, and economic forecasts predict continued modest growth in the alcohol industry throughout the period of FY 2013 – FY 2014. TTB expects that the increase in alcohol businesses will be driven by new wineries, craft breweries, and craft distilleries.

Firearms and ammunition excise taxes are remitted to the Fish and Wildlife Restoration Fund under provisions of the Pittman-Robertson Act of 1937. The U.S. Fish and Wildlife Service, which oversees the fund, apportions the money to state governments for wildlife restoration and research, and hunter education programs. Federal excise tax collections on firearms and ammunition have increased from $193 million in FY 2003 to $515 million in FY 2012, an increase of $322 million over the past nine years, or a 167 percent growth in Federal FAET revenues. The increase in reported tax revenue can be attributed to industry growth, effective outreach and collection initiatives by the Bureau, and the field presence of TTB's auditors, which continues to promote voluntary taxpayer compliance.

## *Civil Tax Enforcement*

## Tax Classification

The tax rate on alcohol and tobacco products is dependent on a variety of factors, including product type (i.e., wine, spirits, or malt beverage) as well as characteristics of the products themselves, such as composition and weight. A critical first step in tax enforcement is the assignment of a tax class to alcohol and tobacco products based on Federal regulatory standards.

For alcohol beverages, classification requires that TTB review the formula of certain products before they enter the market. For example, if an examination of the formula reveals that an imported sake, which is made from fermented rice and is classified and taxed as wine, contains added spirits, then the product is then classified and taxed as a distilled spirits product. This type of formula review, known as a pre-import approval, can have significant tax implications, as wine is subject to a lower tax rate than spirits products.

TTB also conducts marketplace product evaluations to check for proper tax classification. As an example, TTB evaluates samples of products marketed as large cigars to verify that the products are large cigars rather than cigarettes or small cigars, as the tax rates differ markedly between these products. In classifying such a product for tax purposes, TTB evaluates the product's wrapper, the type of tobacco used in the filler, the product's packaging and labeling, and its weight to verify that the product meets the statutory criteria for a large cigar.

### *Shifting Market Trends due to Tax Rates*

The recent increase in the Federal excise tax rate on cigarettes and other tobacco products highlights the importance of TTB's tax classification activities. In reaction to CHIPRA, some manufacturers took advantage of large disparities in the tax rates, shifting their production toward products that carry lower tax burdens by manipulating the character and composition of their products; in some cases, manufacturers and importers intentionally misclassified the identity and classification of their products to evade taxes. These deliberate manipulations, motivated by the desire to avoid taxes and not by market demand, effectively undermine the dual policy objectives of Federal and state governments when they raise excise tax rates: increased revenues and decreased tobacco use.

Since the excise taxes on cigarettes and other tobacco products increased in 2009, TTB has identified and monitored significant market shifts toward lower-taxed tobacco products by manufacturers and price-sensitive consumers. Prior to CHIPRA, TTB faced enforcement challenges due to the disparate tax rates on cigarettes and small cigars, and the ambiguous statutory criteria for these products. The law created parity in the excise tax rates for these two products, thus resolving this long-time tax enforcement challenge. However, CHIPRA created large disparities in tax rates for other tobacco products, thus presenting new challenges for TTB in appropriately classifying and collecting the taxes due on these products.

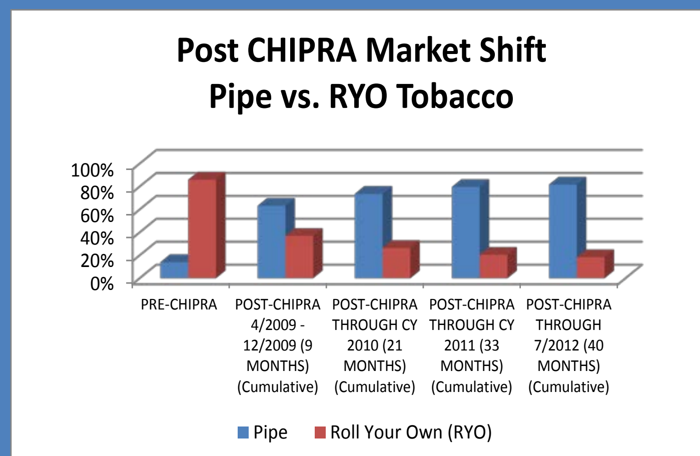
An important trend is the shift in the volume of small cigars to large cigars. Large cigars are the only tobacco product for which the excise tax is based on the manufacturer or importer's sale price; all other tobacco products are taxed at a flat rate based either on the number of units or the weight of the product. The *ad valorum* tax on large cigars can result in significantly lower tax rates on these products, depending on the sale price of the cigar. As a result, since the tax increase on small cigars, TTB has found that manufacturers and importers are increasing the weight of products that TTB had previously evaluated and determined to be small cigars prior to CHIPRA so that they meet the statutory definition of a large cigar.

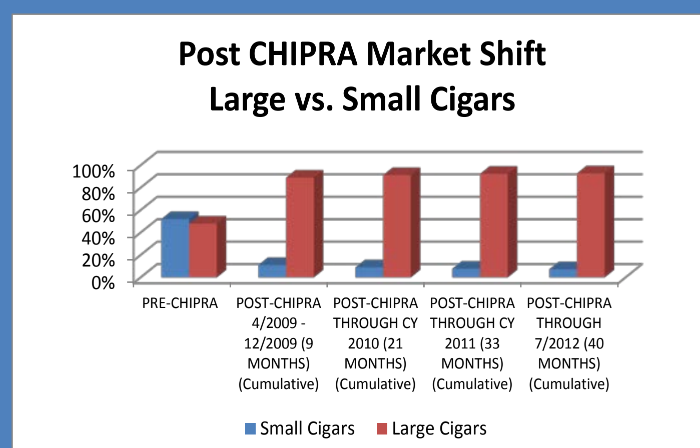
A second trend is the stark shift in pipe tobacco and roll-your-own (RYO) tobacco products, which creates another enforcement challenge due to the lack of clear standards to differentiate the two products.[5] Prior to CHIPRA, the tax rates on pipe tobacco and RYO tobacco were the same at just under $1.10 per pound. As a result of CHIPRA, the tax on pipe tobacco was increased to just over $2.83 per pound, while the tax on RYO tobacco was increased to $24.78 per pound. This significant tax difference resulted in a dramatic increase in the volume of pipe tobacco reported as removed for sale or distribution by domestic manufacturers, with an equally dramatic decrease in the amount of RYO tobacco reported as removed.

Because of the lack of clear standards in the tax code to differentiate pipe tobacco from RYO tobacco, and the consequent potential for misclassification and erroneous tax payment on these products, TTB has undertaken rulemaking on the types of objective standards that would provide a basis for differentiating between these two products for tax purposes. At the same time, the TTB Tobacco Laboratory has been evaluating proposed methods and standards, and undertaking research to develop methods and standards, in support of this rulemaking. The goal is to set forth objective criteria, based on physical characteristics of the products, that distinguish between pipe tobacco and RYO for tax purposes. TTB intends to publish subsequent rulemaking in this area.

## EFFECT OF CHIPRA ON TAXABLE REMOVALS OF TOBACCO PRODUCTS

***Payment of excise tax is due from tobacco manufacturers at the time the product is removed for sale from the manufacturing premises. Since the enactment of CHIPRA, significant shifts in the tobacco products industry developed, particularly in the markets for small and large cigars and RYO and pipe tobacco. An independent review by the Government Accountability Office (GAO) of shifts in tobacco product removals since the tobacco tax rate increase estimates that Federal revenue losses due to market shifts from RYO to pipe tobacco and from small to large cigars could exceed $1.1 billion for the period April 2009 through September 2011.***

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[5] Under the IRC, pipe tobacco is any tobacco which, because of its appearance, type, packaging, or labeling, is suitable for use and likely to be offered to, or purchased by, consumers as tobacco to be smoked in a pipe. RYO tobacco is defined as any tobacco which, because of its appearance, type, packaging, or labeling, is suitable for use and likely to be offered to, or purchased by, consumers as tobacco for making cigarettes or cigars, or for use as wrappers of cigars or cigarettes.

Congress specifically recognized that the differing tax rates applicable to tobacco products can have consequences on both revenue and public health in its passage of the Family Smoking Prevention and Tobacco Control Act (P.L. 111-31), which directed the Government Accountability Office (GAO) to study the cross-border trade of tobacco products. As part of this requirement, GAO reviewed the market shifts in smoking tobacco products since CHIPRA, examined the impact of those market shifts on Federal revenue, and evaluated TTB's actions to respond. In its FY 2012 report, GAO estimated that Federal revenue losses due to market shifts from RYO to pipe tobacco and from small to large cigars range from about $615 million to $1.1 billion for the period April 2009 through September 2011. GAO recommended that Congress consider equalizing tax rates on RYO and pipe tobacco and, in consultation with the Department of the Treasury, consider options for reducing tax avoidance due to tax differentials between small and large cigars. GAO also recognized that TTB has taken steps to respond to these market shifts, including its efforts to differentiate between RYO and pipe tobacco for tax collection purposes, but acknowledged that TTB has limited options.

### *Addressing Revenue Threat from Roll-Your-Own Cigarette Machines*

The tax differential on certain tobacco products also contributed to the proliferation of cigarette manufacturing machines at retail establishments. Following the enactment of CHIPRA, TTB began receiving reports of retail establishments maintaining commercial cigarette-making machines on their premises for customers to use in the manufacture of cigarettes. TTB also received reports that customers were using pipe tobacco, which is subject to a Federal tax rate much lower than that applicable to RYO, to produce lower cost cigarettes. TTB also was approached by individuals interested in purchasing untaxed processed tobacco and reselling that tobacco to retailers for use in the machines.

TTB issued a ruling in September 2010 that defined retailers that engage in this type of activity as manufacturers of tobacco products. The courts enjoined TTB from taking enforcement action until, in July 2012, Congress enacted the Moving Ahead for Progress in the 21st Century Act (H.R. 4348, also known as "MAP-21"), which definitively addressed the legal status of retailers that provide cigarette-making machines to customers. Under MAP-21, any person who for commercial purposes makes available for consumer use a machine capable of making tobacco products (including cigarettes) is a manufacturer of tobacco products under the IRC and, as such, falls under the jurisdiction of TTB. Such manufacturers are required to apply for a permit from TTB, as well as pay Federal excise taxes and comply with other TTB regulatory requirements. Further, in October 2012, TTB issued public guidance that defines a manufacturer of tobacco products and outlines the statutory and regulatory requirements for manufacturers of tobacco products. In FY 2013, TTB will continue its enforcement efforts in relation to the 1,300 cigarette-making machine operating locations identified to date to ensure compliance with TTB permitting and tax requirements.

### *Classifying Non-Traditional Tobacco Products*

In its tax role, TTB also must determine the tax classification of new forms of tobacco products. Some of these new products are a result of market innovation while others are products that are common in other countries but new to the United States. In FY 2012, TTB evaluated a range of non-traditional products, such as a Middle Eastern tobacco product called "dokha" and products labeled as "tobacco-free" tobacco product alternatives.

An emerging product in the United States, dokha appears to be a Middle Eastern pipe tobacco. This and other non-traditional tobacco products present a tax enforcement challenge, as they may be undeclared as tobacco products upon import or misclassified by the importer in order to evade the higher rate of tax. TTB is working with its law enforcement partners at U.S. Customs and Border Protection (CBP) to ensure that this new product is recognized and taxpaid upon import.

TTB also is seeing an increasing number of products labeled as “tobacco-free” produced or imported by companies that TTB regulates. One important initial factor for evaluating these products for tax purposes is determining whether the products actually contain tobacco. If the products do not contain tobacco, the tax would not apply. The TTB Tobacco Laboratory tests these unconventional products to confirm the presence of tobacco. States also rely on TTB for these tobacco verification determinations in their tobacco regulatory and tax enforcement efforts.

As a global authority in the technical analysis of tobacco products, TTB’s scientific expertise is sought after by its international law enforcement partners. In FY 2012, the TTB Tobacco Laboratory provided technical assistance to the Royal Canadian Mounted Police (RCMP) in the investigation and subsequent prosecution of a tobacco excise tax case in Canada. Specifically, the RCMP requested that TTB analyze and confirm the presence of tobacco in six hookah-type products that displayed “No Nicotine, No Tobacco” claims on the packages. TTB’s Tobacco Laboratory has been a government leader in the development of methods and protocols to identify chemical markers unique to tobacco leaf, and was identified by law enforcement officials in this case as the only agency that could perform a “tobacco-free” confirmation analysis.

In the year ahead, TTB will continue to share its scientific and regulatory expertise with other state, Federal, and international agencies to review new and emerging non-traditional tobacco products in the United States market and ensure that they are properly classified and taxpaid. In this vein, TTB also will continue to serve in its leadership role in the North American Tobacco Regulatory Laboratory Network technical forum, organized by TTB chemists and held for the first time in April 2012 at the TTB National Laboratory Center in Beltsville, Maryland. Forty scientists and regulators representing 11 Federal agencies from the United States, Canada, and Mexico participated in the forum to discuss tobacco science in the context of tobacco regulation. The forum establishes a network of laboratories to exchange information on technical regulatory matters, collaborate on testing protocols, develop analytical methods, and build a partnership to proactively address emerging issues on tobacco.

*John Shifflet, Chemist in TTB’s Tobacco Laboratory, speaking to producers and industry representatives during a tour of TTB’s Tobacco Laboratory in Beltsville, Maryland. Scientists and regulators representing Federal agencies from the United States, Canada, and Mexico participated in the tour.*

## Tax Verification

In effecting its revenue mission, TTB uses a coordinated enforcement approach to verify that industry members remit the excise taxes due on the alcohol, tobacco, firearms, and ammunition products sold to U.S. consumers. The Bureau’s auditors, investigators, agents, chemists, and tax and regulatory specialists work jointly to verify and validate that industry members pay the proper amount of tax on these strictly regulated commodities. The strategic risk-based approach used to deploy limited staff resources enables TTB to leverage its field presence to cover a wide universe of taxpayers.

In FY 2012, TTB continued to address revenue risk areas through enhanced risk modeling and increased automation of its investigative targeting models. This included expansion of TTB's use and analysis of its internal and external data for enforcement actions, resulting in the identification of industry members and others that could be involved in diversion and tax fraud.

### *Enforcing Importer Compliance*

Due to the known revenue risk in the import and export trade in tobacco products, and as the Federal permitting authority for tobacco importers, TTB developed a tobacco importer risk model to identify the highest risk tobacco importers operating with a Federal permit. In FY 2012, TTB integrated its tobacco importer risk model into its data analytics platform and implemented upgrades that allow for more real-time targeting of tobacco importers for audit or investigation.

Further, in FY 2012, TTB developed a pilot risk model for alcohol importers. The alcohol importer risk model combines import data from CBP with tax and permitting data from TTB databases to identify potential non-permitted alcohol imports and other anomalies. This model will be used to identify audit candidates in FY 2013 and, based on those results, TTB will evaluate and enhance the accuracy of its model. TTB also intends to explore options to more efficiently update and add external data into its risk models.

In just two years, the Bureau's audits of these businesses resulted in the identification of more than $10 million in additional excise tax liability associated with imported alcohol and tobacco products. TTB has referred these cases to CBP, the agency responsible for collecting the Federal excise tax on imported products. In 2009, CHIPRA extended the statute of limitations to three years for the collection of taxes on imported alcohol and tobacco products. TTB is partnering with CBP's Office of Regulatory Audits (ORA) to ensure that the taxes due on these imported products are collected. During FY 2012, TTB and CBP's ORA agreed to pilot a joint audit of a tobacco importer. Under the pilot audit, TTB and CBP are working together to identify and collect any outstanding tax liabilities identified during the audit. Developing effective relationships with its enforcement partners is critical to TTB's long-term strategy and, following this pilot enforcement initiative, TTB will assess additional opportunities to work with CBP ORA to ensure alcohol and tobacco importer compliance.

### *Addressing the Revenue Risk from Tobacco Processors*

As required by CHIPRA, tobacco processors now report to TTB on the removal, transfer, or sale of processed tobacco. As processed tobacco is untaxed, the diversion of this product outside the lawful distribution chain for use in the illegal manufacture of tobacco products poses a significant revenue risk. In FY 2011, TTB initiated a pilot project to address the identified revenue threat posed by processed tobacco sold to non-permitted manufacturers who did not report or file Federal excise taxes.

There are 30 domestic tobacco processors and approximately 180 importers of processed tobacco who distribute roughly 1.1 billion pounds of processed tobacco to a myriad of brokers, manufacturers, and other tobacco processors. The TTB risk model developed for the pilot project indicated that many of these businesses warranted a joint investigation/audit to determine compliance with TTB laws and regulations. In its first year, this enforcement initiative identified approximately $9 million in additional Federal excise tax due on illegally manufactured tobacco products.

In FY 2012, TTB expanded this enforcement initiative to a nationwide program. TTB conducted field examinations of these manufacturers and importers of processed tobacco, and then conducted subsequent audits and forward traces of suspicious processed tobacco removals outside of the permitted system. As of the close of FY 2012, TTB identified approximately $182.2 million in potential tax liabilities. In the year ahead, TTB plans to increase the number of audits and investigations of manufacturers and importers of processed tobacco, and will explore methods of refining its targeting model to incorporate transactional sales data from domestic tobacco processors.

### *Enforcing the Floor Stocks Tax*

In FY 2012, TTB continued to address the significant revenue exposure that remains from the floor stocks tax (FST) levied on tobacco products under CHIPRA. An FST is a one-time excise tax placed on a commodity undergoing a tax increase, and was imposed on all tobacco products held for sale as of April 1, 2009. The FST is equal to the difference between the new tax rate and the previous rate. As TTB has no regulatory authority over tobacco wholesalers and retailers, the enactment of the FST has presented an ongoing enforcement challenge for TTB as it added approximately 400,000 new taxpayers to TTB's enforcement responsibility. TTB has used a variety of techniques to enforce the FST and ensure collection of the revenue due.

Since its enactment, TTB has continued its FST enforcement efforts based, in part, on findings that many wholesalers and retailers failed to report or underreported their tobacco inventory and associated tax payments. In three years, TTB has completed FST field examinations for many of the largest taxpayers, with findings of more than $15 million and collections of more than $7 million, as well as resulting criminal investigations. However, the number of FST non-filers is so great that existing enforcement resources cannot conduct on-site examinations of the entire population of high-risk taxpayers.

In FY 2012, TTB enhanced its FST non-filer program to pursue tax liabilities at companies where TTB's targeting analysis indicates that FST liabilities still exist, but where it is not cost effective or practical to conduct an on-site examination. The National Revenue Center uses the results of TTB's targeting analysis to initiate a "substitute-for-return" process to issue assessments on the estimated tax liabilities en masse. The IRC allows TTB to create a tax return for a taxpayer where no return has been filed, or where the return that was filed is considered false. In FY 2012, this approach resulted in TTB compliance actions against 188 taxpayers that had failed to file FST, with potential FST liabilities of $22.5 million, plus interest and penalties. In total, the FST non-filer program has resulted in TTB collections in excess of $1.28 million in FY 2012. In FY 2013, TTB will continue collection actions and seek resolution of outstanding FST liabilities identified through the non-filer project.

Additionally, in FY 2012, TTB met with legal representatives for five Native American companies that received non-compliance notifications from TTB, resulting in a settlement with one company for $1 million. TTB continues to work with the remaining four companies to collect inventory and sales records to support the FST amount due.

## *Criminal Enforcement*

TTB is the Federal agency responsible for detecting and addressing Federal excise tax evasion in relation to alcohol and tobacco products. Under its criminal authority, TTB is charged with identifying any gaps in tax payment from entities and individuals manufacturing or selling alcohol and tobacco products outside of the lawful distribution system. By developing leads from TTB's internal data collected through its regulatory mission, government databases, referrals from other Federal and state agencies, and other external sources, TTB is able to identify trends and schemes used to facilitate or engage in tax fraud and diversion.

Although tax losses from diversion are difficult to estimate due to the clandestine nature of the activity, a 2010 Department of the Treasury study of Federal revenue losses from cigarette diversion estimates that tax receipts were diminished by as much as $1.5 billion annually for the years 2005 to 2007 due to smuggling and other criminal diversion activity.[6] At the current tax rate, assuming all other factors remain constant, potential Federal revenue losses from cigarette diversion could be $5 billion annually. In its 2009 review of Federal tobacco tax enforcement efforts, the Department of Justice Office of the Inspector General cited Federal and state government estimates of $5 billion in annual revenue losses resulting from the diversion of tobacco products. [7]

The stakes surrounding diversion enforcement were raised in 2009, however, when Congress roughly tripled the Federal excise tax on tobacco products and, thus, multiplied the potential illegal profits to be gained from tobacco diversion. Since the Federal tax increase, 19 states and the District of Columbia have also raised taxes on cigarettes, further increasing the diversion profit incentive. Historical data establishes that tax increases result in increased profit potential from diversion and, as a result, increased tax evasion. The relationship between tax rates and diversion was specifically recognized in an August 2010 report by the Framework Convention on Tobacco Control[8] when it stated that high tax increases provide financial incentives for diversion of tobacco products from lawful commercial channels, particularly when enforcement and tax laws are weak, penalties are small, and the prosecution process is long.

In recent years, the increased profit motive for cigarette trafficking has resulted in a proliferation of tobacco diversion schemes. A March 2011 Government Accountability Office Report found that there are a wide range of schemes used to evade tobacco excise taxes and fees and described the scope of current diversion activity, which extends to high and low tax states alike, as well as Native lands and other countries.[9] However, the

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[6] "Department of the Treasury Report to Congress on Federal Tobacco Receipts Lost Due To Illicit Trade and Recommendations for Increased Enforcement," U.S. Department of the Treasury, Feb. 2010.

[7] "The Bureau of Alcohol, Tobacco, Firearms and Explosives' Efforts to Prevent Diversion of Tobacco," U.S. Department of Justice, Office of the Inspector General, Report No. I-2009-005, Sept. 2009.

[8] World Health Organization Framework Convention on Tobacco Control, "Price and Tax Policies," FCTC/COP/4/11, Aug. 15, 2010, p. 8, para. 33. The FCTC is the international treaty organization established to address the health and revenue effects of tobacco use and the illicit trade of tobacco products.

[9] "Illicit Tobacco: Various Schemes are Used to Evade Taxes and Fees," U.S. Government Accountability Office, GAO-11-313, March 2011.

diversion of products to evade Federal excise tax is not limited to tobacco. Though TTB has no similar estimates of revenue losses from the diversion of alcohol, criminal case work in FY 2012 indicates that fraud in the alcohol beverage trade poses both a public safety risk and a serious revenue threat.

### *Implementing the TTB Criminal Enforcement Program*

Until FY 2011, addressing criminal activity in the alcohol and tobacco industries required that TTB coordinate with other law enforcement agencies to exercise the Bureau's criminal jurisdiction. Without dedicated special agents to address the evasion of alcohol and tobacco excise taxes, TTB's criminal case referrals were subject to the availability of other law enforcement agencies, which have their own resource limitations and mission priorities.

Recognizing the Bureau's lack of resources to hire special agents and its inability to enforce its criminal jurisdiction without agents, Congress authorized TTB funding in 2010 and 2012 to establish a criminal enforcement program to address tobacco smuggling and other diversion activity. With this funding, TTB entered into an agreement with IRS Criminal Investigation (IRS CI) to obtain criminal investigative services, effectively allowing TTB to leverage the existing law enforcement resources within the Treasury Department to enforce its criminal jurisdiction. This arrangement allowed TTB to engage in operations quickly and bypass certain operational costs, both of which were critical considerations given the short-term nature of the funding.

The complexity of diversion cases requires leveraging all of TTB's enforcement resources to identify, investigate, and successfully prosecute offenders. Recognizing the expertise required to develop these cases effectively, in FY 2012, TTB provided advanced fraud and diversion training to its auditors and investigators and expanded its team-based enforcement approach for major criminal cases with potential nationwide impact. National Response Teams, or NRT, are comprised of auditors, investigators, and intelligence analysts that work collaboratively on cases when TTB suspects that fraud and diversion are present. A total of eight NRT cases were carried out in FY 2012, resulting in successful civil examinations, criminal case referrals, and the identification of more than $75 million in potential excise tax liabilities. TTB will continue its use of NRT in FY 2013 to enhance its criminal enforcement program.

### *Achieving Criminal Enforcement Results*

In its two years of operations, the criminal enforcement program at TTB has produced significant results. Using a small contingent of agents supported by a robust team of forensic auditors, investigators, and intelligence analysts, TTB has opened a total of 48 cases, 27 of which were opened in FY 2012. The total estimated tax liability associated with these 48 cases is nearly $340 million. As of the close of FY 2012, TTB had referred 43 of these cases to an Assistant United States Attorney (AUSA), all of which were accepted for investigation. This unprecedented acceptance rate for criminal referrals demonstrates both the merit and the magnitude of these cases. The success of these investigations reflects the synergy that results from combining experienced civil fraud auditors and investigators who are knowledgeable about the industry with skilled agents to develop criminal cases.

The types of investigations initiated in the two years of TTB's criminal enforcement program are representative of the extensive tax fraud and criminal activity in the illicit alcohol and tobacco trade. The schemes employed to evade excise tax payment include:

- Manufacturing of tobacco products without payment of Federal excise tax
- Cigarette distributors evading tobacco FST
- Cigarette distributors selling “exported” cigarettes in the U.S. without payment of Federal excise tax
- Cigarettes smuggled into the U.S. without payment of Federal excise tax
- Failure to pay Federal excise tax on distilled spirits
- Importation of misclassified distilled spirits to evade Federal excise tax
- Operating without a permit/wholesaling violations
- Importing alcohol without a permit
- False wine labeling and sales of counterfeit wine

Significantly, though criminal cases are often multi-year endeavors, TTB has resolved several cases in its two year of operations. Notably, in FY 2012, three subjects indicted for illegal trafficking of cigarettes, tax evasion, and other related crimes pleaded guilty. This case involved a TTB permittee operating in Florida who evaded approximately $37.5 million in excise tax liabilities through off book manufacturing and sales of cigarettes. The primary defendant in this case was sentenced on October 18, 2012, in United States District Court to 60 months of incarceration and three years of supervised release. He was also ordered to pay $9.4 million in restitution and was ordered to forfeit $19.6 million. Two additional defendants were also sentenced to 30 months and 24 months of incarceration, respectively, and ordered to pay restitution of over $9.4 million for Federal excise taxes, Department of Agriculture tobacco buy-out assessments, and escrow deposits due to states for the tobacco litigation settlement fund.

Of the criminal cases currently under investigation, six subjects entered plea negotiations in FY 2012. These subjects are expected to enter guilty pleas in early FY 2013.

### *Coordinating with Law Enforcement Partners*

In FY 2012, TTB met with AUSAs from the Eastern, Northern, and Western Districts of New York to establish a working relationship for matters of mutual interest in tax enforcement. In these exchanges, both parties exchanged information regarding the current tobacco environment in New York as well as the practical considerations involved with tobacco enforcement on Native lands. Enforcement of Federal excise tax laws on Native American reservations involves the application of Federal revenue laws to activities that occur on tribal lands, which raises issues regarding claims of tribal sovereignty in some cases. These matters are extremely sensitive and have presented difficult enforcement issues based upon existing law establishing that Federal excise tax laws apply on Native American lands.

During the meetings, TTB briefed the AUSAs on ongoing tax enforcement initiatives to ensure that TTB’s efforts will not impede any ongoing criminal investigations. The Northern District AUSA also coordinated a meeting between TTB and an Indian Tribal Nation. This meeting led to an ongoing relationship with the Nation that will assist in our efforts to resolve potential Federal tax matters in FY 2013.

Unlicensed cigarette manufacturing on Native lands continues to be an enforcement problem and, in FY 2013, TTB will continue to work proactively with tribal leaders, Federal law enforcement partners, and the AUSAs to bring all of the illegal operations into compliance or terminate their operations.

# Protect the Public

TTB's public protection mission has broad meaning and is inclusive of activities that directly impact American consumers, such as testing the safety of alcohol beverage products and verifying that label claims are truthful, accurate, and not misleading, as well as work that directly impacts the U.S. economy by facilitating lawful trade and fair competition within the alcohol and tobacco trade. TTB's role in regulating the trade of alcohol and tobacco products ensures consumer confidence in the integrity of the products manufactured in the U.S. and ensures that businesses are operating on a level playing field—key outcomes that promote job growth and a strong economy.

TTB's work in this mission area aligns under three main programs: 1) Permits and Business Assurance; 2) Trade Facilitation; and 3) Advertising, Labeling, and Product Safety. Taken together, these programs ensure the integrity of the businesses that produce and distribute alcohol and tobacco products, the integrity of the alcohol beverage products, and the integrity of the market in which these businesses operate.

## *Business Integrity*

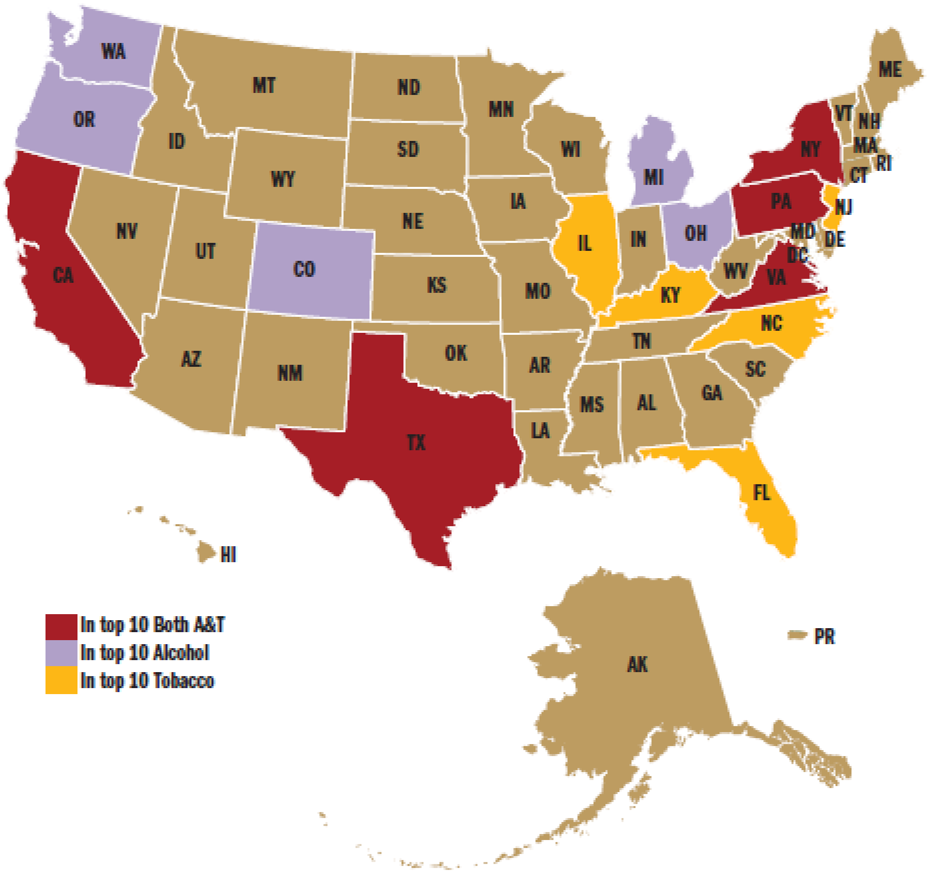
TTB facilitates growth in the U.S. economy by ensuring that only qualified applicants enter business as an alcohol producer, wholesaler or importer, or as a tobacco products manufacturer, importer or exporter. The FAA Act includes provisions to require a permit for those who engage in the business as a producer, importer, or wholesaler of alcohol beverages. The IRC includes similar permitting requirements for tobacco manufacturers, importers, and export warehouses, as well as some alcohol industry members.

The number of applicants filing for an original permit or registration with TTB has grown 50 percent between FY 2008 and FY 2012. Today, the Bureau regulates nearly 61,700 industry members, an increase of 32 percent over the 46,700 permit holders in FY 2008.

Under its FAA Act authority, TTB conducts a multi-tiered background evaluation prior to issuing a permit to ensure that only qualified persons obtain a permit to operate within the regulated industries. Through this process, and other activities under its Permits and Business Assurance Program, TTB prevents prohibited persons from commencing operations and potentially diverting products from legitimate commercial channels in order to fund illicit activity. Given the substantial tax revenue associated with the commodities TTB regulates, the incentive to operate under color of law for illegal purpose and illegal profit is substantial and, therefore, an important area of the Bureau's focus.

In order to make the most effective use of limited resources, TTB applies risk criteria to its review of permit applications and refers the highest risk applications to its investigators for a field inspection. TTB investigators also perform field investigations on a random sample of applicants who received a permit to verify that the business' operations comply with Federal law. If TTB determines that a business is violating the conditions of its Federal permit, TTB may suspend or revoke its permit.

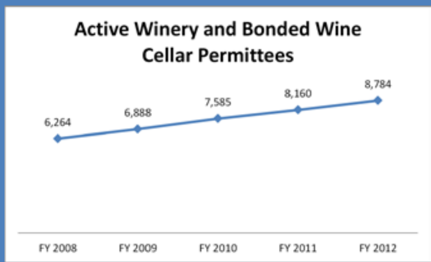
## FY 2012 Permitees by State

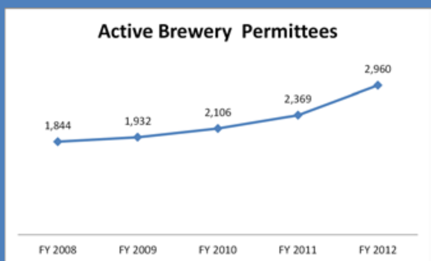



| Top 10 States by Number of Alcohol Permits | |
|---|---|
| State | # Active Permit Holders |
| California | 4,263 |
| Washington | 1,116 |
| Oregon | 674 |
| New York | 586 |
| Texas | 462 |
| Michigan | 403 |
| Pennsylvania | 360 |
| Virginia | 342 |
| Colorado | 318 |
| Ohio | 303 |

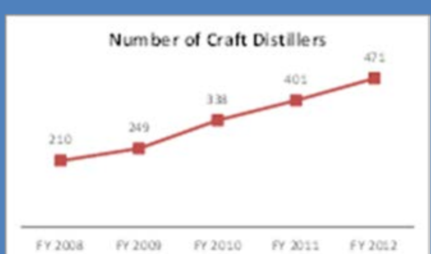
| Top 10 States by Number of Tobacco Permits | |
|---|---|
| State | # Active Permit Holders |
| Florida | 233 |
| California | 95 |
| New York | 75 |
| North Carolina | 71 |
| Texas | 41 |
| Virginia | 34 |
| New Jersey | 33 |
| Pennsylvania | 31 |
| Kentucky | 20 |
| Illinois | 19 |

## ALCOHOL INDUSTRY PERMIT ACTIVITY




*The number of wineries and breweries in the U.S. continues to trend up even during a period of recession in the global economy. Both the number of wineries and breweries has grown significantly since FY 2008, with wineries up 40 percent and breweries up more than 60 percent in a period of 5 years. Breweries increased a remarkable 25 percent compared to the prior year. Market data indicates that growth is strong in the craft brewer segment, which includes microbreweries and brewpubs.*




*Over the last five years, there has been explosive growth in the number of craft distilleries, defined as beverage distilled spirits that taxpaid less than 100,000 proof gallons annually. This segment has increased by nearly 125 percent since FY 2008.*

Efficiency in permit processing is equally critical to support improved economic opportunities for U.S. businesses. Prompt turnaround time for permit application processing enables those who are qualified to hold a Federal permit to begin their operations sooner, facilitating U.S. economic growth in a fair marketplace.

### *Improving Service in Permit Processing*

TTB processes applications for more than 20 types of permits or registrations for the alcohol, tobacco, firearms, and ammunition industries. New or existing alcohol and tobacco industry members must be approved by TTB in order to commence a new regulated industry operation or to update critical permit information, such as a change in location for an existing business. The new businesses permitted by TTB are predominantly small businesses, which contribute to local job opportunities as well as America's competitiveness in the global market.

Over the past several years, the number of permit applications that TTB has received has increased dramatically. The increase in workload volume, combined with declining resources, has made it difficult for the Bureau to maintain prompt processing times. Since TTB's inception in 2003, the permit processing workload has increased 119 percent. In the year between fiscal years 2011 and 2012, TTB's permit processing activity has increased 33 percent. Without intervening action, TTB projected that average processing times would have exceeded 90 days by early FY 2012, compared to 65 days in FY 2010. Not addressing delays in permit issuance would have placed TTB in an obstructive posture at a time when job creation and United States competitiveness abroad are national priorities.

After a year of intensive development, in FY 2011, TTB implemented its electronic permit application system to address these service delivery issues. With the first two releases, in February and April 2011, Permits Online enabled certain industry members—alcohol wholesalers, alcohol importers, wineries, specially denatured alcohol users or dealers, and tax-free alcohol users—to complete and submit permit applications online. These application types account for more than 70 percent of the total number of original permit applications received by TTB. In FY 2012, TTB completed its implementation of Permits Online with a third system release that enabled electronic filing for its remaining high volume permit types: breweries, distilled spirits plants, alcohol fuel plants, tobacco manufacturers and processors, and firearms manufacturers.

Significant system features include online self-registration, self-monitoring of an application's status, and electronically guided assistance through the application process. The built-in prompts and self-help instructions at each step of the application process also ensure that the applications that reach TTB specialists are completed correctly and contain all the required documentation. In FY 2012, TTB added numerous system enhancements to improve both internal processing efficiencies and the ease of use for its customers, including pre-population of certain required fields and streamlined fields for permit amendments.

The impact of Permits Online has been substantial. At year end, the overall adoption rate for Permits Online was 62 percent. This level of electronic filing helped TTB to reduce the average processing time for original applications to 67 days, which represents processing times 7 days faster than the FY 2011 average. The average processing time for all approved permit applications filed in Permits Online was just under 57 days. This improvement is notable given the influx of permit applications in FY 2012 and the decrease in the number of employees processing them.

Going forward, TTB will continue to promote the use of Permits Online and implement enhancements that improve its functionality. Enhancements planned for FY 2013 include the uploading of historical permit information from TTB's legacy permit system to Permits Online, which will allow existing industry members to use Permits Online for filing amendments to their approved permit. As TTB receives more than 18,000 amendments annually, this upgrade will result in efficiencies for both TTB and its regulated industry members. TTB also is working on an initiative that will make available to industry members who obtain their permits through Permits Online an encrypted electronic copy of their application data, which may be provided to state liquor authorities when applying for the equivalent state licenses. If states adopt this program, the application process will be streamlined for applicants as they will only be required to enter certain information once that is needed by both TTB and the states in the permitting process.

### *Importing Tobacco Products without a Permit*

In support of the Bureau's business integrity objectives, TTB monitors compliance with Federal permit requirements among tobacco product importers through a variety of data analysis and investigative techniques.

In FY 2012, through this data analysis, TTB intelligence analysts identified that 13 percent of active tobacco importers in FY 2012 had illegally imported products. TTB responded by issuing cease and desist letters to these importers. These efforts to identify and address compliance violations have proven effective, as all of the importer entities notified by TTB have subsequently complied with their legal obligations or ceased operations, and the overall rate of non-compliance with Federal permit requirements has declined since TTB began tracking this information.

The rate of non-permitted tobacco importers that have declared entries of tobacco products to U.S. Customs has declined since the Bureau initiated this enforcement strategy in FY 2008. During this period, the level of illegal importers has dropped from 22 percent to 13 percent in FY 2012. As tobacco products are often smuggled into the U.S. through undeclared importations, however, TTB must continue to supplement these data mining efforts and to monitor importer activity through audits, investigations, and other intelligence efforts to detect undeclared importations and address the substantial potential tax losses that they represent.

## EURASIAN WINE TRADERS TOUR TTB LABORATORY

***Eighteen producers and industry representatives from the countries of Azerbaijan, Georgia, Moldova, and the Ukraine visited TTB's Beverage Alcohol Laboratory in Beltsville, Maryland, in February 2012. The wine marketing and promotion group toured the Laboratory and received a briefing by TTB chemists.***

***The tour was part of the Department of Commerce's Special American Business Internship Training program (SABIT). The SABIT program provides technical assistance by training Eurasian business leaders in U.S. business practices.***

***TTB participated in this program to explain U.S. import requirements to these producers and industry representatives. TTB has previously met with similar groups through SABIT in January 2010 and January 2011.***

***According to data from the Department of Commerce and the U.S. International Trade Commission, the U.S. imported wine valued at more than $2.31 million from these countries in 2010 (Georgia-$1.1 million; Moldova-$857,000; Ukraine-$239,000; Azerbaijan-$114,000).***

***Meetings like this support Treasury's goal of enhancing U.S. competitiveness by encouraging free trade and open markets and providing direct assistance to developing countries. Further, this work assures that alcohol beverage products comply with Federal production, labeling, and advertising requirements.***

## *Market Integrity*

TTB is charged with assuring that the alcohol marketplace is free from practices that would stifle competition and act as a barrier to trade. Under its Trade Facilitation program, TTB meets this mandate through a variety of activities, ranging from investigations of industry trade practices to engaging foreign counterpart agencies to keep the channels of commerce open and operating in compliance with U.S. and international laws.

TTB's work in this area has direct influence on the Nation's economic recovery. Industry trade association reports[10] state that the alcohol beverage industry contributes directly or indirectly to the U.S. economy by providing nearly 4 million jobs and roughly $400 - $500 billion in economic activity. Overseas demand for the products TTB regulates remains strong, with U.S. exports of all alcohol beverages totaling nearly $3 billion in 2011. The majority of these exports are spirits and wine products.

### *Promoting Fair Competition in the U.S. Marketplace*

As part of its Trade Facilitation Program, TTB has reinvigorated its FAA Act trade practices program to investigate acts that violate Federal law relating to alcohol beverage marketing practices. The FAA Act provisions that TTB enforces require TTB to ensure fair competition in the alcohol beverage trade by not only verifying that persons who engage in the trade are qualified to do so within the meaning of the statute but also by ensuring the trade practices among industry competitors comply with the law. Regulated trade practices entail restrictions involving exclusive

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[10] "*The Impact of Wine, Grapes and Grape Products on the American Economy 2007*," MKF Research LLC; "*The National Trade Association Representing Producers and Marketers of American's Favorite Brands of Distilled Spirits,*" Distilled Spirits Council of the United States; "*Beer Industry Contributes Nearly $200 Billion to U.S. Economy*," Beer Institute and National Beer Wholesalers Association. Economic Impact study conducted by John Dunham & Associates, New York City, using data compiled in 2008.

outlets, tied-house arrangements, commercial bribery, and consignment sales. Unlawful trade practices threaten fair competition because such practices undermine equal access to the marketplace, precluding healthy small business activity, and limit consumer choices by allowing influential producers to unlawfully interfere with the supply chain.

In FY 2012, TTB issued two industry circulars providing guidance to industry members on trade practice prohibitions. TTB issued Industry Circular 2012-01, Guidance Regarding Industry Members' Participation in Retail Programs, to inform all industry members and other interested parties of the Bureau's position regarding participation in retail promotional programs. In this circular, TTB provided guidance on the promotional activities it considers permissible between alcohol beverage suppliers and retailers. This circular was issued following the 2011 settlement of a series of trade practice investigations. As a result of these investigations, the Bureau alleged that certain suppliers violated the tied-house "slotting fee" provisions of the FAA Act by offering inducements to a large casino chain in order to receive preferred shelf and warehouse space. These TTB investigations resulted in offers in compromises from six companies totaling approximately $1.9 million, and marked the largest set of offers in compromise ever accepted by TTB for trade practice violations.

TTB also issued Industry Circular 2012-2, Tie-In Sales, to update its published guidance to reflect current terminology and industry practices. This circular advised alcohol industry members and others that tie-in sales of alcohol beverage products were prohibited inducements under the "Tied-House" provisions of FAA Act. A tie-in sale is a form of unlawful quota sales, and occurs when an industry member requires a retailer to purchase a product that the retailer did not want to purchase in order to obtain the product the retailer wants.

Finally, in FY 2012, TTB successfully brought to resolution a program implemented by an alcohol beverage control state[11] that conflicted with Federal trade practice law. TTB learned that a state's department of liquor control had established a new policy that required alcohol suppliers and wholesalers to include an "exit strategy" for those products that they wanted to sell in the state Alcoholic Beverage Control (ABC) stores. Under the new policy, the supplier was required to "exit" the product if, within one year, the product failed to meet certain criteria established by the state for continued listing in its stores, including sales projections. TTB informed state officials that the exit strategy requirement placed both the state and participating industry members in jeopardy of violating the consignment sales prohibition of the FAA Act, since the sales under this program placed conditions on the purchase of the product and did not represent a bona fide sale. The state's department of liquor control acted to address this issue, and informed TTB that it would eliminate the exit strategy provision.

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[11] A control state has a state monopoly over the wholesaling and/or retailing of alcohol beverages within their state. There are 18 control states in the U.S.

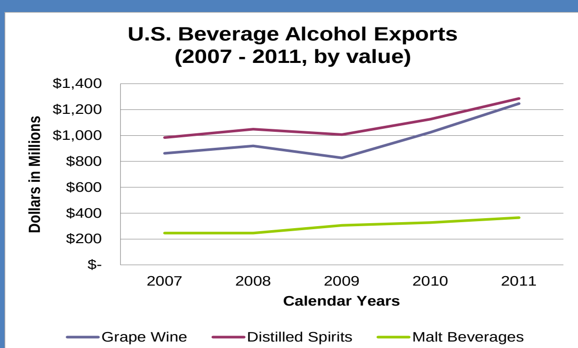
*Facilitating U.S. Penetration into Foreign Markets*

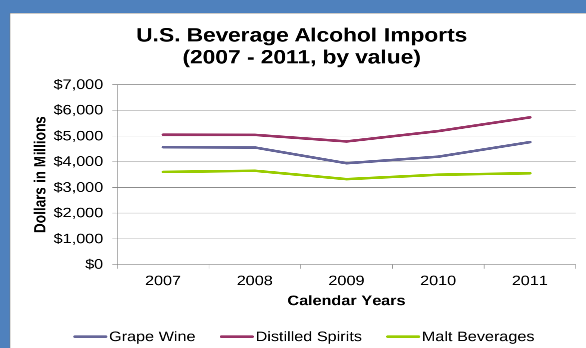
TTB has been actively engaged with U.S. trade officials in facilitating fair and open trade in alcohol beverages to support new opportunities for U.S. businesses in overseas markets. U.S. exports of alcohol beverages totaled nearly $3 billion in 2011, the most recent full year of data available. In line with increases in overall export volume, alcohol beverage exports increased 17 percent compared to the prior calendar year. As the technical expert in these commodities, TTB seeks to promote U.S. exports by facilitating industry compliance with foreign requirements and by working with foreign regulators to address barriers that block market access for U.S. products.

TTB must process certificates for U.S. producers to facilitate export sales because many foreign countries require that shipments be accompanied by a certification from an appropriate government authority prior to allowing entry of the product. This activity affirms the integrity of domestically produced alcohol beverages and supports the U.S. trade policy goal to double exports by the end of 2014, as stated in the Administration's National Export Initiative.

For those countries that maintain a certification requirement, in FY 2012, TTB issued nearly 10,000 export certificates for beer, wine, and distilled spirits. Without these certificates, which are only issued by TTB, U.S. producers of alcohol beverages cannot sell their products in major markets abroad. Through its international outreach and negotiations, TTB has arranged for the elimination or reduction of certification requirements for wine exported to the 27 member states of the European Union, Argentina, Australia, Canada, Chile, Georgia, New Zealand, and South Africa.

## TRENDS IN ALCOHOL BEVERAGE IMPORTS and EXPORTS

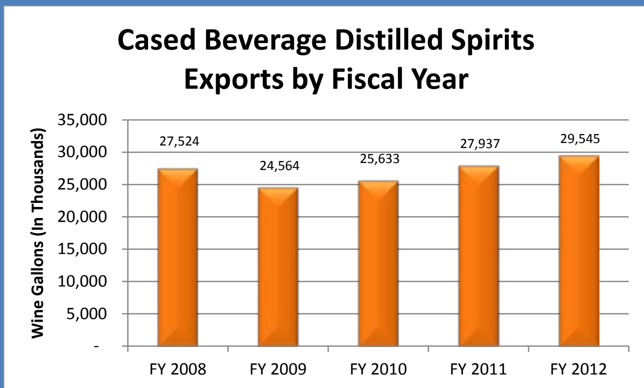


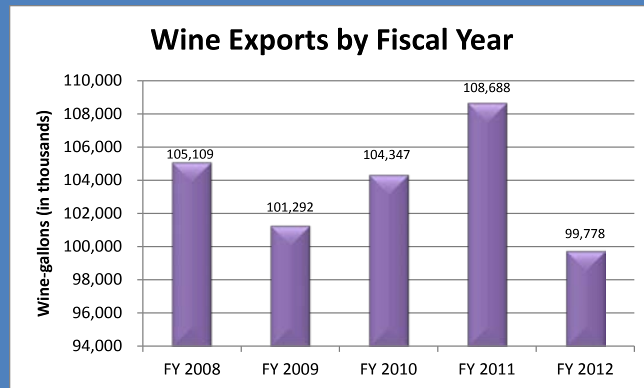




***The value of the commodities that TTB regulates has increased, particularly in regard to wine products. In 2011, for example, global exports of U.S. wine totaled more than $1.2 billion, which represents a 22 percent increase from 2010. With the exception of the 2009 calendar year, exports of wine (by value) have increased each year for the previous five years. Distilled spirits exports reflect a similar trend, though at a more moderate level. Global exports of U.S. spirits totaled more than $1.3 billion in 2011, representing a 14 percent increase over the same period in the prior year. Malt beverage exports also indicate a positive trend, with a consistent increase in exports since 2007.***

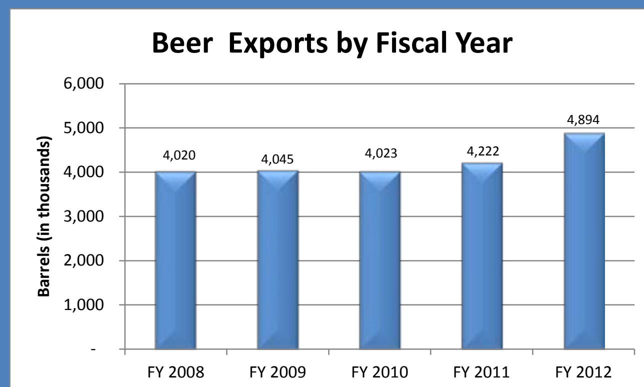
***Imports of beverage alcohol products (by value) in 2011 increased from previous years. From 2010 to 2011, there was a 14 percent increase in wine, a 10 percent increase in distilled spirits, and a 2 percent increase in malt beverages. Statistics indicate a slight decrease in imports from 2008 to 2009, which was also a trend with exports. Distilled spirits and wine imports reached a five-year high in 2011, totaling $5.7 billion and $4.8 billion, respectively.***

## ALCOHOL BEVERAGE EXPORTS



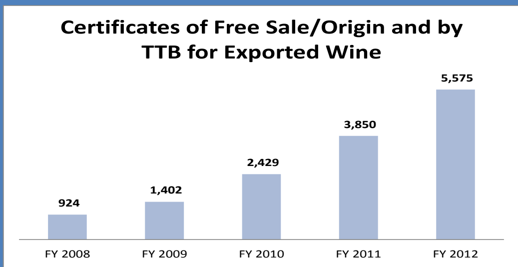


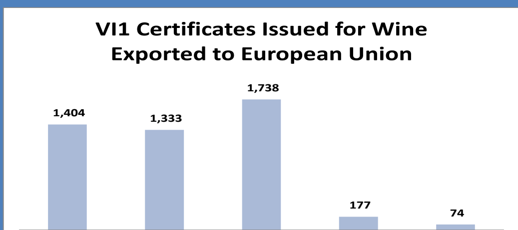


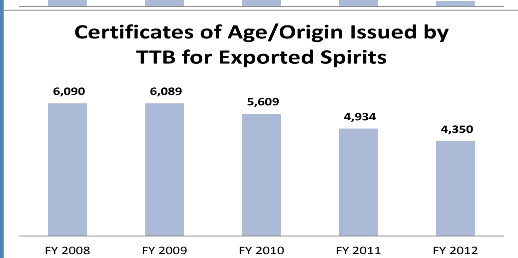

| **Total Exports by Fiscal Year** *(in thousands)* | **FY 2008** | **FY 2009** | **FY 2010** | **FY 2011** | **FY 2012** |
|---|---|---|---|---|---|
| **Beverage Alcohol** | | | | | |
| Beer (barrels) | 4,020 | 4,045 | 4,023 | 4,224 | 4,894 |
| Wine (wine gallons) | 105,109 | 101,292 | 104,347 | 108,688 | 99,778 |
| Bulk Distilled Spirits Exports (proof gallons) | 122,200 | 111,444 | 249,132 | 471,659 | 681,571 |
| Cased Beverage Distilled Spirits (wine gallons) | 27,524 | 24,564 | 25,633 | 27,937 | 29,545 |

| **Percent Change from Prior Year** | **FY 2008** | **FY 2009** | **FY 2010** | **FY 2011** | **FY 2012** |
|---|---|---|---|---|---|
| **Beverage Alcohol** | | | | | |
| Beer (barrels) | N/A | 0.6% | -0.5% | 5.0% | 15.9% |
| Wine (wine gallons) | N/A | -3.6% | 3.0% | 4.2% | -8.2% |
| Bulk Distilled Spirits Exports (proof gallons) | N/A | -8.8% | 123.5% | 89.3% | 44.5% |
| Cased Beverage Distilled Spirits (wine gallons) | N/A | -10.8% | 4.4% | 9.0% | 5.8% |

## TRADE CERTIFICATE PROCESSING




*In FY 2012, TTB issued almost 10,000 export certificates for wine and distilled spirits products. Without these certificates, U.S. producers and exporters of alcohol beverages cannot register or sell their products in many key markets abroad, such as China, the EU, and Japan.*

*TTB's workload in processing export certificates increased by 33 percent between FY 2007 and FY 2011, the most recent five years of data available. Exports of alcohol beverages are on the rise, with wine and spirits exports in 2010 of $2.5 billion, a 37 percent increase from 2007. In order to facilitate the issuance of certificates, TTB now provides an electronic submission option for certificate requests through its Permits Online system.*

*TTB continues to work with U.S. trading partners to eliminate unnecessary or burdensome certification requirements. Export certifications as a whole increased 12 percent between FY 2011 and FY 2012; however, TTB processed 58 percent fewer VI1 forms required for wine exported to the EU.*

TTB's workload in processing export certificates increased by 19 percent between fiscal years 2008 and 2012, reflecting the growth in U.S. wine and spirits exports. Exports of these alcohol beverage commodities increased approximately 38 percent in the last five calendar years, totaling nearly $3 billion in 2011. In order to facilitate and expedite the issuance of certificates, TTB implemented an enhancement to its Permits Online system to enable the electronic submission of certificate requests.

Going forward, TTB will continue to seek agreements with U.S. trade partners to reduce or eliminate certification requirements where possible.

### *Preventing and Addressing Barriers to Trade*

The TTB Trade Facilitation Program also involves identifying and addressing barriers to trade in the international marketplace. TTB is the principal advisor and technical expert for the Office of the United States Trade Representative (USTR) and other Federal agencies in the administration of U.S. alcohol laws, regulations, and policies, and coordinates with these agencies as appropriate in responding to alcohol beverage and tobacco trade issues. TTB provides expert reviews of foreign regulatory proposals impacting the alcohol and tobacco trade to identify and assess the impact of potential trade barriers for U.S. alcohol and tobacco exporters. The USTR estimates that between 10 – 20 percent of new barriers to trade relate to alcohol beverages, and TTB plays a crucial role in the early identification and resolution of these issues.

Members of the World Trade Organization (WTO) are obligated to submit proposed, new, and amended technical regulations to the WTO for review by, and comment from, other WTO members. The notification process prevents new non-tariff trade barriers. TTB participates in the interagency Technical Barriers to Trade (TBT) and Sanitary and Phytosanitary (SPS) Measures Working Group and provides its expertise on alcohol beverage regulations submitted to the WTO TBT Committee. In FY 2012, TTB addressed issues related to alcohol beverage regulations or standards proposed by the EU, India, Russia, South Korea, and Vietnam. For example, the EU proposed regulations seeking exclusive use of traditional terms such as "tawny," "ruby," "reserve," "classic," and "chateau" on wine labels, which the United States views as descriptive and commercially valuable terms that are commonly used by U.S. wine producers. Additionally, Russia proposed regulations on alcohol beverage product safety, warehousing, and tax stamps that present potential barriers to U.S. industry.

In all, during FY 2012, TTB reviewed 34 new regulatory measures submitted to the WTO TBT Committee related to alcohol beverages, and provided comments to the notifying country on the 13 measures that presented potential technical trade barriers for U.S. producers. The measures TTB provided comments on included Colombian technical regulations on alcohol, Ugandan food additives, Dominican Republic technical regulations on alcohol, Brazilian oenological practices, EU requirements for wine, and Central American Customs Union requirements for labeling of distilled spirits.

TTB also participates in Codex Alimentarius committee meetings to prevent this standards-setting organization from adopting new standards that would impede the U.S. export trade in alcohol beverages. The Codex Committee on Food Additives (CCFA) sets the maximum use levels of food additives. In FY 2012, the committee discussed and proposed maximum use levels for several colors, preservatives, and sweeteners in various categories of foods, including alcohol beverages, and proposed maximum use levels were sent to the Codex Commission for endorsement. The committee participants discussed the food categories, including alcohol beverages, where the use of acidity regulators and stabilizing agents were appropriate for inclusion in the General Standard for Food Additives (GSFA). Many developing countries look to the GSFA when setting national legislation and do not allow the addition of additives that are not listed in the GSFA. This practice can lead to trade barriers for U.S. alcohol beverages entering these countries.

Additionally, TTB participates in the Codex Committee on Food Labeling (CCFL). In FY2012, the CCFL discussed non-addition claims for sugar and salt, guidelines for the use of “comparative” claims (i.e., claims of reduced energy or nutrient content, “light” claims, and claims related to trans-fatty acids.

### *Supporting International Trade Agreements for Alcohol Beverages*

TTB also works to address barriers in the international marketplace by participating with other Federal agencies in the negotiation of international trade agreements related to alcohol and tobacco products on behalf of the U.S. Government. In FY 2012, TTB participated with the USTR in three negotiating rounds of the Trans-Pacific Partnership Agreement (TPP). The TPP—a free-trade agreement being negotiated between Australia, Brunei, Canada, Chile, Malaysia, Mexico, New Zealand, Peru, Singapore, Vietnam, and the United States—includes a Wine and Spirits Annex in the chapter on technical barriers to trade. The annex aims to reduce barriers to trade in the regulation of wine and spirits by laying out acceptable procedures in the areas of labeling, identity standards, conformity assessments, compliance periods, and acceptance of oenological practices. Negotiations on this free-trade agreement continued in Auckland, New Zealand, in December 2012.

In FY 2012, TTB also continued its role in the interagency project with the USTR, the USDA Foreign Agricultural Service, the U.S. Department of Commerce, and the U.S. Department of State to establish open dialogue and exchange of information with the Asia-Pacific Economic Cooperation (APEC) economies in support of expanding markets for U.S. exports. This forum is particularly important as emerging markets are creating increasing numbers of technical barriers to trade in alcohol beverages.

APEC is the premier forum for facilitating economic growth, cooperation, trade, and investment in the Asia-Pacific region.[12] The 21 APEC members are: Australia, Brunei Darussalam, Canada, Chile, the People's Republic of China, Hong Kong, Indonesia, Japan, the Republic of Korea, Malaysia, Mexico, New Zealand, Papua New Guinea, Peru, the Republic of the Philippines, Russia, Singapore, Chinese Taipei, the United States, Thailand, and Vietnam. Many of the APEC member economies are emerging export markets for the U.S. wine industry.

TTB worked with APEC economies to streamline and reduce unnecessary certification requirements, as these requirements are a significant burden to U.S. exporters and TTB. During an April 2012 workshop, participants from 26 countries discussed the role that export certificates play in ensuring that imported products are properly regulated and safe, and the ways to reduce barriers posed by certificates or other assurance systems. Moving forward, TTB will continue to work with APEC members to help those economies develop responsible regulatory activity that does not impede trade in alcohol beverages.

Finally, in March 2012, certain provisions of the United States-Korea Free Trade Agreement (FTA) went into effect, including the gradual elimination of Korean import tariffs on alcohol beverage products from the United States. TTB assisted with the initial negotiation sessions of the FTA, providing technical expertise on distinctive product designations for alcohol beverages. In addition, TTB has posted to its Web site a copy of the United States-Korea FTA Certificate of Origin template, a self-certifying document needed to claim the reduced tariff. As part of this effort, and at the request of USTR, TTB published Ruling 2012-1 in January 2012, which established TTB's recognition of Andong Soju and Gyeongju Beopju as geographical designations for certain distilled spirits products from the Republic of Korea. This ruling formalizes the provision in the United States–Korea FTA in which the United States agreed to recognize those products as distinctive products of Korea.

### *Coordinating with Foreign Counterparts to Extend Regulatory Controls*

The global trade in alcohol beverages is active and increasing and, to be an effective regulator, TTB must seek innovative and efficient ways to achieve its consumer protection and revenue collection mission. One key strategy to ensure that U.S. businesses remain competitive on a global scale is through improved communication with our trading partners. TTB's expansion of international agreements has fostered a global network of regulators in the alcohol and tobacco industries that ensure markets remain open and that illegal activity in the global trade is addressed promptly.

In FY 2012, TTB made significant progress on international agreements with multiple counterpart agencies in Brazil and Chile, continued its efforts toward a Memorandum of Understanding (MOU) with Russia, and leveraged its established MOU with France and the People's Republic of China in response to reports of fraudulent or counterfeit wine products. TTB establishes these agreements to facilitate trade by increasing mutual understanding of each country's alcohol and tobacco production, labeling, and licensing requirements, and by providing a process for the exchange of regulatory information that has the potential to impact trade, compliance, and product safety. TTB, working with its trade partners in the World Wine Trade Group (WWTG),

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[12] APEC is an inter-governmental grouping that operates on the basis of non-binding commitments and open dialogue. Unlike the World Trade Organization (WTO) or other multilateral trade bodies, APEC has no treaty obligations required of its participants. Decisions are reached by consensus and commitments are undertaken on a voluntary basis.

also signed an agreement to eliminate routine certification or other reporting requirements for wine products or ingredients that would obstruct free flowing trade.

### *Brazil*

Brazil is an important emerging market for U.S. exporters, but a number of trade barriers remain. Brazil accounted for $294 million in alcohol and tobacco trade with the United States in 2011, and it is the world's sixth largest economy. TTB shares several mutual issues of interest with Brazil in the regulation of alcohol and tobacco products, including joint challenges in preventing the loss of revenue from diversion. Brazil is also an important export market for U.S. alcohol producers, who currently face multiple technical barriers to export trade, such as onerous certificate requirements on a per shipment basis and a lack of clarity regarding labeling regulations.

In August 2012, TTB signed an MOU with the Brazilian National Health Surveillance Agency (ANVISA), a semi-autonomous government agency responsible for exercising sanitary controls over the production and marketing of products and services, including tobacco. The MOU is intended to establish a consistent channel for information exchange regarding imported and exported tobacco products. TTB also participated in the inauguration of ANVISA's pilot laboratory, which will allow it to conduct analyses on tobacco content and emissions. Both agencies identified a number of specific technical areas in which cooperation under the MOU could produce mutually beneficial results.

In FY 2012, TTB built additional relationships with its Brazilian counterpart agencies. In meeting with representatives from the Ministry of Federal Revenue (Receita Federal), TTB learned about Brazil's tax stamp system for tobacco products, which involves a track-and-trace system to ensure proper payment of excise taxes, and a similar system for alcohol beverages. TTB and Receita agreed to consider pursuing an MOU in order to encourage the exchange of information with the intent of preventing revenue losses from tobacco diversion.

TTB also met with the Brazilian Ministry of Agriculture, Livestock, and Food Supply (MAPA), the governmental agency responsible for regulating the labeling and content of imported and domestic alcohol beverages. During the meeting, both agencies provided an overview of the procedures required to provide recognition for each other's distinctive products – Cachaça, in the case of Brazil, and Bourbon and Tennessee Whiskey, in the case of the United States – and also discussed a number of other recent regulatory developments with regard to alcohol beverages. Both agencies agreed to continue discussions on an MOU in order to enhance prospects for trade in alcohol beverages.

### *Chile*

Two-thirds of Chile's wine is exported and the United States is its biggest export market. Since 2007, the United States' imports of Chilean wine have increased by 41 percent. In March 2012, TTB met with the Director of the Servicio Agricola y Ganadero (SAG), Government of Chile, to follow up on TTB's proposal to establish an MOU with SAG. SAG is responsible for ensuring that all wineries in Chile follow domestic and international requirements. TTB discussed the benefits of a TTB-SAG MOU to help ensure that all imported Chilean beverage alcohol products comply with Federal production, labeling, and advertising requirements.

## BRAZIL, U.S. SIGN EXCHANGE OF LETTERS ON DISTINCTIVE PRODUCTS

**TTB participated in a signing ceremony on April 9, 2012, between the United States and Brazil. The U.S. Trade Representative, Ambassador Ron Kirk, and the Brazilian Minister for Development, Industry and Foreign Trade, Fernando Pimentel, signed an agreement in the form of an exchange of letters on distinctive products.**

**As a result of this agreement, the United States agreed to publish a notice of proposed rulemaking (NPRM) that would propose to recognize Cachaça as a type of rum that is a distinctive product of Brazil and propose to eliminate the requirement that Cachaça be labeled as "rum." The NPRM was published in the Federal Register on April 30, 2012.**

**The next step would be for the U.S. to publish a final rule granting official recognition for Cachaça as a distinctive product of Brazil. Brazil has agreed to recognize Bourbon Whiskey and Tennessee Whiskey as distinctive products of the United States within 30 days of the final rule's publication.**

**This exchange of letters creates increased opportunities for U.S. spirits in the Brazilian market and ensures that products in Brazil labeled as Bourbon Whiskey and Tennessee Whiskey reflect their true origin.**

**According to the USTR, in 2011, Brazil was our eighth largest goods trading partner with $74 billion in total trade between the two nations.**

*Fernando Pimente, Brazilian Minister for Development, Industry and Foreign Trade, and Ambassador Ron Kirk, U.S. Trade Representative, sign an agreement in the form of an exchange of letters on distinctive products in Washington, D.C., April 9, 2012.*

### *France*

France, along with Italy, is typically the largest or second-largest source of imported wine in the United States, according to United States trade data. As a result, it is important that TTB develop effective partnerships with the French authorities that have jurisdiction over the production, sale, and labeling of wine so that American businesses and consumers have assurances as to the integrity of products that originate in France. To this end, TTB signed an MOU with France's General Directorate for Competition Policy, Consumer Affairs, and Fraud Control (DGCCRF), which TTB signed on September 1, 2011. In FY 2012, this regulatory relationship served to address an incident of fraudulent wine produced by a French winery. The DGCCRF, in accordance with the MOU, contacted TTB in July 2012 to alert the Bureau to a recently discovered fraud case involving high-end wines from Burgundy. The wine may have been labeled with "inexact" vintage dates and with an appellation of origin designation to which the wine was not entitled. According to the DGCCRF, between one and five percent of the winery's output was affected by the fraud. TTB continues to work with the DGCCRF to obtain additional information about the mislabeled wine, including confirmation of whether any of the mislabeled wine was exported to the United States.

## *China*

The People's Republic of China is an important emerging market for U.S. alcohol beverage exporters and represents the single largest destination country for export certifications processed by TTB. China is also a potential source of counterfeit goods in the global marketplace. Thus, the MOU that TTB established with China's General Administration of Quality Supervision, Inspection and Quarantine (AQSIQ) in 2007 is an important tool used by TTB to promote a stable export market for United States alcohol beverages and a domestic market that is free of counterfeit products. In FY 2012, TTB received reports of counterfeit ice wine produced in China. Under TTB regulations, ice wine sold in the United States must be made from grapes naturally frozen on the vine. Many regions of the United States, including New York, produce ice wine, and counterfeit product places them at a competitive disadvantage. TTB contacted the AQSIQ in accordance with its MOU regarding the counterfeit ice wine reports. TTB also continues to monitor wine imported from China and, to date, has not found counterfeit ice wine in the United States.

## *Russia*

Although Russia is an important emerging market for U.S. exporters, current exports of U.S. alcohol beverage products to Russia are low, in part, because of uncertainties related to Russia's regulations for alcohol beverage products. A functional relationship between TTB and Russia's regulatory authorities on alcohol could prevent or mitigate a number of potential trade problems.

In July 2012, TTB joined its partners in the USTR, USDA Foreign Agriculture Service, and the Department of Commerce to discuss possibilities for engaging with Russia on alcohol beverage trade issues. TTB had previously engaged representatives of Russia's Federal Service for Alcohol Market Regulation (FSR) regarding initiating negotiations for an MOU and, in FY 2012, continued its work with U.S. trade agencies to further its long-term goal of signing a TTB-FSR MOU in order to promote effective regulation of the alcohol market and facilitate compliant trade in alcohol between the United States and Russia.

## *World Wine Trade Group*

The United States is a participant in the WWTG, an informal grouping of government and industry representatives from the wine-producing countries of Argentina, Australia, Canada, Chile, Georgia, New Zealand, the United States, and South Africa.

The WWTG, founded in 1998, aims to share information collaborate on a variety of international issues and endeavors to create new opportunities for wine trade. Since its inception, the WWTG has completed a number of agreements related to oenological practices, labeling practices for wine, and trade certifications, all of which seek to minimize trade barriers and facilitate international trade.

In October 2011, the United States, along with representatives from Argentina, Australia, Chile, Georgia, and New Zealand, signed an MOU on Certification Requirements, which aims to reduce barriers to international wine trade and support exporters of wine in each participating country by encouraging the elimination of burdensome requirements and routine certifications of wine products and ingredients. Under the MOU, the participating countries should not require certification related to vintage, varietal, or regional claims for wine unless they have legitimate concerns about such claims. If certification is necessary, the MOU encourages participants to accept certificates issued by the official certification body or by an officially recognized certification body of the exporting country.

TTB also provided technical advice to USTR during July 2012 negotiations with WWTG related to a second-phase agreement on wine labeling. The parties to the draft agreement would accept the importation of wine that is labeled in conformity with the exporting country's rules on alcohol tolerance, single and multiple grape varieties, single and multiple wine regions, and vintage dates, provided that the wine meets the specified minimum standards. If implemented, the agreement would facilitate trade among the parties by reducing unnecessary labeling-related trade barriers.

TTB also worked in FY 2012 with its WWTG trade partners on additional issues, such as new regulations and oenological practices adopted by member countries, pesticide maximum reside levels, and sustainability issues, including ways to prevent sustainability standards and labeling from becoming technical barriers to trade.

## *Product Integrity*

Consumer confidence is essential to ensuring that U.S. and world economies perform at their full economic potential. TTB is the Federal agency responsible for carrying out provisions of the FAA Act that ensure that labeling and advertising of alcohol beverages provide adequate information to the consumer concerning the identity and quality of the product and to prevent misleading labeling or advertising that may result in consumer deception regarding the product.

This consumer protection function falls under TTB's Advertising, Labeling, and Product Safety Program. Before an alcohol beverage product can be sold in the United States, TTB reviews the product label to ensure that it contains all mandatory information and does not mislead the consumer. In addition, labels are reviewed for compliance with the Alcohol Beverage Labeling Act, the Federal law that mandates that a health warning statement appear on all alcohol beverages offered for sale and distribution in the United States. The approved label application is called a Certificate of Label Approval (COLA).

TTB also conducts a marketplace sampling of alcohol beverages for container content and label compliance through its Alcohol Beverage Sampling Program (ABSP). This involves examining a statistical sample of domestic and imported wine, spirits, and malt beverage products to determine if the labels meet Federal requirements, and the contents of the bottle match the label description. This process also includes a chemical analysis of selected products by the TTB Laboratory for product identification and safety purposes. TTB also reviews advertisements for alcohol beverage products from television, radio, the Internet, and other ad sources for compliance with Federal regulations.

As part of the Bureau's Advertising, Labeling, and Product Safety Program, TTB works to ensure that alcohol beverages meet the standards of identity that their labels reflect and that all ingredients and treating materials are authorized and within the limits set forth under applicable law and regulations. In the event that a food safety or other product integrity issue occurs, the Bureau responds by working directly with the responsible parties and, as appropriate, shares its findings with other regulatory and enforcement agencies and works in partnership to timely resolve the issue.

### *Streamlining the Alcohol Beverage Label Approval Process*

TTB reviews alcohol beverage label applications to fulfill the statutory requirement that bottlers and importers of alcohol beverages have an approved COLA or an exemption certificate before the product enters domestic commerce. The number of applications for label approval that TTB received between fiscal years 2008 and 2012 increased 14 percent. After a drop off in FY 2009, which may be attributable to the economic downturn, the number of label filings trended up again in fiscal years 2010 through 2012. In one year, label applications processed by TTB increased 5 percent. Again in FY 2012, the significant majority of label applications received were for wine products, with the wine industry submitting 80 percent of all label applications processed by TTB.

Due to resource and workload challenges, the Bureau initiated an evaluation of its COLA pre-approval process and alcohol beverage product labeling regulations to focus on ways to streamline operations. TTB adopted a number of changes that will reduce costs to the Bureau and industry, encourage the use of automated processes, help industry to get products to the marketplace faster, and improve service.

TTB began the process of modernizing its alcohol beverage labeling program in FY 2011, and continued its work in FY 2012 by implementing three main initiatives in support of this effort: 1) providing clear guidance to industry, 2) improving its automated label application submission database, and 3) using a stratified random sampling of alcohol beverage products in the marketplace as part of the ABSP to enhance enforcement efforts and establish a tool for tracking compliance. The goal of this streamlining effort is to shift TTB's focus in the labeling area from pre-market approvals to a more useful marketplace review.

As part of this three-pronged approach, TTB continued its efforts to modernize the alcohol beverage labeling regulations in parts 4, 5, and 7 of Title 27 of the Code of Federal Regulations. As part of this process, TTB identified regulations that should be revised to reflect the current alcohol beverage market and industry practices. By modernizing the labeling regulations to remove ambiguity and to remain current with market conditions, TTB anticipates that industry will gain greater understanding of Federal requirements and be more compliant. TTB plans to have a draft notice of proposed rulemaking (NPRM) for revisions to parts 4, 5, and 7 in Bureau review by the end of FY 2012.

TTB also evaluated its current published labeling policies and internal processes to determine if the Bureau could improve the COLA application process to reduce workload for both industry members and TTB. To date, TTB has updated the COLA form and liberalized its list of allowable changes that industry members may make to labels without resubmitting a COLA application. TTB anticipates that, over time, these changes will reduce the number of resubmitted and new label applications. TTB also has amended personalized label guidance to allow industry members to make certain additional changes without resubmitting labels for approval. Further, TTB has relaxed its requirements related to type size requirements on labels and reduced review times by eliminating its review of certain image-related issues on electronically filed label applications.

TTB is continuing to review each practice associated with the label approval process to identify practices that the Bureau may streamline, cease, or enhance.

### *Evaluating Marketplace Compliance through the Alcohol Beverage Sampling Program*

Once alcohol beverages enter the marketplace, TTB monitors labeling compliance through the Alcohol Beverage Sampling Program (ABSP). In FY 2012, for the second year, TTB conducted the ABSP to garner compliance results for all three alcohol beverage commodities (wine, distilled spirits, and malt beverages).

The purpose of the ABSP is to determine the compliance rate of alcohol beverage labels for all products found in the marketplace in a determined period of time. Specifically, TTB seeks to determine the percentage of products that are fully and accurately labeled, i.e., where the label accurately reflects the contents of the bottle. The Bureau accomplishes this by examining a statistically valid sample of alcohol beverages in the marketplace and reviewing the labels and contents of those products. TTB reviews the label of each product included in the ABSP sample to ensure that it contains all legally required information and determines if there is a valid COLA for the product. TTB also chemically tests each product to evaluate whether the label information accurately reflects the content of the container. Based on the statistically valid sample collected by the ABSP, TTB then extrapolates the ABSP findings to make conclusions about all products available in the marketplace during the specific time period.

In FY 2011, TTB expanded the ABSP to include an investigative component, which provided additional "content" compliance information for domestic wine. In FY 2012, TTB continued these efforts, focusing on distilled spirits and malt beverages. TTB investigators performed limited product integrity investigations on certain distilled spirits and malt beverages that were sampled for the ABSP, conducting reviews of proprietors' records to verify the contents of the bottle were accurately represented by the label. Certain claims made on labels, such as vintage date or varietal, require an inspection of production records, as these claims cannot be verified by chemical analysis.

Preliminary data indicates that there is no statistically significant difference between the estimated compliance rates for distilled spirits, malt beverages, and wine between FY 2011 and FY 2012. However, preliminary data indicates that the overall compliance rate for distilled spirits decreased between 2011 and 2012, primarily due to issues with proofing. As in prior years, there was no statistically significant difference between the estimated overall compliance rates for domestic versus imported alcohol beverage products in FY 2012. Significant findings that required TTB intervention included wines that were misclassified for tax purposes. TTB resolved these issues during the course of the ABSP investigation or through follow-up action with industry members.

The Bureau's monitoring of product and label compliance through the ABSP enables TTB to evaluate and ensure the continued integrity of U.S. alcohol beverage products, both in the view of U.S. consumers and TTB's international counterparts, which is critical to gaining foreign market access for U.S. exporters. The complete results of the ABSP for FY 2012 can be found on TTB.gov.

### *Improving Formula Processing with Online Filing Solution*

TTB reviews domestic and imported alcohol beverage formulations and issues formulas, statements of process, laboratory analyses, and pre-import letters. In the last five years, the number of formula applications that TTB has received has grown by an average of nearly 1,500 applications per year, and increased 98 percent since 2008.

As part of TTB's strategy to move its core business services into the online environment, TTB developed and deployed Formulas Online, an electronic filing solution for industry to submit their formulas to TTB for review for regulatory and tax compliance. Formulas Online is a Web-based system that allows external users to draft, submit, and track formula applications for alcohol products. Whether TTB receives paper or electronic formula applications, all submissions are captured in Formulas Online, providing a streamlined process for TTB specialists to view, evaluate, request additional information or corrections, and approve or reject applications.

TTB deployed the first release of Formulas Online in January 2011, which enabled alcohol beverage producers and importers to electronically file their formulae with TTB for approval. The system has built-in validations of the data entered to assist industry in complying with Federal regulations. As part of TTB's ongoing efforts to reduce the regulatory compliance burden, TTB integrated the Formulas Online system with its electronic filing system for label applications, COLAs Online. In FY 2012, after just 20 months in production, TTB received 49 percent of alcohol beverage formula submissions electronically through Formulas Online.

In early FY 2012, TTB released the second phase of Formulas Online, which streamlined the formula submission process for nonbeverage alcohol products. Formulas Online now allows companies to submit drawback and specially denatured alcohol formulas electronically, check the status of submissions, and receive notice of TTB's action in near real-time. Through webinars and significant outreach coordinated with key stakeholders, such as the Flavor and Extract Manufacturers Association, TTB has been able to increase the number of formulae submitted electronically to approximately 60 percent in less than one year.

### *Protecting Consumers from Adulterated and Contaminated Products*

In administering the Advertising, Labeling, and Product Safety Program, TTB also conducts routine analysis of sampled alcohol beverages for ingredients or materials whose presence is prohibited or limited. Examples include thujone and toxic heavy metals. Additional examples include wines that are analyzed to ensure safe levels of pesticides and ochratoxin-A, and malt beverages that are tested for mycotoxins, among other things.

TTB has established an intra-agency Pesticides, Adulterants, and Contaminants (PAC) Task Force to clearly define the steps and procedures TTB will take in response to unsafe ingredients, pesticides, or hazards in any beverage product that TTB regulates. As marketplace findings dictate, TTB coordinates with other Federal agencies, foreign governments, and foreign alcohol beverage producers to address any consumer health hazard.

In FY 2012 the PAC Task Force was called into action when a wine-spirits product was discovered to be adulterated with high levels of copper. The PAC Task Force investigation revealed that the adulterated wine-spirits product had also been used to produce Port wine. TTB investigated the incident in consultation with the Food and Drug Administration (FDA), and determined that the Port was also considered adulterated, pursuant to the FDA's policy that adding "adulterated food" to "good food" adulterates the final product. Both the Port and the clear wine-spirits were voluntarily held by the industry member on its premises until the products could be reconditioned through an acceptable method. TTB continues to coordinate with the FDA to address this issue and assure that U.S. consumers are not at risk of exposure to a health hazard.

Additionally, in FY 2012, TTB received notification that tainted liquor was responsible for killing at least 26 people in the Czech Republic during September 2012. The Czech Government reported that the tainted distilled spirits were counterfeit products distributed through unofficial channels. The counterfeit vodka and fruit-flavored spirits were adulterated with methanol, a poisonous form of alcohol normally used for industrial purposes.

In response to this information, TTB coordinated with its partner agencies—FDA, CBP, and USDA—to take precautionary measures to ensure the safety of American consumers. TTB verified through the Embassy of the Czech Republic that there was no evidence to indicate that tainted Czech distilled spirits products were commercially imported into the United States. TTB verified this information by review its labeling database to identify any products that could potentially be imported from the Czech Republic. Federal law requires a COLA for each unique distilled spirits product imported into the United States to ensure that the product complies with Federal alcohol labeling regulations. Additionally, CBP monitored shipments of distilled spirits from the Czech Republic and worked with TTB when follow-up action was necessary. TTB actively monitors situations such as these and responds appropriately to ensure the safety of U.S. consumers.

## Voluntary Compliance

In its Collect the Revenue and Protect the Public programs, TTB promotes voluntary compliance from the regulated industries through its outreach efforts. TTB employs a dedicated staff of liaisons to provide industry members and states with direct assistance on specific needs or guidance on broader issues affecting the regulated commodities.

### *Supporting Compliance through Outreach and Education*

The Bureau sponsors seminars and workshops to educate industry members on Federal requirements in the areas of manufacturing, marketing, importing, and exporting alcohol and tobacco products, as well as paying tax on alcohol, tobacco, firearms, and ammunition products. In FY 2012, TTB held several Webinars for industry to support increased adoption rates for its new e-Gov filing solutions, Permits Online and Formulas Online. TTB developed and delivered six training Webinars for Permits Online, and developed online tutorials for on-demand access to guidance and tips related to the Federal permit application process. Further, since February 2012, TTB has held seven Formulas Online Webinars in which industry members received virtual training on various aspects of the formula system. TTB customized the sessions held in FY 2012 for commodity-specific audiences. Each of the sessions included a recorded demonstration, review of browser compatibility requirements, registration tips, and guidance on how to submit a formula for malt beverage, wine, and distilled spirits products. In the years ahead, TTB intends to continue to leverage the TTB.gov site and other Web-based capabilities to provide online seminars and tutorials so that industry members will have additional on-demand resources and options to obtain answers related to tax and regulatory compliance.

In FY 2012, TTB continued to raise awareness of the Pay.gov system for filing tax returns and operational reports, an important strategy to improve compliance rates as the system facilitates the submission of complete and accurate filings. A multi-faceted effort was implemented across TTB to promote Pay.gov use, which included outreach at industry events and seminars, system enhancements, and targeted education efforts for industry members that are not yet registered in the system. From a systems and operational perspective, TTB increased the number of TTB tax-related forms available via Pay.gov and streamlined the automatic registration of new industry members. These outreach efforts and system enhancements contributed to increased rates of industry members using the system to electronically submit operational reports and tax returns. At year-end, 22 percent of excise tax returns and 33 percent of operational reports were submitted through Pay.gov, a 1 percent and 5 percent increase over FY 2011, respectively. In FY 2013, TTB plans to address a primary hindrance for industry members in using Pay.gov by enabling the system to accept credit card payments. This enhancement would also address a timing issue that requires those who file electronically to remit tax payments early.

### *Improving Access to Online Guidance*

To support transparency in government and improve customer access to information, TTB implemented several initiatives in FY 2012 that should facilitate industry compliance. In September 2012, TTB launched its new TTB.gov Web site, which includes enhancements that improve the accurate and timely distribution of information from TTB, increase site usability, and provide an improved platform for e-Gov solutions and mobile and Web-based technologies.

In developing its new Web site, TTB researched Web best practices, analyzed Web metrics, and evaluated user feedback to determine optimal content organization. TTB also identified the most visited pages, most popular search terms, and most popular tasks from its prior Web site, and used this data to organize information and develop an intuitive layout for the new Web site.

TTB expects the refreshed TTB.gov site to increase voluntary compliance, particularly for new industry members, and improve usage rates for TTB's online systems, such as COLAs Online, Permits Online, and Formulas Online. The new design should also assist TTB employees in providing quality service to industry members by facilitating access to TTB's policies and procedures, which will help industry members understand and comply with Federal requirements.


Further, as part of its efforts to improve public guidance, in FY 2012, TTB reviewed all of the frequently asked questions (FAQ) on TTB.gov, and revised and updated them as necessary. This project entailed the coordinated review of 116 FAQs published to support industry compliance efforts. TTB intends to publish the revised guidance documents in FY 2013, and to keep these documents and all Web content up-to-date through periodic reviews.

### *Streamlining Regulations to Reduce the Compliance Burden*

TTB also strives to reduce the compliance burden on industry by providing clear regulatory guidance. TTB has a continuous regulations modernization effort underway to ensure that its regulations and enforcement strategy keep up with changes in the industries that it regulates and, in FY 2012, TTB made significant progress in updating its regulations to reflect current practices and conditions.

TTB published an NPRM that proposed revisions to the distilled spirits plant (DSP) reporting requirements in 27 CFR part 19 in FY 2012. This NPRM proposed replacing the current four report forms that DSPs use to report their operations on a monthly basis with two new forms that they would submit monthly, or quarterly if they qualify to file taxes on a quarterly basis. TTB undertook this project to address numerous concerns and desires for improved reporting by the affected distilled spirits industry members and to reduce costs to both the industry and TTB by significantly reducing the number of monthly plant operations reports that DSPs must complete and file, and that TTB must process. TTB received some comments in response to the NPRM that suggested changes to the proposed forms; TTB is considering these comments and coordinating with the appropriate stakeholders to revise its proposal. TTB intends to continue this rulemaking project in FY 2013.

In FY 2012, TTB also continued a rulemaking project to revise the specially denatured alcohol (SDA) and completely denatured alcohol (CDA) formula regulations. SDA and CDA are widely used in the American fuel, medical, and manufacturing sectors. The industrial alcohol industry is far larger than the beverage alcohol industry in both size and scope, and it continues to grow rapidly in the United States. Based upon a determination that certain products present minimal revenue risk, TTB is proposing to reclassify some SDA formulas as CDA and to issue new general use formulas for articles made with SDA so industry members would not need to seek formula approval from TTB as frequently, which would assist industry members in getting their products to the marketplace quickly and efficiently. TTB estimates that this effort will decrease the number of formula submissions required from industry by an estimated 80 percent. These changes would also remove unnecessary regulatory burdens and update the regulations to align them with current industry practice. TTB expects to publish a final rule in FY 2013.

Finally, in FY 2012, TTB drafted a temporary rule that reduces to $1,000 the penal sum for a brewer’s bond in certain low revenue risk contexts. In particular, this rule would apply in instances where both the excise tax liability of the brewer is expected to be not more than $50,000 in the calendar year and the brewer was liable for not more than $50,000 in the preceding calendar year. Under the temporary rule, for a period of three years, the penal sum of the required bond will be a flat $1,000 for brewers filing excise tax returns and remitting taxes quarterly. In a concurrent NPRM, TTB proposes to adopt the $1,000 penal sum amount for the brewer’s bond required for brewers filing quarterly excise tax returns as a permanent regulatory change. This proposed rule also proposes amendments to the regulatory text to require that small brewers file Federal excise tax returns and payments quarterly, and submit reports of operations quarterly. TTB undertook this project because these changes, which are consistent with a legislative proposal contained in the President's Budget for FY 2013, would result in cost savings for small businesses and efficiency savings for TTB. TTB expects to publish the Small Brewer’s Bond Reduction temporary rule and NPRM in the first half of FY 2013.

Moving forward, TTB will continue to modernize its regulations to make positive changes to the regulatory framework, which TTB believes will improve voluntary compliance by industry and significantly enhance TTB’s accomplishment of its mission.

# Performance Summary

## Collect the Revenue

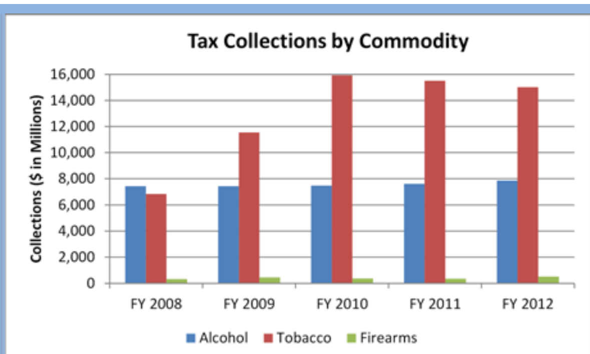
TTB met all of its performance measures under the ***Collect the Revenue*** activity. A detailed summary of TTB performance is discussed in Part II of this report, Program Performance Results.

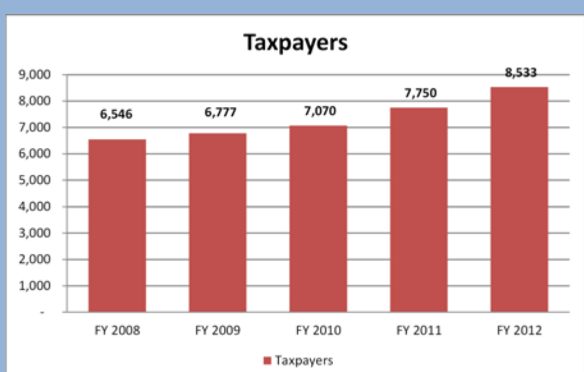
Investments in the Collect the Revenue mission resulted in the following accomplishments in FY 2012:

### *Tax Collection*

- TTB collected $23.4 billion in excise taxes and other revenues from 8,533[13] taxpayers in the alcohol, tobacco, firearms, and ammunition industries. In all, TTB returned $449 for every $1 expended on tax collection activities. Since the tax rate increase on tobacco products took effect, the return on TTB tax collection activities has increased by approximately 42 percent.

- TTB expanded its e-filing capability to allow all excise taxpayers to file and pay taxes, and file monthly operational reports, electronically through the Pay.gov system. The total number of Pay.gov registrants increased by 32 percent in FY 2012, bringing the total to more than 9,500. As registered users increase,




*TTB collected $23.4 billion in tax revenue in FY 2012, a year-to-year decrease of less than one half of 1 percent. Declining tobacco revenues offset the 3 percent increase in alcohol tax collections. TTB tobacco revenue collections reached an historic high in FY 2010 and, as predicted, have undergone a downward trend since the 2009 increase in the Federal excise tax rate as price on tobacco products are closely correlated to consumption patterns and diversion activity. Even with this decline, since 2008, tobacco revenues collected by TTB have increased 119 percent.*

*TTB regulates approximately 61,700 permittees, but only a small percentage file a return and pay taxes in a given fiscal year. The largest segment of TTB permit holders—alcohol importers and wholesalers—do not pay taxes to TTB. Following several years of modest growth, the TTB tax base grew 10 percent for the second consecutive fiscal year. Since 2008, the number of taxpayers has increased 30 percent.*

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[13] About 13,640 TTB permittees were subject to file a tax return and pay excise taxes this fiscal year; however, many operations do not result in the taxable removal of product from bonded premises. Therefore, in FY 2012, a total of 8,533 permittees (63 percent) had operations that required them to file a tax return and pay excise tax.

TTB continued its efforts to promote Pay.gov use through presentations at industry seminars, system enhancements, and improved analytics to target outreach efforts to unregistered industry members. In FY 2012, TTB increased the participation rate of industry members who electronically file operational reports and tax returns and, as of fiscal year-end, 22 percent of excise tax returns and 33 percent of operational reports were filed through Pay.gov, a 1 percent and a 5 percent increase over FY 2011, respectively.

### *Tax Classification*

- The lack of clear standards in the tax code to differentiate certain tobacco products, and the consequent potential for misclassification and erroneous tax payment on these products, presents particular enforcement challenges for TTB. The Children's Health Insurance Program Reauthorization Act of 2009 (CHIPRA) significantly increased tax rates on cigarettes and other tobacco products and highlighted the importance of classification of tobacco products. The law created parity for small cigars and cigarettes to address concerns over misclassification of these products and potential revenue losses; however, CHIPRA introduced disparities in tax rates for small and large cigars and pipe and roll-your-own (RYO) tobacco. These large Federal excise tax disparities among tobacco products create opportunities for tax avoidance, as evidenced by significant market shifts by manufacturers to produce lower tax products and changed purchasing patterns from price-sensitive consumers toward the lower-taxed products.

  In FY 2012, the Government Accountability Office (GAO) studied the market shifts in smoking tobacco products since CHIPRA, and estimated that these shifts have resulted in Federal revenue losses of up to $1.1 billion.[14] GAO recognized that Treasury has taken steps to respond to these market shifts, but has limited options. For example, Treasury has pursued differentiating between RYO and pipe tobacco for tax collection purposes but faces challenges because the definitions of the two products in the IRC do not specify distinguishing physical characteristics. See GAO-12-475 on www.GAO.gov for more details, including GAO recommendations to Congress regarding disparities in the tax code.

- The tax differential on certain tobacco products also contributed to the proliferation of cigarette manufacturing machines at retail establishments. TTB issued a ruling in September 2010 that defined retailers that engaged in this type of activity as manufacturers of tobacco products. The courts enjoined TTB from taking enforcement action until, in July 2012, Congress enacted the Moving Ahead for Progress in the 21st Century Act (H.R. 4348, also known as "MAP-21"), which definitively addressed the legal status of retailers that provide cigarette-making machines to customers. The law clarified that such manufacturers are required to apply for a permit from TTB, as well as pay Federal excise taxes and comply with other TTB regulatory requirements.

- The TTB Tobacco Laboratory analyzed 350 tobacco samples in support of tobacco tax classification, regulatory projects, audits, investigations, criminal diversion cases, and in the development of protocols for counterfeit tobacco product authentication. Year-to-year, the workload in processing tobacco samples remained relatively constant.

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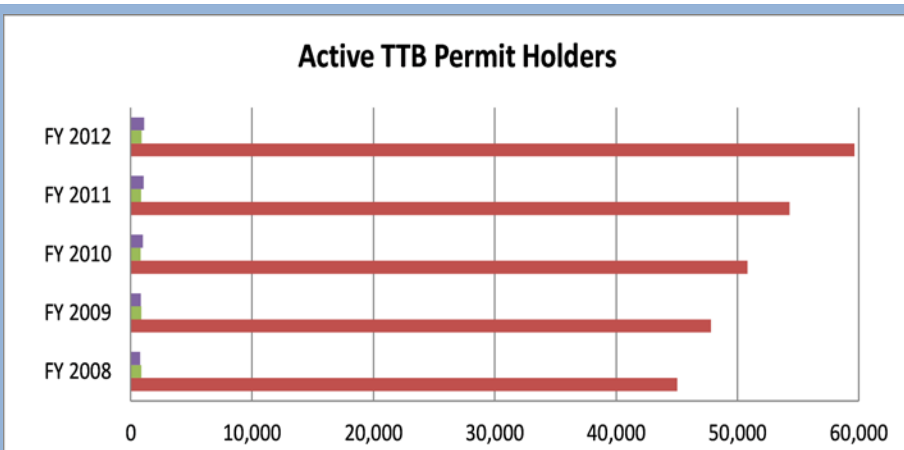
[14] These tax loss estimates cover the period April 2009 through September 2011.

- TTB also analyzes nonbeverage and beverage alcohol samples to assign or verify a tax classification. For this purpose, TTB chemists processed approximately 1,400 specially denatured alcohol formulas and samples to support tax-free alcohol claims. TTB analyzed another 1,300 beverage alcohol samples associated with pre-import evaluation, the 5010 tax credit, and enforcement activities, as compared to 1,200 samples in FY 2011. Pre-import evaluations also serve to protect consumers, as the analytical tests also analyze products for limited or prohibited ingredients.

### *Civil Tax Enforcement*

- During FY 2012, TTB completed approximately 720 audits, examinations, and revenue investigations resulting in $47.7 million in identified tax, penalty, and interest being due, with $11.9 million collected to date.

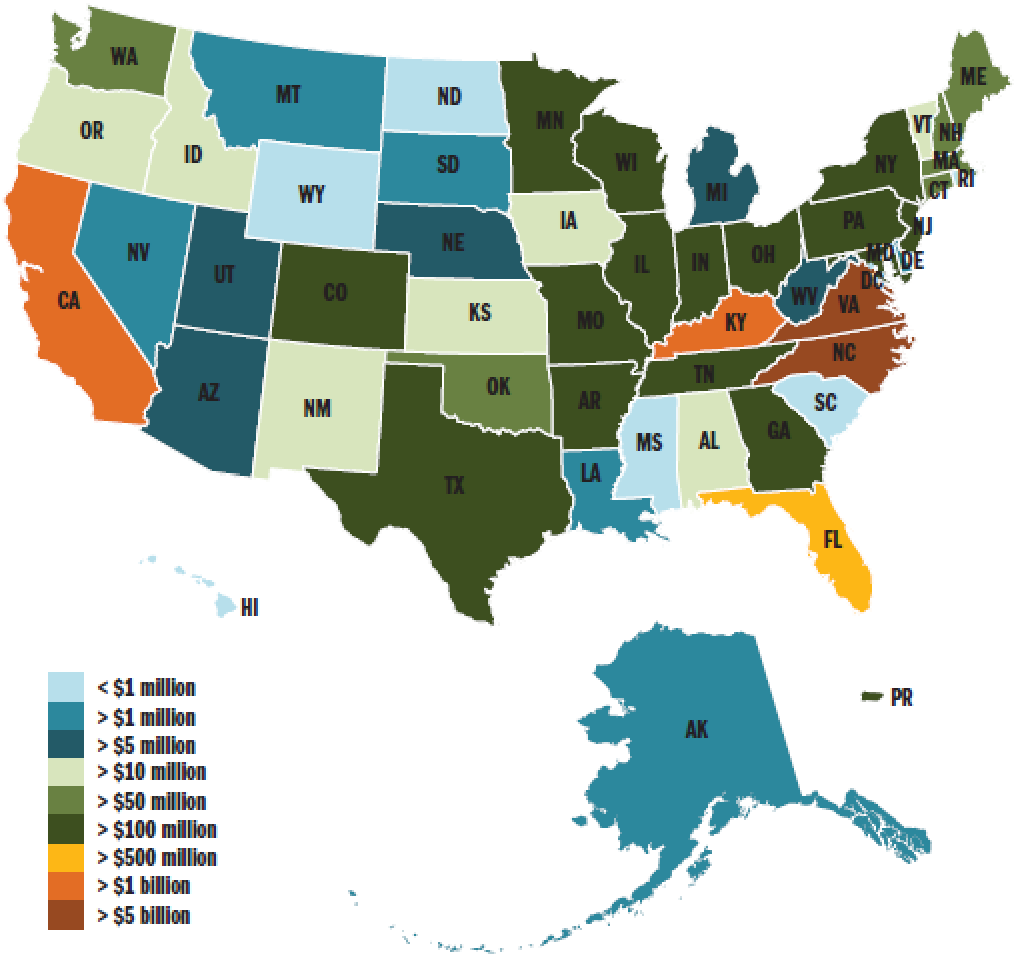
- TTB continued to enforce the collection of the tobacco FST from the manufacturers, importers, wholesalers, and retailers who held tobacco products for sale at the time of the tax rate increase imposed by CHIPRA. In FY 2012, to address the significant revenue risk exposure that remains, TTB developed a national FST automated non-filer project strategy that addresses all FST non-filers, utilizing minimal TTB resources. By combining field analytics with a risk-based assessment approach, TTB identified 188 taxpayers with potential FST liability of $22.5 million, plus interest and penalties. Total FST collections to date are well over $1.2 billion.




| | FY 2008 | FY 2009 | FY 2010 | FY 2011 | FY 2012 |
|---|---|---|---|---|---|
| Firearms | 784 | 855 | 1,012 | 1,071 | 1,126 |
| Tobacco | 883 | 886 | 835 | 857 | 910 |
| Alcohol | 45,018 | 47,818 | 50,823 | 54,289 | 59,653 |

***The total number of active TTB permit holders in the alcohol, tobacco, and firearms industries has increased 32 percent since FY 2008. This year, the number of active permit holders increased 10 percent, much higher than the average annual increase of 7 percent, due principally to the 33 percent increase in active alcohol permittees. Firearms and tobacco permittees also trended up, with 5 and 6 percent increases respectively.***

# FY 2012 TAX COLLECTIONS BY STATE




**States^ with the Largest Percentage Increase in Federal Excise Tax Collections (FY 2008 - FY 2012)**

| State | FY 2008 | FY 2012 | % Increase |
|---|---|---|---|
| AL | $10,092,000 | $59,816,544 | 493% |
| AZ | $1,480,014 | $7,856,253 | 431% |
| VA | $1,688,042,052 | $7,094,472,602 | 320% |
| MI | $2,823,790 | $9,481,759 | 236% |
| OK | $31,871,977 | $102,960,022 | 223% |
| NE | $3,775,403 | $9,430,204 | 150% |

^Includes only those States where industry members remitted more than $5 million in FET.

- Under the CHIPRA legislation, tobacco processors must now obtain a permit and report on the first removal, transfer, or sale of processed tobacco to another entity. There is no requirement that processed tobacco be transferred or sold to a permittee or that subsequent transfers be reported. Consequently, transfers of this non-taxpaid tobacco product carry a high revenue risk. TTB initiated a pilot project in FY 2011 to conduct “forward traces” of processed tobacco from the point of removal by the permittee and discovered that the product was being distributed to non-permitted manufacturers who did not report or file Federal excise taxes. As of the close of FY 2012, driven by a newly developed risk model, TTB auditors and investigators have identified $182 million in potential tax liability, based upon these forward trace investigations.

### *Criminal Tax Enforcement*

- TTB has criminal enforcement authority over the commodities it taxes and regulates. Tax fraud in these industries, whether through unlawful product diversion or other means, poses a high risk to Federal revenue collection. Diversion includes tax evasion, theft, distribution of counterfeit products, and distribution in the United States of products marked for export or for use outside the U.S. TTB entered into a reimbursable agreement with the IRS Criminal Investigation division agent services in FY 2012, to operate a law enforcement program to counteract illicit trade in the alcohol and tobacco industries. In just two years of operations, TTB agents opened 48 cases for investigation, 27 of which were opened in FY 2012. The total estimated tax liability associated with these cases is $336.7 million, with an additional $115.8 million in seizures and forfeitures. As of the close of FY 2012, TTB had referred 43 of these cases to an Assistant United States Attorney, all of which were accepted for investigation.

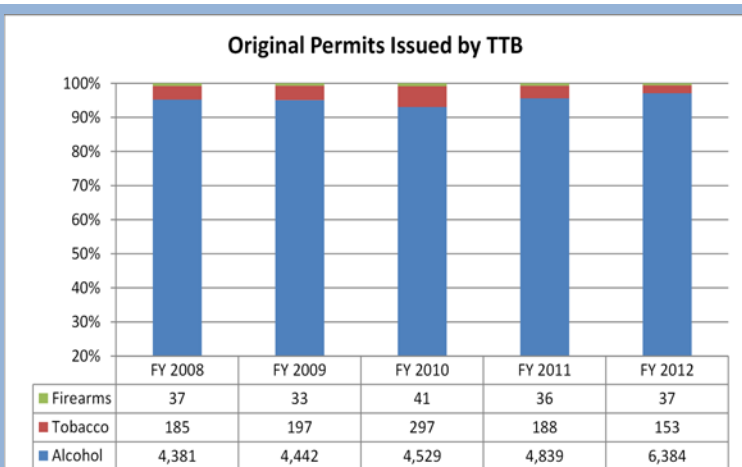
# Protect the Public

TTB met all of its performance measures under the ***Protect the Public*** activity. A detailed summary of TTB performance is discussed in Part II of this report, Program Performance Results.

Investments in the Protect the Public mission resulted in several key achievements during FY 2012:

### *Permitting of Alcohol and Tobacco Businesses*

- TTB issues original and amended permits to persons who are engaged in the alcohol and tobacco industries and, in FY 2012, TTB processed 7,941 original and 19,416 amended permits. Original permit applications have increased 33 percent over last year, the largest annual increase in applications since TTB was established. Since 2004, the average annual rate of increase has been 4 percent.
- TTB managed the increase in applications and achieved improvements in the average processing time for original permit applications through efficiencies gained from its new Permits Online system and other efficacy measures. Fully implemented in FY 2012, Permits Online enables the electronic submission and processing of 19 of the 23 permit types issued by the Bureau, cutting down on both the burden for industry and the manual and administrative processing tasks for TTB. TTB also streamlined its internal processes related to issuing permits, applying risk factors to ensure that high risk applications receive the appropriate scrutiny. These efforts resulted in TTB exceeding its performance target by 11 percent, reducing processing times from 74 days in FY 2011 to 67 days in FY 2012. In total, TTB issued 6,574 permits and registrations to qualified applicants.
- As illicit activity in the alcohol and tobacco industries has the potential to be highly lucrative, it is crucial that TTB prevent criminal operatives from obtaining a permit to engage in the alcohol and tobacco trade through its permit investigation process. In support of this objective, TTB initiated approximately 300 permit investigations to verify that applicants were qualified and not prohibited from engaging in business activity in the alcohol and tobacco industries, and that those operating in these industries were properly permitted and operating in compliance with Federal regulations. TTB also performs post-application investigations to verify that those who were issued a permit in the prior year supplied accurate information on their application and that they are conducting compliant operations.



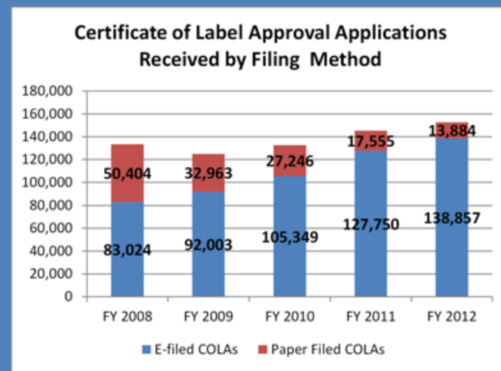

| | FY 2008 | FY 2009 | FY 2010 | FY 2011 | FY 2012 |
|---|---|---|---|---|---|
| Firearms | 37 | 33 | 41 | 36 | 37 |
| Tobacco | 185 | 197 | 297 | 188 | 153 |
| Alcohol | 4,381 | 4,442 | 4,529 | 4,839 | 6,384 |

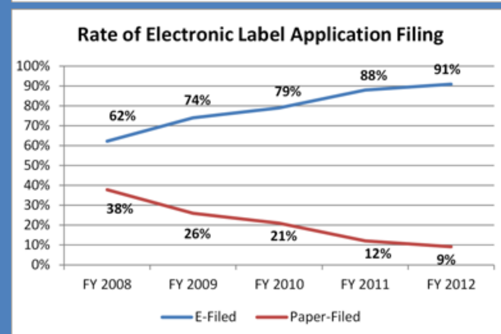
*In five years, the total number of original permits and registrations approved by TTB has grown 43 percent. Between fiscal years 2011 and 2012, the total number of original permits issued increased by 30 percent. This year, TTB approved an additional 1,500 permits compared to FY 2011. Firearms registrations approved by TTB remained relatively constant, while the number of tobacco permits issued continued to trend down, decreasing 19 percent compared to the prior year.*

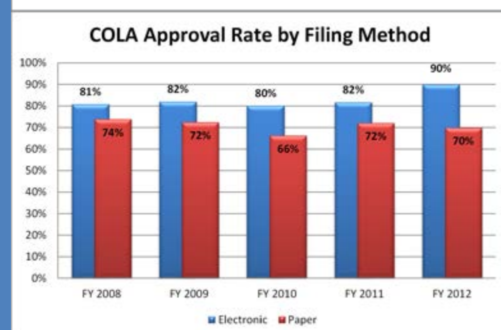
### *Alcohol Beverage Label Approval*

- The number of Certificate of Label Approval (COLA) applications submitted by the alcohol beverage industry and processed by TTB has steadily increased in each of the last three years. TTB approved 134,618 (88 percent) of the 152,741 COLA applications received; the remaining 18,123 (12 percent) were either rejected, returned for correction, withdrawn, expired, or surrendered. The number of COLA applications received increased by 5 percent from 2011.
- TTB made progress in streamlining its labeling program to address the annual workload increases through a revision of its COLA form (TTB Form 5100.31). The most significant change involved the expansion of the list of items that may be changed on an alcohol beverage label without TTB approval. These changes are expected to reduce the number of resubmitted and new label applications. Going forward, TTB will continue to look for similar solutions to reduce regulatory burden and help industry members get their products to the marketplace faster without compromising our mandates under the Federal Alcohol Administration Act. A revision of its labeling regulations, initiated in FY 2012, will mark a major milestone in addressing the operational challenges TTB faces and ensuring the long-term effectiveness of this crucial Protect the Public program.
- Nearly 140,000 (91 percent) of the COLA applications received by TTB in FY 2012 were submitted through COLAs Online, the Bureau's system for the electronic filing of label applications. TTB was successful in increasing the rate of e-filing by 3 percent over the previous fiscal year. The increase in online applications is due in large part to outreach efforts by TTB through educational workshops, improvements to online information, and one-on-one demonstrations to those industry members who are the highest volume label application filers.
- In support of truthful and accurate labeling, as well as tax collection, TTB reviews and approves formulae for

## ALCOHOL BEVERAGE LABEL PROCESSING



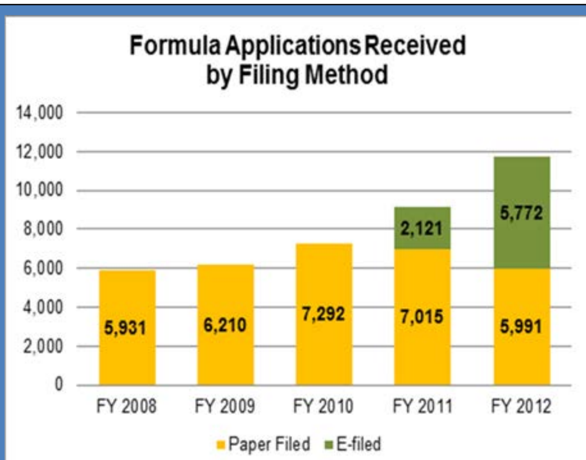

***Between fiscal years 2008 and 2012, the number of alcohol beverage label applications submitted to TTB increased 14 percent. Following a year of 10 percent growth in label applications, the annual increase in COLA submissions in FY 2012 was 5 percent. TTB implemented changes to its labeling program to reduce both the filing burden on industry and the processing burden on TTB that included the expansion of allowable changes to a label that do not require a new COLA. Through targeted education efforts, the Bureau was successful in increasing usage rates for the electronic label filing system by 3 percent, with 91 percent of all label applications submitted electronically.***

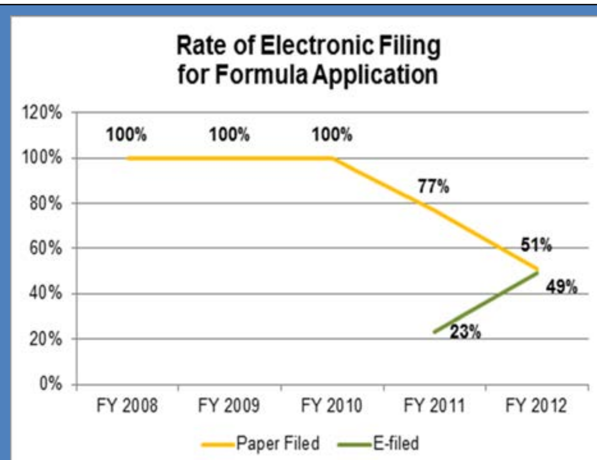
alcohol beverages. Over the period of FY 2011 to FY 2012, formula submissions for domestic and imported alcohol beverage products increased 28 percent, to more than 11,700 submissions. TTB deployed an electronic filing system, Formulas Online, in January 2011 to help manage the workload and prevent erosion in processing times. Formulas Online allows external users to draft, submit, and track formula applications for domestic and imported alcohol beverages, and in just 20 months of operations, has achieved an e-filing rate of 49 percent.

- In FY 2012, TTB rolled out an enhancement to Formulas Online that enabled e-filing nonbeverage alcohol products, such as flavors and specially denatured alcohol products. At year end, TTB was successful in achieving a 60 percent e-filing rate for these formula submissions. The success of the system is due, in part, to outreach efforts. TTB held multiple Formulas Online Webinars to offer training to new users on topics such as system registration; the basics of drafting, submitting, and tracking formula applications; and common pitfalls to avoid when submitting electronic formula applications.

### *Product Safety and Testing*

- In assuring the integrity of alcohol beverage products offered for sale to U.S. consumers, TTB analyzed and reviewed for compliance approximately 650 alcohol beverage products as part of the Alcohol Beverage Sampling Program (ABSP). The ABSP uses statistically valid sampling of products in the marketplace to validate that they are properly labeled to protect consumers. This program enables TTB to be proactive rather than reactive to potential labeling issues or threats to the food supply. Fiscal year 2012 marked the second year that the ABSP was expanded to include all three beverage alcohol commodities in order to produce timely compliance information on an annual basis. TTB also continued its field investigations of the sampled products to verify alcohol beverage label claims, such as grape varietal or vintage, which can only be determined by reviewing production records. In FY 2012, TTB focused its product integrity investigations on distilled spirits and malt beverages. Non-compliance findings in FY 2012 did not present significant tax or consumer safety issues, and TTB took corrective actions as appropriate with the responsible producers or importers. TTB also continued its work with the FDA to resolve an FY 2011 ABSP finding that related to traces of lead found in a rum product. For a full report on the ABSP, please visit TTB.gov.



### *Trade Practice Enforcement*

- As part of its Trade Facilitation Program, TTB has reinvigorated FAA Act trade practices activities to investigate acts that violate Federal law relating to alcohol beverage trade practices. Trade practice violations undermine fair competition within the trade and, thus, artificially influence consumer access to products based upon anti-competitive practices by influential producers. In FY 2012, TTB issued two industry circulars providing guidance to industry members to ensure a level playing field. TTB issued Industry Circular 2012-01, Guidance Regarding Industry Members' Participation in Retail Programs, to inform all industry members and other interested parties of the Bureau's position regarding participation in retail promotional programs. In this circular, TTB provided guidance on its views of several permissible and impermissible activities for industry members who provide promotional support to alcohol beverage retailers. TTB issued Industry Circular 2012-2, Tie-In Sales, to update its guidance related to the use of current terminology and industry practices found in today's marketplace. The purpose in publishing this circular was to remind alcohol industry members and others that tie-in sales of alcohol beverage products are unlawful prohibited inducements under the FAA Act. Both industry circulars are available on TTB.gov.

### *International Trade Facilitation*

- TTB's Trade Facilitation program helps to strengthen the U.S. economy by facilitating import and export trade in alcohol beverage products, while administering the consumer protection standards under its jurisdiction. In FY 2012, TTB made progress on establishing or effectively employing its international agreements with its counterpart agencies in Brazil, Chile, France, China, and Russia. These countries represent important trade partners and major markets for U.S. businesses. These agreements are designed to facilitate trade by increasing mutual understanding of each country's alcohol and tobacco production requirements and labeling and licensing standards, and provide a process for the exchange of regulatory information that has the potential to enhance protection of the revenue or impact product trade, compliance, and safety.
- As the technical expert in these commodities, TTB must process certificates for U.S. producers in order for the producers to be able to export their alcohol beverages to many foreign countries. In FY 2012, TTB issued approximately 10,000 export certificates for beer, wine, and distilled spirits. Without these certificates, which are only issued by TTB, U.S. producers of alcohol beverages cannot sell their products in major markets abroad. Through its international outreach, TTB has arranged for the elimination or reduction of certification requirements for wine exported to 27 Member States of the European Union and participants in the World Wine Trade Group (Argentina, Australia, Canada, Chile, Georgia, New Zealand, and South Africa). In October 2011, TTB and WWTG participants signed an MOU on certification requirements that will facilitate trade by encouraging the elimination of routine certifications or reports for wine products and ingredients. In FY 2012, as part of the United States-China Strategic and Economic Dialogue, an annual meeting of U.S. and Chinese government officials to discuss trade and other economic issues, TTB introduced an agenda item related to the consolidation of the required export certifications that U.S. alcohol beverage exporters submit. Currently, United States exporters send four separate certificates with each shipment in an attempt to meet China's import rules, including the certificates of free sale, origin, health, and sanitation. The U.S. delegation indicated it would follow-up with China's General Administration of Quality Supervision, Inspection, and Quarantine and the General Administration of Customs on the proposed consolidated export certificate for alcohol beverage products shipped to China.

- In FY 2012, TTB continued its coordination with wine regulators from the economies of the Asia-Pacific Economic Cooperation (APEC). APEC is the premier forum for facilitating economic growth, cooperation, trade, and investment in the Asia-Pacific region, and the 21 member countries are emerging export markets for the U.S. wine industry. TTB is leading the effort to produce a compendium of wine labeling, compositional, and pesticide residue requirements, with the goal of increasing transparency for U.S. exporters to facilitate export trade in wine.
- TTB supported the USTR by participating in three negotiating rounds of the Trans-Pacific Partnership Agreement (TPP) held in FY 2012. The TPP—a free-trade agreement being negotiated between Australia, Brunei, Canada, Chile, Malaysia, Mexico, New Zealand, Peru, Singapore, Vietnam, and the United States—includes a Wine and Spirits Annex in the chapter on technical barriers to trade. The annex aims to reduce barriers to trade in the regulation of wine and spirits by laying out acceptable procedures in the areas of labeling, identity standards, conformity assessments, compliance periods, and acceptance of oenological practices.

## AMERICAN VITICULTURAL AREAS

**An American Viticultural Area (AVA) is a delimited grape-growing region having a viticulturally significant name, a delineated boundary, and distinguishing features as described in part 9 of the TTB regulations. Distinguishing features may include climate, geology, soils, physical features, and elevation.**

**An AVA designation allows vintners and consumers to attribute a quality, reputation, or other characteristic of a wine made from grapes grown in an area to its geographic region. The establishment of an AVA allows vintners to more accurately describe the origin of their wines to consumers and helps consumers to identify wines that they may purchase.**

**TTB published 14 AVA-related documents in FY 2012. Seven of those documents established new AVAs, some of which included the Pine Mountain-Cloverdale Peak AVA, the Fort Ross-Seaview AVA, the Naches Heights AVA, and the Coombsville AVA. TTB proposed and subsequently established three AVAs in FY 2012, including the Wisconsin Ledge AVA, the Middleburg Virginia AVA, and the Inwood Valley AVA. Additionally, TTB proposed the establishments of the Ancient Lakes of Columbia Valley AVA, the Elkton Oregon AVA, and the Indiana Uplands AVA. TTB also published a final rule that expanded the boundary of the already existing Russian River Valley and Northern Sonoma AVAs.**

**At the end of FY 2012, TTB and its predecessor agency, the Bureau of Alcohol, Tobacco and Firearms, had established a total of 205 AVAs.**

**TTB also published the new "AVA Manual for Petitioners" in FY 2012. This manual contains frequently asked questions, regulatory requirements for new, modified, and overlapping AVAs, information on how to prepare petitions to establish new AVAs and to modify existing AVAs, as well as tables to help petitioners organize distinguishing feature data.**

***Aerial photographs of the Naches Heights in Yakima Valley, which received TTB approval as a certified American Viticulture Area effective January 13, 2012. Naches Heights is an elevated plateau in Yakima County, Washington, that encompasses 13,254 acres.***

***The new AVA is the fifth appellation located in Yakima County (other county appellations are Columbia Valley AVA, Yakima Valley AVA, Rattlesnake Hills AVA and Snipes Mountain AVA).***

# Financial Summary

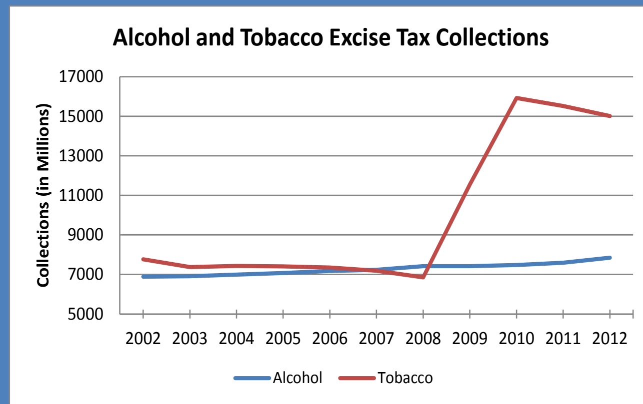
## Federal Excise Tax Collections

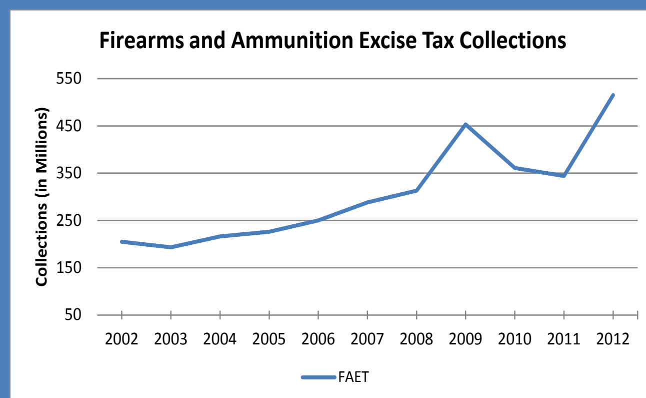
TTB collects excise taxes from the alcohol, tobacco, firearms, and ammunition industries. In addition, the Bureau collects Special Occupational Tax (SOT) from certain tobacco businesses. During FY 2012, TTB collected $23.4 billion in taxes, interest, and other revenues.

Substantially all of the taxes collected by TTB are remitted to the Department of the Treasury General Fund. The firearms and ammunition excise taxes (FAET) are an exception. This revenue is remitted to the Fish and Wildlife Restoration Fund under provisions of the Pittman-Robertson Act of 1937. The U.S. Fish and Wildlife Service, which oversees the fund, apportions the money to State governments for wildlife restoration and research, and hunter education programs.

***FY 2012 Excise Tax Collections:***

| | | |
|---|---|---|
| Alcohol | $ | 7,856,391,000 |
| Tobacco | $ | 15,002,616,000 |
| FAET | $ | 514,622,000 |
| SOT | $ | 249,000 |
| FST | $ | 5,942,000 |
| Other | $ | 61,000 |
| **Total** | **$** | **23,379,881,000** |




*TTB's tax collections for domestic alcohol beverages have shown a relatively stable rising trend for several years. The tax for imported alcohol beverages is collected by U.S. Customs and Border Protection.*

*Tobacco tax revenues in FY 2012 decreased by 3 percent from the prior year. This trend tracks with Congressional Budget Office projections for tobacco tax revenue following the passage of the CHIPRA legislation.*

*Since TTB assumed the responsibility for administering the FAET in 2003, collections have increased 167 percent.*

## Refunds and Other Payments

During FY 2012, TTB issued $709 million in tax refunds and cover-over payments, and drawback payments on taxes paid by Manufacturers of Nonbeverage Products (MNBPs).

### *Cover-over Payments*

Federal excise taxes are collected under the Internal Revenue Code of 1986, 26 U.S.C., on certain articles produced in Puerto Rico and the Virgin Islands, and brought in or imported into the United States. In accordance with 26 U.S.C. 7652, such taxes collected on rum imported into the U.S. are "covered over," or paid into the treasuries of Puerto Rico and the Virgin Islands, less the collection expenses incurred by TTB. During FY 2012, cover-over payments totaled $386 million. Year-to-year, cover-over payments can vary. Cover-over payments to the Virgin Islands decreased 3 percent, while payments to Puerto Rico decreased nearly 17 percent.

### *Drawback Payments*

Under current law, 26 U.S.C. 5134, MNBPs may be eligible to claim a refund of taxpaid on distilled spirits used in their products.

During FY 2012, drawback payments totaled $289 million. In the case of distilled spirits on which the tax has been paid or determined, a drawback is allowed on each proof gallon at the rate of $1 less than the rate at which the distilled spirits tax had been paid or determined. The refund is due upon the claimant providing evidence that the distilled spirits on which the tax has been paid or determined is unfit for beverage purposes, or was used in the manufacture of medicines, medicinal preparations, food products, flavors, flavoring extracts, or perfume. The claimant must submit a product formula to the TTB laboratory for analysis and approval of the nonbeverage claim. To assess drawback claims, the TTB Laboratory analyzed approximately 10,000 formulas and samples in FY 2012.

***FY 2012 Excise Tax Refunds:***

| | | |
|---|---|---|
| Alcohol and Tobacco Excise Tax Refunds | $ | 30,293,000 |
| Cover-over Payments, Puerto Rico | $ | 376,373,000 |
| Cover-over Payments, Virgin Islands | $ | 9,337,000 |
| Drawbacks on MNBP Claims | $ | 289,330,000 |
| Interest and Other Payments | $ | 3,824,000 |
| **Total** | **$** | **709,157,000** |

# FY 2012 Bureau Budget

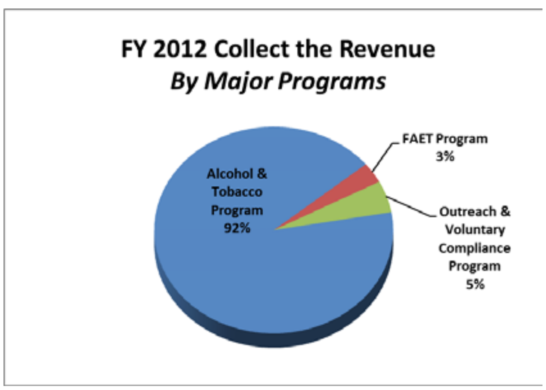
## Direct Appropriations (Salaries & Expense Account)

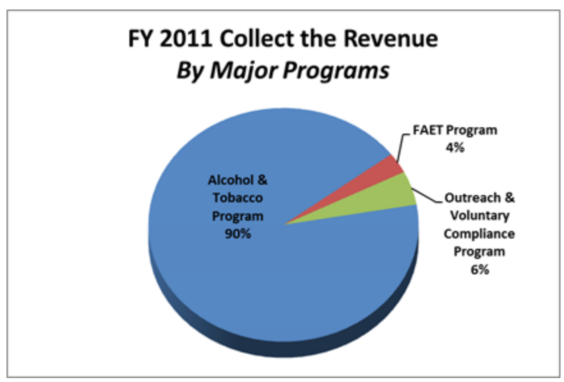
The TTB budget authority for appropriations received in FY 2012 from the salaries and expense account was $99,878,000. This amount included $2 million for the costs of special law enforcement agents to target tobacco smuggling and other criminal diversion activities. TTB elected not to hire the agents directly, but to enter into an interagency agreement with the Internal Revenue Service Criminal Investigation office to conduct criminal investigations into violations of the tax laws TTB enforces. The authorized full-time equivalent (FTE) staffing level for direct positions was 496.

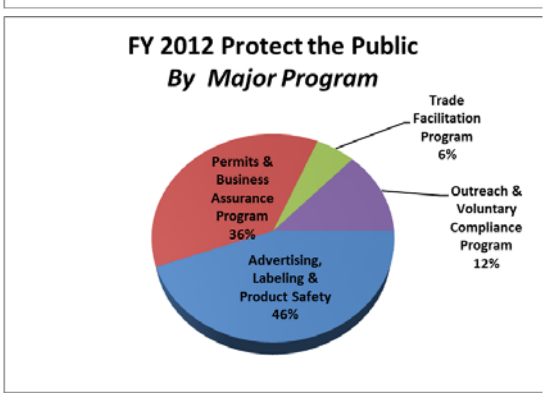
## Offsetting Collections and Reimbursable Accounts

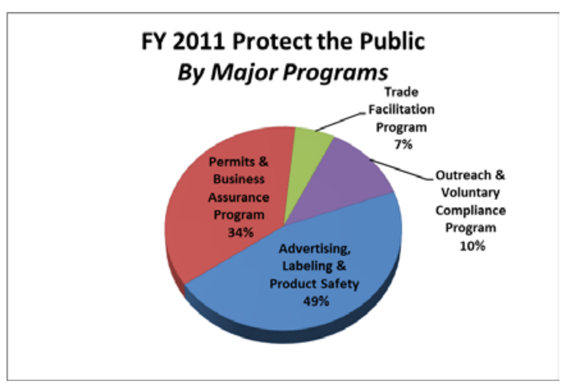
During FY 2012, the Bureau realized spending authority in the amount of $6.8 million, which includes offsetting collections and changes in unfilled customer orders. Those funds originated from multiple sources including recoveries from the operation of the cover-over program and other enforcement activities in Puerto Rico, and funding from the Department of the Treasury's Executive Office of Asset Forfeiture to cover investigative expenses; and funding from the Community Development Financial Institutions Fund (CDFI) for reimbursement of information technology support services.

## Obligations and Expenditures by TTB Program




*The Bureau's expenditures by its major programs remained relatively consistent between fiscal years 2011 and 2012.*

## Audit of TTB's FY 2012 Financial Statements

The Department of the Treasury is one of 23 Federal agencies that are required by law to produce annual audited financial statements. TTB's financial activities are an integral part of the information reported on by the Treasury Department.

TTB's Annual Report includes audited FY 2012 and FY 2011 financial statements; the Independent Auditors' Report on these financial statements, as well as reports on the Bureau's internal control over financial reporting and compliance with laws and regulations.

## Management Assurances

An independent, full-scope financial statement audit was conducted for FY 2012 and TTB received an unqualified audit opinion. For FY 2012, TTB provides reasonable assurance that the objectives of the Federal Managers' Financial Integrity Act have been achieved, and the Bureau's financial management systems are in substantial compliance with the Federal Financial Management Improvement Act. This overall determination is based on past and current practices, an improved controls environment, scrutiny by external audit sources, internal evaluations, and administrative and fiscal accounting system enhancements.

During the year TTB implemented corrective actions to improve internal controls that were designed to ensure the review of the allowance for doubtful accounts on tax and trade receivables and accurate recording of financial transactions into the asset accounts of the general ledger and accurate reporting of assets in the financial statements. These changes were made to address prior year audit findings.

Also during FY 2012, TTB applied its custom risk management tools to its Revenue Accounting Section to identify risks in the accounting and tracking of TTB's annual Federal excise tax collections, and to the National Revenue Center, with a focus on its key business processes. Those tools disclosed that TTB has adequate internal controls in place to mitigate risk to operations, and that the overall risk of fraud, waste, and abuse is characterized as "LOW."

## Bureau Challenges

TTB plans to revisit the vulnerability and risk management tools that are used each year to monitor the internal controls over tax collections to ensure these documents reflect the key business processes in operation at the National Revenue Center and fully support our internal control program at the Bureau. As systems and businesses processes change it is important that TTB update the tools that are being used to monitor its tax processing activities.

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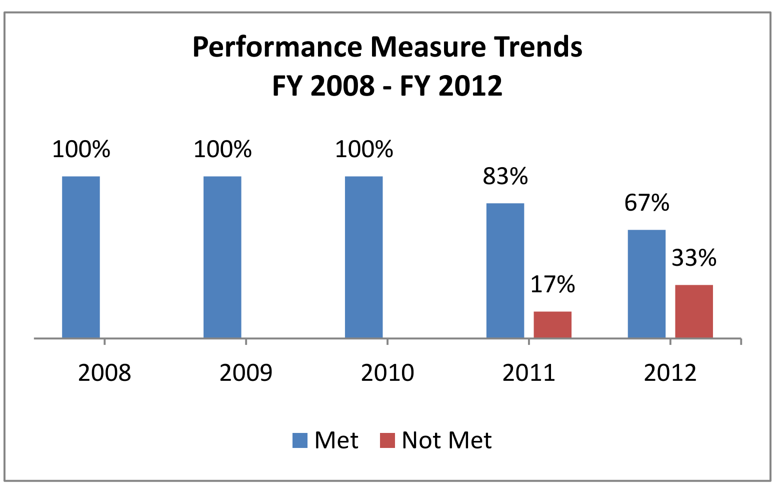
# Part II
# Program Performance Results

## Performance Overview

TTB reports its performance in terms of six metrics that represent its ability to supply satisfactory service to its customers in the industry, foster compliance from taxpayers, employ technology to meet its public protection mission, and return value to the Nation for the investment in TTB programs.

TTB exceeded the performance targets for four of the six measures reported to its stakeholders in FY 2012. For the two remaining performance measures, TTB came within two percent of achieving its targeted level of performance. Based on external factors and the results achieved this fiscal year, TTB reviewed its FY 2012 performance targets and set targets that reflect workload projections, resource constraints, planned business process improvements, and anticipated impacts from technology enhancements. To meet its performance goals in FY 2012, TTB will implement an aggressive strategic agenda that integrates new technology, human capital management strategies, and targeted efforts in both outreach and enforcement. All performance results are subject to management review and periodic audit by the Department of the Treasury.

| FY 2012 Performance Measure Status | |
|---|---|
| **Performance Targets Met** | **4** |
| **Performance Targets Not Met** | **2** |
| **Baseline** | **0** |
| **Total Performance Measures** | **6** |



## Summary of Collect the Revenue Performance

| Performance Measure | FY 08 Actual | FY 09 Actual | FY 10 Actual | FY 11 Actual | FY 12 Target | FY 12 Actual | FY 13 Target | FY 12 Target Met? | % of Target Reached |
|---|---|---|---|---|---|---|---|---|---|
| **Amount of revenue collected per program dollar** | $313 | $427 | $478 | $468 | $410 | **$449** | $400 | Y | 110% |
| **Percentage of voluntary compliance from large taxpayers in filing timely tax payments (in terms of revenue)** | 94% | 94% | 94% | 95% | 94% | **92%** | 90% | N | 98% |

## Performance Discussion

In FY 2012, TTB met one of its two annual targets for the performance measures under the Collect the Revenue budget activity. Taken together, these measures demonstrate the effectiveness and efficiency with which TTB operates its revenue collection mission. TTB considers its two Collect the Revenue performance measures to be important indicators of performance under this budget activity; however, the downward trends in performance results do not necessarily indicate faltering performance, as they must be interpreted to account for certain factors that fall outside of TTB's direct influence and their impact on performance results.

**Improve Efficiency of Tax Collection**

The amount of revenue collected per program dollar measure uses annual collections figures and the actual expenditures and obligations for collection activities to quantify the efficiency of the TTB tax collection program. In FY 2012, TTB reported a return on investment of $449 for every dollar spent on collection activities. TTB exceeded its target by 10 percent due to ongoing and successful compliance audit and investigation efforts combined with process improvements and streamlining efforts. Moving forward, TTB expects to meet its targeted performance levels due to savings achieved from the implementation of improved targeting techniques for enforcement efforts and through proposed revisions to its industry reporting requirements.

Tax Collection Activities

TTB collects approximately $23.4 billion in excise taxes, interest, and other revenues from alcohol, tobacco, firearms, and ammunition industries. In determining its performance targets for this measure, TTB examines historical collections trends across each of its regulated commodities, as well as other predictors that influence consumer behaviors.

The following displays the historical collections at TTB from FY 2001 to 2012 by revenue type:

**Excise Tax and Other Collections by Fiscal Year**

Dollars in Thousands

| Fiscal Year | Alcohol | Tobacco | FAET | SOT | FST | Other | Total |
|---|---|---|---|---|---|---|---|
| 2003 | 6,910,631 | 7,380,807 | 193,414 | 103,781 | 1,628 | - | 14,590,261 |
| 2004 | 6,995,366 | 7,433,852 | 216,006 | 100,562 | - | 359 | 14,746,145 |
| 2005 | 7,074,076 | 7,409,608 | 225,818 | 10,190 | 9 | 141 | 14,719,842 |
| 2006 | 7,182,940 | 7,350,058 | 249,578 | 2,895 | 638 | 146 | 14,786,255 |
| 2007 | 7,232,138 | 7,194,081 | 287,835 | 2,808 | - | 32 | 14,716,894 |
| 2008 | 7,420,576 | 6,851,705 | 312,622 | 448 | - | 634 | 14,585,985 |
| 2009 | 7,424,292 | 11,548,504 | 452,693 | 272 | 1,192,375 | 970 | 20,619,106 |
| 2010 | 7,476,789 | 15,913,479 | 360,813 | 300 | 8,558 | 180 | 23,760,119 |
| 2011 | 7,594,330 | 15,515,073 | 344,262 | 268 | 5,220 | 2,257 | 23,461,410 |
| 2012 | 7,856,391 | 15,002,616 | 514,622 | 249 | 5,942 | 61 | 23,379,881 |
| **Average** | **$ 7,316,753** | **$ 10,159,978** | **$ 315,766** | **$ 22,177** | **$ 121,437** | **$ 478** | **$ 17,936,590** |

FAET - Firearms and Ammunition Excise Tax  SOT - Special Occupational Tax  FST - Floor Stock Tax  Other - Suspense Account

*Note: Tobacco revenue increased in 2009 as a result of the passage of the Chidren's Health Insurance Program Reauthorization Act (CHIPRA) legislation, which increased the tax rate on tobacco products. Also, legislation was enacted in July 2005 that repealed the SOT for all alcohol taxpayers. The SOT for tobacco permitees remains intact.*

Since 2008, the return on investment for the Collect the Revenue program increased by more than 30 percent, principally because of the higher Federal excise tax rate imposed on tobacco products under the February 2009 CHIPRA legislation. This legislation nearly tripled the Federal tax rate on certain tobacco products and, as a result, TTB's return on investment reached an historic high in FY 2010 of 478:1. However, shifts in consumption patterns, product manufacturing, and trade will impact Federal revenues in the years ahead. In accounting for these types of marketplace shifts, TTB used CBO revenue projections for increased tobacco excise tax collections to determine its targeted performance levels for fiscal years 2013 – 2014.

Streamlining Efforts for Tax and Regulatory Requirements

The performance target of $400 for FY 2013 reflects TTB's analysis of collections data, and will be met, in part, through continued efficiencies gained in TTB's costs to operate its Collect the Revenue activities. Specifically, TTB issued a proposed regulation in December 2011 to streamline its distilled spirits plant reporting requirements to reduce the compliance burden for industry and, consequently, the TTB workload. This revision to the regulations would replace the current four report forms used by distilled spirits plants to report their operations on a monthly basis with just two report forms. Plants that qualify to file taxes on a quarterly basis would submit the new reports on a quarterly basis. The Bureau plans to publish a final rule to implement this change in FY 2013.

TTB also expects to achieve savings in the processing of surety bonds and tax filings through the legislative initiative, which, in turn, should improve the efficiency quotient for this measure. TTB continues its efforts to seek a legislative change to repeal the bond requirement for businesses owing $50,000 or less annually and mandate the quarterly filing of tax returns. Currently, the cost of the bond requirement deters these taxpayers from filing tax returns and payments on a quarterly basis, and its elimination will reduce this filing and financial burden on industry, increase quarterly filings, and, thus, result in efficiencies for TTB.

In the interim period, TTB plans to propose a regulatory change to eliminate the bond requirement for small brewers and mandate quarterly filing of tax returns and reports for these taxpayers to produce efficiencies for both the industry and the Bureau.

**Increase Voluntary Compliance from Taxpayers**

Fostering voluntary compliance among excise taxpayers is a primary tax administration strategy for TTB and supports the high priority performance goal of the Department of the Treasury. A key performance metric shows that 92 percent of large taxpayers (i.e., those that pay more than $50,000 in annual taxes) voluntarily file their tax payments on or before the scheduled due date.

In FY 2013, TTB will employ several complementary strategies to meet its performance target of 90 percent, including renewing its focus on enhanced e-filing options, developing a balanced field approach of audits and investigations that targets non-compliant industry members, establishing an identifiable presence within the industry that encourages voluntary compliance, and identifying any gaps in tax payment from illegal entities and individuals operating outside of the lawful distribution system for alcohol and tobacco products.

TTB's effective use of its new automated tool to identify and address non-compliance in the timely filing of tax payments resulted in increased filings in FY 2012; however, as these additional filings were submitted late, TTB's overall rate of voluntary compliance declined for the fiscal year. Initiated in FY 2010, TTB has continued to develop its automated system, the Error Tracking Database (ETD), to identify late filers, non-filers, and errant filings of operational reports as well as missing excise tax returns for breweries and tobacco manufacturers. The ETD identifies approximately 70 types of errors on the operational report, including whether the report was missing, and generates compliance letters to be mailed out. As industry members take action in response to TTB's notifications, TTB expects that compliance in timely filings may continue to decline before these enforcement efforts lead to improved compliance rates. TTB plans to expand the ETD to include wineries and distilled spirits plants in FY 2013. Also in FY 2013, to meet its performance target of 90 percent, TTB will continue its outreach efforts to educate and train industry members on Federal compliance requirements, maintain a visible field presence, and continue to promote the use of Pay.gov. Electronic filing through Pay.gov reduces errors on operational reports and tax returns, and contributes to timely filings.

<u>Electronic Filing Improvements</u>

TTB aims to improve voluntary compliance by working toward allowing TTB permitted and taxpayers to file all payments, returns, and applications online with the National Revenue Center. In FY 2012, TTB expanded the e-filing program to allow all excise taxpayers to file and pay taxes and file monthly operational reports electronically through the Pay.gov system. The total number of Pay.gov registrants in FY 2012 increased over the prior year by approximately 33 percent, bringing the total to more than 9,500.

Going forward, TTB is intensifying its efforts to increase the electronic filing rate of operational reports and tax returns through the Pay.gov system. At the close of FY 2012, TTB had made some progress in promoting Pay.gov, with the e-filing rate for operational reports reaching 33 percent and the e-filing rate for tax returns increasing to 22 percent, a gain of 5 percent and 1 percent over FY 2011, respectively. In order to raise the industry awareness level and demonstrate the benefits of electronic submissions, a multi-faceted approach has been initiated, which includes: conducting Pay.gov presentations at industry-sponsored seminars; emphasizing Pay.gov in communications with new industry members; adding information about Pay.gov to notification letters related to missing or late tax payments; and increasing the number of TTB tax-related forms available in Pay.gov.

Further, TTB is working to allow credit card payments through Pay.gov, which would address a system issue that requires early payment of taxes for those that elect to e-file. This timing issue is the primary obstacle that prevents industry members from filing and paying their taxes through the electronic filing system.

Tax Enforcement Audits and Investigations

An identifiable enforcement presence is a well-established driver of compliance rates. In FY 2012, in support of its voluntary compliance efforts, TTB used increasingly sophisticated risk models and audit targeting techniques to complete field work for approximately 720 targeted audits, examinations, and revenue investigations. These audits and investigations resulted in the identification of $47.7 million in additional tax, penalties, and interest from industry members.

TTB initiated several priority enforcement initiatives in FY 2012 that leverage technology and analytical techniques to better identify high-risk targets so that TTB makes the most efficient use of its enforcement resources. A primary focus was the development of an integrated tobacco risk model for the identification of high-risk tobacco importers for audit or investigation. With this new model, TTB is able to perform more real-time targeting of tobacco importers, including importers of processed tobacco.

In FY 2012, due to the potential for tax evasion, TTB concentrated a portion of its enforcement resources on manufacturers of processed tobacco. Under the CHIPRA legislation, tobacco processors must now obtain a permit and report on the first removal, transfer, or sale of processed tobacco to another entity. There is no requirement that processed tobacco be transferred or sold to a permitted or that subsequent transfers be reported. Consequently, transfers of this non-taxpaid tobacco product carry a high revenue risk. TTB initiated a pilot project, driven by a newly developed risk model, which directs its auditors and investigators to conduct “forward traces” of processed tobacco through the distribution system. These forward trace investigations have resulted in multiple civil and criminal cases that have identified more than $182 million in potential revenue loss from the diversion of more than 10 million pounds of processed tobacco to non-permitted entities.

Going forward, TTB will continue its development of a similar risk model for alcohol importers. The alcohol importer risk model analyzes import data from CBP and alcohol importer permit data from TTB’s databases to identify potential import activity by non-permitted entities and other anomalies for potential audit. After initial testing in FY 2012, TTB is refining and expanding the scope of the alcohol importer risk model to include national data on alcohol imports. In FY 2013, TTB plans to use the new risk model in its audit planning, and to continue refinements to all of its alcohol and tobacco risk models through the integration of viable external data, including FinCEN data and Census population data, among other sources.

Interagency Partnerships

TTB also uses an interagency approach in applying its enforcement strategies that involves cooperation with local, state, Federal, and foreign government counterpart agencies to maximize the deterrent impact of enforcement actions. In FY 2012, in response to the specific revenue threat from imported alcohol and tobacco products, TTB engaged CBP to address alcohol and tobacco importers that are delinquent in paying tax liabilities, as identified through TTB audits and investigations. In general, CBP's decisions regarding duty and tax collection are deemed to be final within 180 days after liquidation. However, in 2009, CHIPRA extended the statute of limitations for the collection of taxes on imported alcohol and tobacco products to three years. While this amendment addressed the time period in which assessment and collection can occur, it did not address how these actions were to be enforced. TTB seeks to close this gap by partnering with CBP's Office of Regulatory Audits to conduct joint audits of tobacco importers. TTB initiated a pilot project with CBP in FY 2012, and intends to begin implementing this unified enforcement approach in FY 2013.

Criminal Enforcement

Further, in its efforts to maintain tax compliance within the industries it regulates and to collect all revenue due on alcohol and tobacco products, the bureau worked to address the illicit activity present in the marketplace. Failure to address illicit trade not only deprives the U.S. Treasury of revenue, but also gives non-compliant actors an unfair competitive advantage over their lawful counterparts.

TTB has criminal enforcement authority under the IRC, which includes penalties for illicit tobacco product manufacturing and evasion of excise tax. Until FY 2010, however, TTB did not have the resources for special agents to effectuate this authority. Instead, TTB had to rely on the availability and interest of other Federal and state law enforcement agencies, agencies with separate and distinct missions, to either initiate joint investigations that would include violations of IRC provisions enforced by TTB or accept a criminal investigation referral.

Using two-year funding, TTB entered into an interagency agreement in FY 2011 to reimburse IRS for agent services to enforce the criminal provisions of TTB's jurisdiction. After a lapse in funding due to the Continuing Resolution in place for the first quarter of FY 2012, TTB received an additional $2 million in its FY 2012 appropriation to continue its efforts to combat tobacco smuggling and other criminal diversion activities. TTB used this funding to recommence its criminal enforcement program under an interagency agreement with the IRS. Between fiscal years 2011 and 2012, in just 16 months of actively opening new investigations, this program has resulted in the initiation of 48 cases with a total estimated Federal excise tax liability of over $336 million, and combined seizures and forfeitures totaling approximately $115 million. Of the 48 active cases, 25 relate to illicit tobacco trade (52 percent), 21 relate to the illegal alcohol trade (44 percent), and 2 cases involve both alcohol and tobacco products, demonstrating that criminal activity is present across the industries TTB regulates. TTB has presented 43 cases to an AUSA for prosecutorial investigation, and 100 percent have been accepted, indicating the quality of the cases that TTB has referred.

Criminal cases are often multi-year endeavors and, in FY 2012, TTB was successful in bringing several cases to final resolution in the legal system. Two cases forwarded for prosecution in 2011 resulted in guilty pleas by the defendants during FY 2012. One defendant received probation, and the second defendant is scheduled for sentencing in December 2012. Another three subjects were indicted and pleaded guilty, with two of the subjects sentenced to approximately two years of incarceration. The third subject in the case is scheduled for sentencing in FY 2013. TTB also entered plea negotiations for six of its cases in FY 2012, and expects to reach agreements in early 2013. Successful cases, applying the full effect of both civil and criminal penalties, result in a disincentive to those who would otherwise commit alcohol and tobacco tax and criminal fraud activities. Absent a criminal tax enforcement presence, this activity will continue to go unchecked.

## Summary of Protect the Public Performance

| Performance Measure | FY 08 Actual | FY 09 Actual | FY 10 Actual | FY 11 Actual | FY 12 Target | FY 12 Actual | FY 13 Target | FY 12 Target Met? | % of Target Reached |
|---|---|---|---|---|---|---|---|---|---|
| **Percent of electronically filed Certificate of Label Approval (COLA) applications** | 62% | 74% | 79% | 88% | 88% | **91%** | 92% | Y | 103% |
| **National Revenue Center (NRC) customer service survey results** | 90% | 89% | 89% | 90% | 85% | **84%** | 85% | N | 99% |
| **Average number of days to process an original permit application at the NRC** | 64 | 64 | 65 | 74 | 75 | **67** | 65 | Y | 111% |
| **Percentage of importers identified by TTB as illegally operating without a Federal permit** | 22% | 15% | 15% | 14% | 14% | **13%** | 14% | Y | 107% |

### Performance Discussion

In FY 2012, TTB met three of its four annual targets for the performance measures under the Protect the Public budget activity. TTB tracks its success in meeting its trade and consumer protections goals through four principal performance measures that indicate how timely the Bureau is in issuing permits to qualified alcohol and tobacco businesses, how satisfied businesses are with TTB's permitting and claims process, how effective TTB is in deterring illicit importation of tobacco products by non-permitted entities, and the efficiency of the Bureau's alcohol beverage label application processing activity. Taken together, these measures reflect the priorities of a service-oriented organization, which applies technology to the greatest extent in order to perform its consumer protection role and in order to assure that commerce is fair, lawful, and open.

**Improve Efficiency and Effectives of Permitting Process**

TTB protects consumers by screening permit applicants to ensure only qualified persons engage in operations in the alcohol, tobacco, firearms, and ammunition industries. For this purpose, in FY 2012, TTB processed approximately 7,940 original and 19,400 amended permits, and performed 300 investigations into high-risk applicants to meet TTB's business integrity objective. TTB also monitors its timeliness in processing permit applications, as undue delays in permit application processing stunt Federal revenues and impede economic growth, primarily in the small business sector, as taxable commodities, such as finished wine, beer or spirits products, cannot be lawfully produced without a Federal permit from TTB. TTB targeted a 75-day turnaround time for original permit applications in FY 2012, and exceeded its target by achieving an average processing time of 67 days for applications. Moving forward, TTB will promote electronic filing, continue to implement system enhancements to Permits Online, and streamline its processing procedures to meet its performance target of 65 days in FY 2013.

TTB completed its rollout of the Permits Online system in FY 2012 in order to improve permit processing times and increase the number of paperless transactions with the business community TTB services. Permits Online provides a secure, Web-based solution that allows members of the alcohol and tobacco industries to electronically submit applications for permits to operate. Applicants who plan to produce finished distilled spirits, wines, malt beverages, and tobacco products, and persons wishing to operate businesses such as alcohol wholesalers, alcohol importers, tobacco importers, specially denatured spirits users and dealers, tax-free alcohol users, alcohol fuel plants, tobacco processors, and tobacco export warehouses, must submit original and amended permit applications. TTB's National Revenue Center currently processes original application packets for 23 types of permits/ registrations.

Over the past several years, however, the volume of paper applications has increased making it difficult to maintain service levels. Between 2008 and 2011, TTB experienced an average annual increase of 3 percent in original permits applications. In FY 2012, however, the number of original permit applications received increased 33 percent, primarily due to growth in the brewery and alcohol wholesalers segments. In comparing applications received in FY 2012 to those received FY 2011, the number of brewer and alcohol wholesaler applications have increased 74 percent and 61 percent, respectively. TTB made improvements to processing times in the first half of FY 2012, but progress has slowed in the second half of the fiscal year, in part, due to this increase in the number of permit applications.

Even with greater than anticipated adoption rates for the Permits Online system, which reached 62 percent for the year, TTB does not anticipate achieving sustained reductions to turnaround time until the latter quarters of FY 2013 or early FY 2014. Rather, the immediate benefit of Permits Online has been cost savings, with system efficiencies contributing to nearly $1 million in reductions in TTB's budget. These reductions (equivalent to 9 FTE) have produced monetary savings, but have slowed anticipated improvements in service delivery. TTB projects to average 65 days to process an original permit application at the close of FY 2013, with greater improvements expected by the close of FY 2014. Incremental improvements to performance during a period of declining staff and increasing workloads will demonstrate TTB's effectiveness and the success of its new e-filing system, without which processing times would exceed 90 days.

TTB intends to meet its 65-day performance target through a combination of streamlining its internal procedures, industry outreach, and ongoing system enhancements. TTB will update its risk model and its procedures used to process permit applications. Increased focus on risk modeling and statistical sampling will help TTB maintain its assurance that it is permitting only qualified applicants while managing workloads. In addition, TTB will continue to promote use of the Permits Online system by all permit applicants, including through Webinars and online training modules.

TTB also understands that the customer experience in using the system is a critical driver of adoption rates. With that in mind, TTB routinely updates the business rules and customer support features embedded in the system to help prospective industry members submit complete and accurate information on their permit application the first time. By receiving complete applications, TTB can reduce the time spent in returning applications to customers for correction and re-reviewing corrected submissions, thus improving the time from application to permit issuance.

TTB is also making steps to speed its transition to an entirely online processing environment. System enhancements planned for fiscal years 2013 and 2014 include the data upload of historical permit application data from TTB's permit and tax database to the Permits Online system. This initiative will allow TTB's 61,700 permittees who originally filed a paper permit application to file for amendments to their permit electronically through Permits Online. As TTB receives approximately 18,000 permit amendments annually, this project will result in efficiencies for both TTB and the businesses its serves.

**Increase Customer Satisfaction with TTB Service Delivery**

TTB also measures its performance in its permit processing function through surveying the businesses that apply for a TTB permit. The NRC customer survey solicits feedback on the level of service provided to applicants for an original or amended permit, and those industry members who file a claim to recover taxes paid on nonbeverage alcohol or overpayments of tax. TTB targets a sustained score of 85 percent on customer satisfaction for permit application and claims processing, and achieved a composite score of 84 percent in FY 2012. TTB's satisfaction rate, derived from a telephone survey of industry members who received permitting or claims service from the TTB National Revenue Center in the prior month, decreased in FY 2012 due in part to the process changes associated with the Permits Online system. For those who elected to file original or amended permit applications electronically, increased satisfaction with faster response times was potentially offset by the learning curve associated with adapting to the new system. This was true for those industry members types added to the system in FY 2012, which represented the most complex permit applications, and who reported decreased satisfaction rates. For those who paper-filed their permit applications, satisfaction scores were also impacted due to the Permits Online rollout, as processing times for paper applications increased during this period.

Service enhancements, including the initiative to enable all permittees to file a permit amendment electronically through Permits Online, are expected to contribute to the Bureau's ability to meet its targeted performance level. The FY 2013 target for performance of 85 percent factors in anticipated growth in adoption rates of the Permits Online system, as well as other improvements to business processes and TTB call centers that directly impact the business community that TTB services. TTB will introduce an e-mail survey in FY 2013 to replace the labor intensive telephonic surveying method that supports this measure. TTB will reconsider its performance target after establishing a new baseline for this measure in FY 2013.

**Ensure Compliance with Importer Permit Requirement**

Maintaining lawful operations in the trade of alcohol and tobacco commodities is a principal TTB objective. TTB continues its enforcement of Federal permit requirements, targeting entities identified as importing cigarettes and other tobacco products without a TTB permit. By monitoring the CBP's International Trade Data System, and comparing import data against the permittees on file with TTB, the Bureau is able to identify and take action against those entities engaging in unlawful operations. In FY 2012, through this data comparison, TTB determined that 13 percent of entities reporting importations of tobacco products had done so without a permit. TTB intelligence analysts found that individuals ordering tobacco products from overseas via the Internet to evade not only Federal excise tax, but State and local taxes and import duties, represented the vast majority of non-permitted importers. TTB's issuance of cease and desist letters, and appropriate follow up activities, ensured that the responsible parties ended operations or obtained a permit. TTB's enforcement activities resulted in an improvement over its prior year result of 14 percent for this measure and, since 2008, have resulted in a 40 percent improvement in the rate of compliance.

TTB intends to meet its FY 2013 performance target of 14 percent for this measure by continuing to monitor and take action to address imports of tobacco products by non-permitted parties. These efforts support the enforcement of Federal laws designed to prevent tobacco smuggling and to ensure the collection of all taxes levied on tobacco products. As an example, the Prevent All Cigarette Trafficking Act (PACT Act), a law enacted in 2010, prohibits shipments of tobacco products via the U.S. Postal Service (USPS). As the vast majority of the non-permitted importers are individuals purchasing tobacco products in small quantities for personal consumption through online tobacco outlets via the USPS and FedEx, TTB continues to coordinate with the USPS and other ground carriers to provide enforcement assistance. TTB also will continue to focus its enforcement efforts on the importation of processed tobacco, which is subject to new regulation and oversight under CHIPRA, to ensure that importers comply with Federal law. Processed tobacco is the subject of intense TTB enforcement scrutiny, as it is a non-taxpaid tobacco product that may be diverted for illegal manufacturing of cigarettes. TTB will incorporate import data into its risk models for audit and investigation targets to help deter illegal importations of tobacco.

**Improve Efficiency and Effectiveness of Alcohol Beverage Label Processing**

TTB protects U.S. consumers by ensuring that the alcohol beverage products offered at retail outlets are properly labeled and comply with Federal production standards. In FY 2012, TTB met this objective and facilitated U.S. commerce through the approval of more than 134,600 of the 152,700 COLA applications received; the remaining 18,100 (12 percent) were rejected, returned for correction, withdrawn, or expired. In furtherance of the Department-wide goal of increasing paperless transactions, the Bureau reported increases in the percent of electronically filed COLA applications, which in FY 2012 reached 91 percent of all applications. The ongoing rise in electronic filing is due to system improvements that track with customer feedback and which simplify the filing process for industry members.

TTB has set a performance target of 92 percent for FY 2013 for this electronic filing measure and, to meet this performance goal, the Bureau will use targeted outreach to reach the segments of the industry that have not migrated to the online filing environment. Beginning in FY 2013, TTB plans to modify its internal operating procedures to process paper label applications electronically. This move to a paperless processing environment will result in efficiencies in communicating with industry members regarding rejected applications or applications that are returned to the applicant for correction.

Even with high rates of electronic filing, annual increases in label applications necessitate consideration of broader efforts to streamline the alcohol beverage label application process. Between fiscal years 2011 and 2012, the number of label applications has increased 5 percent, and since 2008, the number of applications has increased by 14 percent. Addressing this issue requires TTB to continue its efforts to update and streamline its labeling program. Through various changes to forms, guidance, and internal processing procedures, as well as planned modernization of the Federal alcohol labeling regulations, the Bureau will shift from a labor-intensive label application pre-approval process to a more useful marketplace review of labels. These efforts will speed up the time it takes industry to enter compliantly labeled alcohol beverages into the marketplace. TTB plans to publish a rulemaking document proposing changes to its labeling and advertising regulations in FY 2013, and will follow up with a final rule after reviewing the comments.

Additionally, in FY 2012, TTB acted to further its unique regulatory role in assuring that alcohol beverage products in the marketplace meet Federal standards and do not mislead consumers. The integrity of U.S. products is critical in global commerce, and incidents of mislabeling or product safety can have crippling effects on trade. In support of this objective, TTB conducted its fifth year of the Alcohol Beverage Sampling Program (ABSP)—a program designed to generate statistically reliable information that can be used to estimate the percentage of alcohol beverage products in the market that are fully and accurately labeled. TTB uses this information to target enforcement efforts as well as to make improvements to industry guidance. Approximately 650 products were evaluated in FY 2012, and the program results will be published in FY 2013.

## Summary of Management and Organizational Excellence Performance

In order to effectuate the Bureau's revenue collection and public protection mission, TTB must create the conditions necessary for programs to reach and sustain excellence. In all aspects of performing its mission, TTB aims to ensure that its programs operate efficiently and effectively, and with full accountability. TTB accomplishes this by ensuring that program offices receive the high-quality management and administrative support needed to achieve the Bureau's goals.

The Bureau's objectives in the area of Management and Organizational Excellence align with the Administration's emphasis on automating processes to improve services and enhancing internal operations to be more efficient and effective. In FY 2012, the Bureau demonstrated its ability to enhance efficiency and reduce costs through its strategic management of human capital, IT enhancements to improve operations, and rigorous financial management practices.

### Human Capital Management

TTB continues to implement the strategic goals, strategies, and measures outlined in the current Human Capital Strategic Plan. As the majority of TTB's human resource functions are operated through the Bureau of Public Debt Administrative Resource Center (BPD ARC), TTB establishes and updates, as appropriate, performance benchmarks and measures to monitor these outsourced functions. In FY 2013, TTB will publish its 2013-2017 Human Capital Strategic Plan to align with the strategic direction of the Bureau. The new plan takes into account the overall business and cultural vision for TTB, to include:

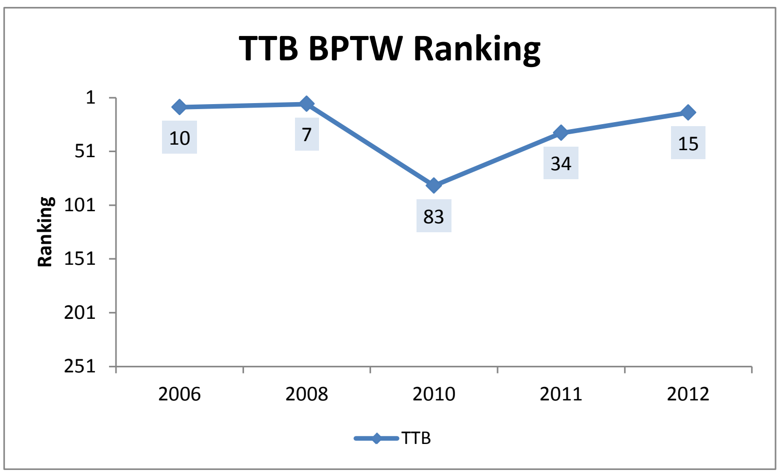
- Addressing retirement trends by identifying and closing competency gaps and creating a succession plan, enhancing our recruitment and retention plan, and identifying targeted skills sets;
- Providing an employee friendly culture that strikes a work/life balance through employee recognition, performance management, flexible schedules, and teleworking;
- Incorporating organizational needs into human capital planning as identified by the 2011 OPM Employee Viewpoint Survey results; and
- Streamlining human resources functions through various human resources information systems, including a new electronic employee official personnel file, performance management system, and enhanced self-service personnel actions available online.

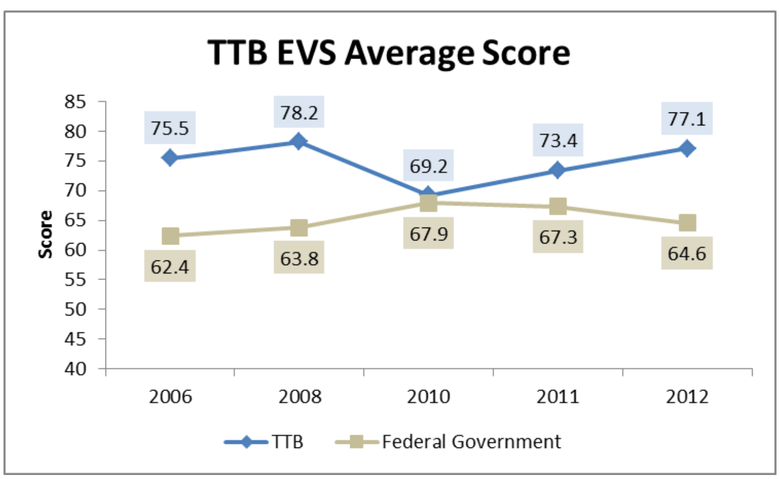
In FY 2012, TTB held Labor/Management Partnership Council meetings with the National Treasury Employees Union (NTEU) under the provisions of the Collective Bargaining Agreement. These meetings have been instrumental in fostering enhancements in the Bureau's labor management relations. In furtherance of improved labor management relations, TTB and the NTEU collaborated on several pre-decisional projects, including the reorganization of the National Revenue Center.

TTB also conducted impact and implementation bargaining with the NTEU for a number of significant human resources policies during FY 2012. These included the TTB policy orders related to the Mission, Organization, and Responsibilities; Student Loan Repayment Program; Details; and Position Classification under the General Schedule.

Employee satisfaction is critical to a productive workplace. Each year, the Office of Personnel Management administers the Federal Employee Viewpoint Survey (FEVS) to measure the satisfaction of the Federal workforce. The TTB EVS average score for FY 2012 trended up to a 77.1 percent positive response rate from employees. In response to the scores TTB received on this Government-wide survey, TTB will develop an FY 2013 FEVS Action Plan to address areas that showed a decline from the prior year.

Based on this survey data, the Partnership for Public Service determines rankings for Federal agencies. TTB ranked 15th out of 292 sub-component agencies on the FY 2012 Best Places to Work in the Federal Government rankings, an increase from its 2011 ranking of 34 out of 240.



In its efforts to improve upon the 2011 ranking, throughout FY 2012, TTB worked to implement the actions identified in its FY 2012 FEVS Action Plan. This involved, in part, conducting a series of focus group meetings at the Bureau's two primary locations—the National Revenue Center and TTB Headquarters—in an effort to solicit feedback from both employees and managers. The purpose of these sessions was to offer a forum where employees could freely share information, express concerns, and to offer suggestions on how to improve the work environment for all TTB employees. The focus group sessions were supported and facilitated by EEO and human resources personnel.

During FY 2012, under the revised FEVS Action Plan, TTB targeted the areas of effective hiring practices, an inclusive workplace, and workforce engagement to build upon the improvements in employee satisfaction realized in FY 2011. Specifically, TTB:

- Provided recruitment lifecycle and interviewing training to hiring managers;
- Established an on-boarding and mentoring program customized for veterans and individuals with disabilities;
- Ensured all hiring managers and human resources personnel received veterans hiring and diversity training;
- Developed and implemented an action plan to support Job Satisfaction, Talent Management, Results-Oriented Performance Management, Leadership and Knowledge Management, and Employee Retention;
- Developed and implemented an action plan for building an inclusive workplace (i.e., veterans (disabled and non-disabled) and individuals with disabilities); and
- Developed and implemented an action plan to effectively promote and support the Department-wide objectives to hire the best talent by decreasing time to hire.

Implementing these and other initiatives on the FY 2012 FEVS Action Plan increased communication to employees, ensured a highly talented and well-developed staff, and enhanced employee engagement.

As a knowledge-intensive organization, TTB requires a highly trained workforce to fulfill its responsibility to protect the public and collect the revenue within a dynamic and global environment. During FY 2012, TTB used a variety of human capital policies and programs for recruiting and attracting talent to ensure qualified people with the necessary skills are in the right positions, and to continue to retain those professionals in the future. Successful strategies included partnerships with a diverse range of universities across the country and use of the Treasury Veterans Program.

Succession planning is also a strategic priority for the Bureau, especially as it relates to TTB's mission-critical positions. One in five TTB employees is eligible to retire in FY 2013. To mitigate the loss of expertise and close skill gaps in mission-critical occupations, TTB continues to use the personnel interventions identified in the Pay Demonstration Program—a successful pay-for-performance pilot project established in 1999—to enable the Bureau to improve its capacity to recruit, develop, and retain high-caliber employees. TTB uses tailored approaches designed and implemented specifically for the Bureau's continuing and evolving needs in order to meet mission requirements and remain competitive for highly skilled talent.

Finally, in FY 2012, TTB continued its Emerging Leader's Program (ELP), established in FY 2009, and selected its fifth class of the ELP. This leadership development initiative offers three unique certificate programs for non-supervisors, first-level supervisors, and second-level managers at TTB. The three-year program series supports TTB's succession planning strategies, and prepares participants with the competencies critical for higher levels of leadership responsibility. Based on participant feedback, TTB is working on expanding the programs offerings to include mentoring opportunities and detail assignments to tax or regulatory counterpart agencies to broaden the exposure of program participants.

## Financial Management

TTB established and monitored key performance standards to ensure that its business activities covering financial accounting and reporting operate in a highly effective and efficient manner. In FY 2012, TTB, in collaboration with its shared service provider at BPD ARC, achieved all of its financial management performance metrics.

This joint effort in providing financial management services has allowed the Bureau to meet its financial goals and deliver quality accounting and budget services to program staff, including:

- Paying vendor invoices on time (Prompt Payment Rate) greater than 98 percent;
- Incurring interest on late payments less than 0.02 percent;
- Achieving an Electronic Fund Transfer Compliance Rate of greater than 96 percent;
- Completing timely and accurate Cash/Fund Balance reconciliations within 15 days after the end of the accounting period;
- Reconciling Cash/Fund Balance to 100 percent of the proper balance;
- Clearing suspense accounts within 60 days;
- Ensuring prompt deposits and recording of tax collections;
- Providing timely and useful financial management data;
- Providing excellent customer service; and
- Establishing a new account code structure under the Oracle 12 release that captures and measures costs of TTB programs.

The Bureau also met established due dates to ensure timely submission of required Financial Management Service (FMS) reports. Monthly closing of financial data was completed within three business days, and payroll information was downloaded into the Oracle core accounting system within three working days of receipt of payroll tapes from the National Finance Center.

Joint reviews of payroll activity were conducted to obtain reliable projections of payroll costs relative to continuously changing on-board staffing levels. The payroll projection system has proven to be a valuable tool and its use has led to better financial information for decision making on the budget and has helped the Bureau avoid Anti-Deficiency Act violations. The ability to extract information from both the core accounting system, and make sound payroll projections, continues to provide reliable and accurate financial information for management use in executing the budget.

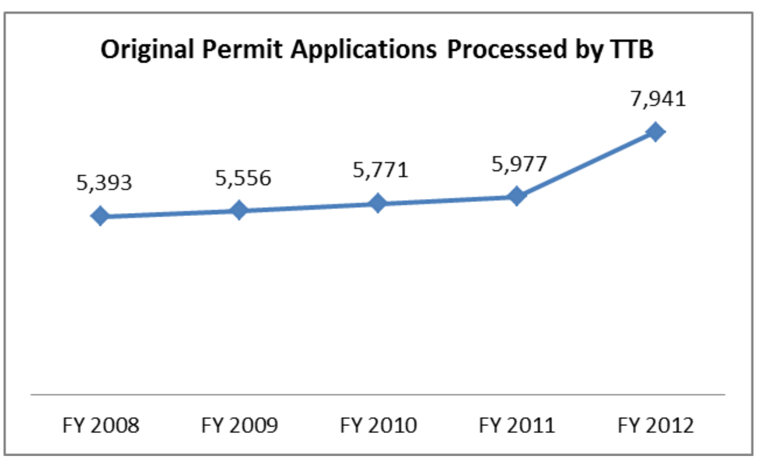
In FY 2012, the Bureau was able to conduct timely reviews of financial information so that program offices were afforded the data necessary to make efficient use of the Bureau's annual appropriation, and fulfill TTB's tax collection and regulatory responsibilities as outlined under its budget plan. By closely monitoring the Bureau's financial status, TTB was successful in making a number of key investments in support of its mission. These financial reviews were not limited to the current year's appropriation. TTB also conducted a review of prior year obligations. This endeavor led to the close out of accounts that no longer legally obligated TTB. As a result of this comprehensive effort, the Bureau was able to increase its FY 2011 unobligated balance, of which 50 percent, or $83,630, was reapportioned for use in FY 2012 for a one-time investment in information technology (IT) infrastructure equipment to replace obsolete network equipment.

In support of Treasury's OMB Circular A-123 requirements over financial reporting controls, the TTB Office of Finance and Performance Budgeting tested internal controls related to the financial reporting of tax collections. The review identified no control weaknesses over TTB's collection activity and the reporting of those collections.

## Expansion of Technology Solutions

TTB made significant progress in achieving its strategic vision of using technology to streamline the delivery of its critical lines of business. In FY 2012, TTB continued with business application development to automate its paper-intensive permit application and formula submission processes in order improve internal operational efficiency and to reduce the regulatory burden on industry members.

The Permits Online initiative, a major software development project that began in FY 2010, enables industry members to electronically submit new and amended permit applications to TTB for approval. TTB processes application packets for 23 types of permits or registrations for the alcohol, tobacco, firearms, and ammunition industries. This IT initiative helped TTB achieve its performance goal of expeditiously processing permit applications, which allows qualified persons to commence operations sooner, and contributes to the overall growth and health of the U.S. and global economy.

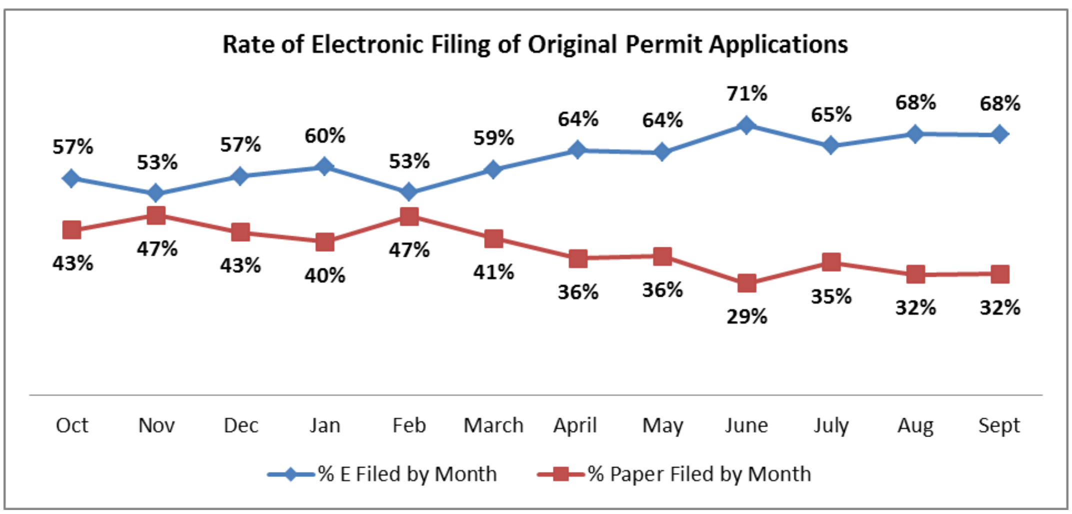


TTB released this e-Gov system in phases. In FY 2011, TTB completed three releases that enabled electronic filing for alcohol wholesalers and importers, wineries, specially denatured alcohol users or dealers, and tax-free alcohol users. In FY 2012, TTB completed its final system releases to include breweries, distilled spirits plants, alcohol fuel plants, tobacco manufacturers and processors, and firearms manufacturers.

Significant system features include online self-registration, self-monitoring of an application's status, and electronically guided assistance through the application process. The built-in prompts and self-help instructions at each step of the application process assure that the applications that reach TTB specialists are completed correctly and contain all the required documentation. In FY 2012, TTB implemented numerous system enhancements to improve processing and customer friendliness, including pre-population of the required documents list and concurrent amendment blocks.

Processing efficiencies enabled TTB to process original applications in an average of 67 days, which represents processing times 7 days faster than the FY 2011 average. The TTB-regulated industries are transitioning to the new system quickly, with the overall adoption rate for Permits Online at 62 percent for the year.

Going forward, TTB will continue to improve the usage rate of Permits Online through its outreach efforts and system enhancements that improve its functionality. Significantly, TTB is in the process of developing and testing enhancements that will enable 61,700 active industry members to use Permits Online to electronically file for an amendment to their permit. TTB receives approximately 18,000 permit amendments annually, and this system enhancement will result in efficiencies for both TTB and industry members. TTB will also make available to industry members that qualify in Permits Online an electronic encrypted copy of their application data that may be uploaded to state liquor authorities. If states adopt this program, the application process will be streamlined for applicants as they will only be required to complete a single application at the Federal level.




TTB also made significant progress in its implementation of electronic filing for a second critical line of business—beverage and nonbeverage alcohol formula approval. TTB released its first phase of Formulas Online in January 2011, enabling industry members to submit beverage alcohol formula forms and documentation via the Web. Some alcohol beverages require formula approval prior to the issuance of a Certificate of Label Approval and, to simplify this process, TTB integrated Formulas Online with the label filing system, COLAs Online. Industry members can use a single logon ID and password for both e-Gov systems. Industry members using Formulas Online also benefit from step-by-step guidance to filing an application, and built-in validation checks ensure that the application submitted is accurate and complete. Industry members also have the option to receive current information on the status of a formula application via e-mail.

The system also benefits TTB by providing an electronic system that tracks formula applications and streamlines their workflow. Whether TTB receives paper or electronic formula applications, all submissions are captured in Formulas Online, providing internal users with the ability to view, evaluate, request additional information or corrections, and approve or reject applications. During FY 2012, TTB received 11,722 paper and electronic formulas for domestic and imported alcohol beverages. TTB received 5,739, or 49 percent, of those applications electronically.

Also in FY 2012, TTB rolled out a major system release to enable the electronic submission of nonbeverage formulae. Formulas Online now allows companies to submit drawback and specially denatured alcohol formulas electronically, check the status of submissions, and view the disposition of the formula. At year-end, TTB achieved a 60 percent e-filing rate for nonbeverage formulae.

As part of TTB's effort to modernize its laboratory environment, TTB initiated a project in FY 2011 to replace the existing Laboratory Information Management System (LIMS), a platform for consolidating sample analysis data for the four laboratories that comprise the Bureau's Scientific Services Division. In FY 2012, TTB implemented a new system based on a commercial software package that allows for integration with applicable laboratory instruments. The LIMS 2.0 system provides a secure and robust electronic submission process that facilitates the online collection and processing of sample analyses. The system is also crucial to maintaining the laboratory's international accreditation status, as LIMS 2.0 streamlines the process, review, and disposition of sample analyses to ensure compliance with ISO 17025 accreditation. Other benefits include chemical inventory management for the disposal or destruction of reagents and chemicals, and robust reporting capabilities to support the effective management of laboratory process workflows.

In support of the Mobile Treasury initiative, the Department of the Treasury's technology modernization campaign, TTB worked toward improving program results and reducing overall operating costs in FY 2012 through its ongoing support of "cloud computing" initiatives. Cloud computing is a model for enabling convenient, on-demand network access to a shared pool of configurable computing resources (e.g., networks, servers, storage, applications, and services) that can be rapidly provisioned and released with minimal management effort or service provider interaction. TTB is developing both TTB's private cloud by building its virtualized infrastructure and cloud software service and a community cloud by hosting and providing cloud infrastructure as a service to the Community Development Financial Institutions (CDFI) Fund.

These cloud computing efforts have been critical to TTB's effective telework program, one of the most robust telework programs at the Department. TTB's workforce is widely dispersed, with many personnel working from home full time and over 80 percent of the workforce regularly teleworking. Advancements in TTB's IT network completed in 2012 have both furthered the effectiveness of its telework program and contributed to the Administration's goals under the "Bring Your Own Device" initiative of improving mobile work capabilities and reducing IT costs across government. TTB achieved significant savings by reducing the cost of refreshing employee IT hardware, such as PCs and laptops. Replacing desktop and laptop computers every 3 to 4 years cost TTB about $2 million and disrupted the IT program and business users for several months. TTB determined that the best solution was to create a “virtual desktop” by centralizing all computing power, applications, user data, and user settings and allow access to TTB resources by thin client computing devices. A thin client is a computing device or program that relies on another device for computational power. Currently about 70 percent of TTB personnel use thin client devices to access all TTB applications and data. In August, TTB’s virtual desktop implementation was cited by the White House as a case study for the federal BYOD initiative. TTB’s virtual desktop solution is a major achievement that resulted in $1.2 million in IT savings, as well as additional savings in phone and fax lines and potential reductions to dedicated office space. Additional benefits include enhanced IT security, as the virtual desktop/thin client infrastructure eliminates the need to have information stored locally on a user’s machine, and reduced data loss, as the virtual desktop provides for the centralization of information.

# Message from the Chief Financial Officer

As the Nation continues to recover from a prolonged economic downturn, it is incumbent upon Government to lead the way in demonstrating responsible fiscal stewardship through sound management, efficient operations, and smarter and more streamlined services to its constituencies. At TTB, we have embedded the values of efficiency and service in our culture and, this year, we have continued our efforts to build a framework for continuous program improvement at the Bureau. Though we have much to be proud of, as evidenced in this report, the Bureau continues to strive for improvement through sound strategic planning, effective application of technology, and strong fiscal discipline.

Recognizing that we are responsible for producing results for every dollar entrusted to us, it is more important than ever for TTB to examine its operations to ensure that we are efficiently managing our resources and returning value for the investments made in our mission. Assurance that we are effectively allocating limited resources to deliver on our mission requires a comprehensive organizational strategy to guide strategic decisions about our operations and policies. We have chosen to apply the Balanced Scorecard methodology to our planning process in order to integrate our strategic plan into our management and investment decisions to ensure TTB's long-term effectiveness. Developed over the past year, and with implementation scheduled to start in earnest in 2013, the Balanced Scorecard provides a comprehensive management framework to help in making decisions regarding where our limited resources should be directed to achieve the greatest impact in moving the Bureau forward. By effectively using the data provided by the Balanced Scorecard, and maintaining open dialogue about our strategy, we will be able to readily identify issues and opportunities and take targeted actions to improve the organization as a whole.

From the financial perspective, in FY 2012, TTB again received an unqualified audit opinion on its financial statements from an independent public accounting firm, and they reported no significant deficiencies or material weaknesses in internal controls within our operations. Our support of this annual audit affirms our commitment to a vigorous internal control environment and financial reporting excellence. Further evidence of this commitment lies in our management practices, which include routine evaluations of our tax collection and revenue accounting operations at the National Revenue Center to validate that sound internal and administrative controls are in place to ensure the collection and verification of more than $23 billion in annual Federal excise tax collections from alcohol, tobacco, firearms and ammunition industry members.

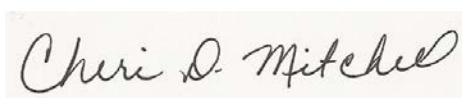
TTB's commitment to fiscal discipline also is demonstrated in our extensive efforts to make smart cuts to our program and overhead costs. TTB has implemented technology enhancements to streamline TTB processing work and proposed regulatory changes to ensure we are not unduly burdening ourselves or industry with unnecessary reporting or recordkeeping requirements. For example, in FY 2012, TTB proposed regulations to reduce the number and frequency of reports for breweries and distilled spirits plants, with a long-term plan to reduce the filing burden for all small businesses that we regulate by requiring quarterly filing of tax returns and payments for certain alcohol beverage producers.

TTB has also realized significant cost avoidance due to its strategic information technology hardware investments which have transformed the TTB IT infrastructure. TTB employees now use low-cost thin client devices to access a “virtual desktop” housed on a central server. This configuration simultaneously reduced recurring IT refresh costs by more than a million dollars and bolstered our mobile workforce capabilities. This technology produced further costs savings in the form of reductions to our office space as more employees transitioned to full-time telework. Currently, more than 80 percent of the TTB workforce participates in telework.

Further, TTB made strategic IT investments in its electronic filing systems in order to meet industry demand and continue to drive up the adoption rates for these systems. With approximately 30 percent increases in both the volume of original permit applications and formula submissions, TTB relies on the efficiencies gained from electronic filing to help our specialists effectively process applications and avoid lengthy processing delays. TTB upgraded its online business applications in FY 2012 to improve our permitting and formula approval services, both of which are critical to supporting lawful and thriving economic activity in the alcohol and tobacco trade.

TTB efforts to make technology enhancements have helped to counterbalance the effects of decreasing staff resources, and have helped TTB to maintain high satisfaction rates among our workforce even as we face increasing demands for service and results. We rely on the annual Employee Viewpoint Survey, distributed to the Federal workforce by the Office of Personnel Management, to gauge the satisfaction of our employees. Our annual scores indicated that our efforts over the past year to address employee concerns and streamline business processes are helping us to return to the top tier of Federal workplaces.

Even as resources contract, we will continue to aim high and put in place improved processes and tools to meet our mission. In the years ahead, strategic investments and sound planning will support the Bureau in improving the management and performance of this organization.



Cheri D. Mitchell
Assistant Administrator, Management/CFO

# PART III
## Financial Results, Position, Condition, and Auditors' Reports

### Budget Highlights by Fund Account

| FY 2012 Salaries and Expenses | | | | |
|---|---|---|---|---|
| Fund Source: | | | | |
| **Salaries & Expenses FY 2012** (P.L. 112-74, Consolidated Appropriations Act, 2012) 1/ | | | **$** | **99,878,000** |
| *Obligations Incurred in FY 2012 from Current Year Appropriations* | *$* | *99,482,000* | | |
| **Salaries & Expenses FY 2011/12** (50% Prior Year Recovery) 2/ | | | **$** | **83,630** |
| *Obligations Incurred in FY 2012 from Current Year Appropriations* | *$* | *81,534* | | |

1/ P.L. 112-10 included $2 million in funding for TTB to use for the costs of special law enforcement agents to target tobacco smuggling and other criminal diversion activities.

2/ General Provisions of the appropriations bill provide that 50 percent of the unobligated balances remaining available at the end of Fiscal Year 2011 shall remain available through September 30, 2012.

In FY 2012, TTB received $99,878,000 in direct appropriations of which $2,000,000 was to be used for special agents. The budget authorized the full-time equivalent (FTE) staffing level of 496 direct FTE. TTB entered into a reimbursable agreement with the Internal Revenue Service Criminal Investigation unit (IRS CI) to provide agent services to TTB.

The budgeted amount maintains a program level consistent with the current level of effort necessary to support TTB's responsibility for revenue collection and the enforcement of laws and regulations governing alcohol and tobacco commodities.

The Bureau obligated or expended 99.6 percent of the $99,878,000 in FY 2012 direct funding from its one-year Salaries and Expenses appropriation.

Also during FY 2012, Congress authorized an additional $83,630 from the prior year account of unobligated available balances (often referred to as the 50 percent account) to cover a one-time investment in IT infrastructure to replace obsolete network equipment.

### Offsetting Collections and Reimbursable Accounts from Puerto Rico Cover Over/ Enforcement Activities

During FY 2012, the Bureau realized spending authority in the amount of $6.8 million, which includes offsetting collections and changes in unfilled customer orders. The primary sources of reimbursable funding were collections from the cover over program and enforcement activity in Puerto Rico, and information technology services provided to CDFI.

***Puerto Rico Cover Over and Enforcement Activities***

All costs associated with the functioning and support of the Puerto Rico office are paid from the cover over program, which is offset from cover over taxes collected in the United States on products originating in Puerto Rico ($376 million) and the Virgin Islands ($9 million).

In Puerto Rico, TTB conducts annual audits and investigations of industry members regarding the collection of revenue, application processing, and product integrity. Revenue inspections are used to conduct tax examinations on major producers of alcohol and tobacco. This is critical due to the requirements of verifying tax payments under the Internal Revenue Code (IRC), as well as TTB's subsequent accountability for all cover over amounts due to the government of Puerto Rico.

All distilled spirits producers and processors, wineries, wholesalers, importers, Manufacturer of Nonbeverage Products claimants, and specially denatured alcohol permit applicants are subject to a qualification inspection under the IRC.

Additionally, major producers of distilled spirits, wine, and malt beverages are subject to inspection and audits in Puerto Rico.

## Linking Budget and Program Spending

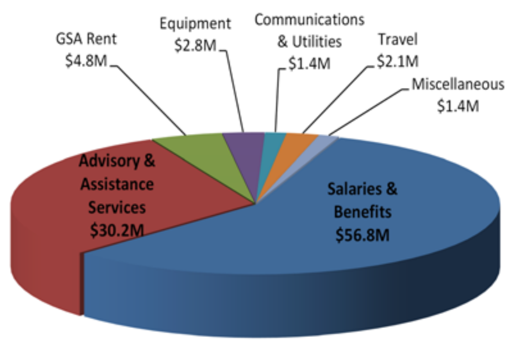
TTB has two primary budget activities: collecting all the Federal tax revenue due on alcohol, tobacco, firearms, and ammunition products and protecting consumers of alcohol beverages. Assisting industry members to understand and comply with the Federal laws and regulations regarding the commodities TTB regulates is an integral part of both activities.

In FY 2012, TTB used an account code structure which provides a direct link from the Bureau budget to specific programs and project activities. An analysis of the data stemming from the account code structure shows that, in FY 2012, TTB incurred obligations of $99,482,000 of its salaries and expenses appropriation, of which 52 percent was spent on the Collect the Revenue and 48 percent was spent on Protect the Public budget activities.


**Obligations Incurred from FY 2012 Appropriation**
**$99,482,000**

In order to ascertain the full costs of each of these budget activities, the overhead costs were allocated and combined with the direct program costs. TTB arrived at the overhead allocation by applying the pro rata share of the number of direct program dollars to each overhead cost category. The overhead is comprised of three major cost components: 1) general and administrative costs; 2) legal costs; and 3) information technology costs. The general and administrative category consists of costs related to operating the human resources, finance, procurement, training, facilities management, and other support-type functions.

## Spending by Major Object Class




**Obligations Incurred from FY 2012 Appropriation**
**by Major Object Class**
**$99.5 Million**

*TTB presents its Obligations Incurred by budget activity and program in its Annual Report to explain the cost of delivering the services that support the mission. TTB also presents specific data regarding the purchase of goods and services by major object class that support its program activities. The majority of TTB's incurred obligations (87 percent) fall into two principal major object classes: Salaries and Benefits and Advisory and Assistance Services (Contracts). Salaries and Benefits comprise 57 percent of total Obligations Incurred by object class, and cover the cost of TTB's roughly 500 FTE positions in FY 2012. The Advisory and Assistance Services object class constitutes 30 percent of FY 2012 incurred obligations, and covers the cost of both commercial and intragovernmental services.*

*The commercial contracts category is predominantly IT contracts in support of engineering, infrastructure, and support services. Also, it includes other commercial contracts for services such as the scanning and imaging of label applications and tax forms, lab maintenance, and Web site development.*

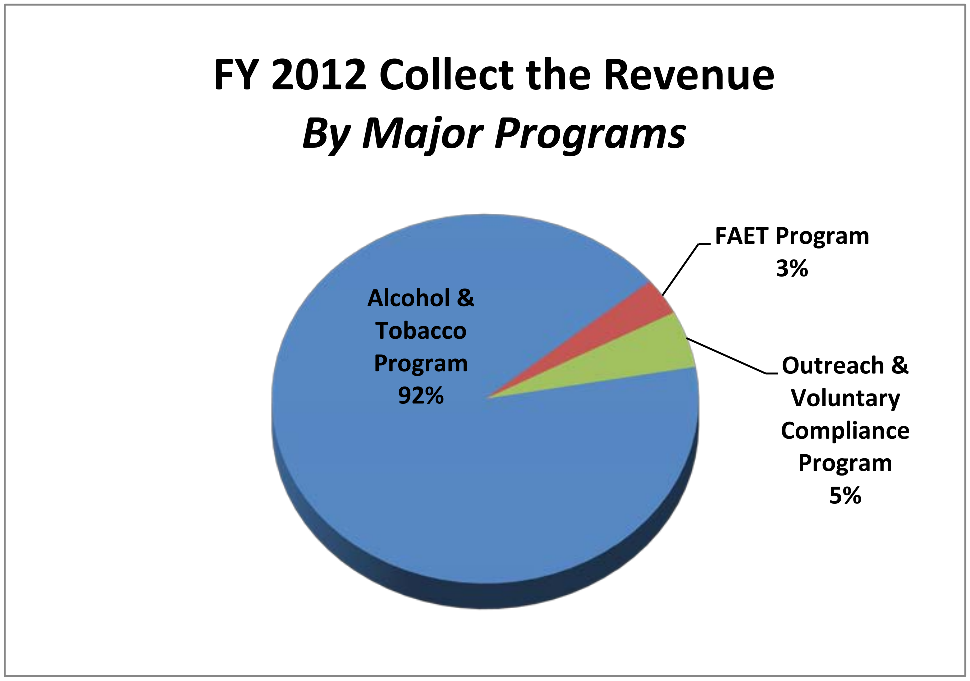
*Intragovernmental services include administrative support services provided by our shared service provider for human resources, accounting, travel, and procurement. Other intragovernmental services include the costs for special agent support, background investigations, and Federal protective services. In FY 2012, the Bureau's travel costs were primarily related to its audits and investigations. The remaining object classes that cover the FY 2012 Obligations Incurred include those cost categories for rent, communications, equipment, and other miscellaneous categories.*

## Obligations Incurred from FY 2012 Appropriations by Budget Activity

***Collect the Revenue….. $52,037,000***

The Collect the Revenue budget activity encompasses TTB's revenue strategy and goal to provide the most effective and efficient system for the collection of all revenue that is rightfully due. It is also designed to prevent or eliminate tax evasion and other criminal conduct and provide high-quality service while imposing the least regulatory burden.

Under the Collect the Revenue activity, TTB administers three programs: 1) Alcohol and Tobacco Tax; 2) Firearms and Ammunitions Excise Tax (FAET); and 3) Outreach and Voluntary Compliance.




In FY 2012, TTB expended 92 percent of its Collect the Revenue resources in collecting Federal excise taxes from the alcohol and tobacco industries and 3 percent in collecting FAET. The specific projects that comprise these costs include the processing of tax returns and operational reports at the National Revenue Center and the audits and investigations conducted on industry.

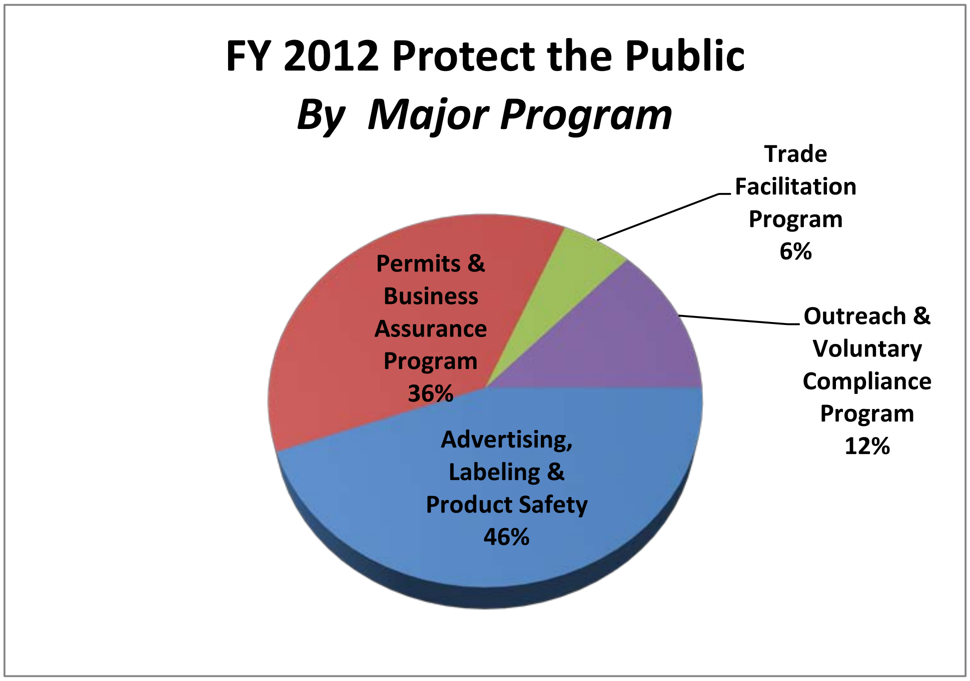
Costs for the Outreach and Voluntary Compliance Program reached 5 percent of our Collect the Revenue resources. These resources went toward efforts to educate and train industry members regarding their obligations in the areas of tax calculations and remittance.

***Protect the Public….. $47,445,000***

The Protect the Public budget activity encompasses TTB's strategy and goal to ensure industry compliance with laws and regulations designed to protect the consumers of alcohol beverages.

TTB does this by assuring the integrity of the people who operate these businesses, of the products themselves, and of the marketplace in which they are traded.

TTB administers four programs under the Protect the Public budget activity: 1) Permits and Business Assurance; 2) Advertising, Labeling, and Product Safety; 3) Trade Facilitation; and 4) Outreach and Voluntary Compliance.




An analysis of the financial data from FY 2012 reveals that TTB spent the preponderance of its Protect the Public resources on two programs: Labeling, Advertising, and Product Safety at 46 percent, and Permits and Business Assurance at 36 percent.

The Labeling, Advertising, and Product Safety Program includes activities designed to assure that beverage alcohol labels fully and accurately describe the products upon which they appear and are not misleading. It also encompasses activities to verify that alcohol advertisements contain all mandatory information and do not mislead consumers. The Product Safety component involves all investigative and laboratory activities performed as part of the Alcohol Beverage Safety and Verification Program, including work related to domestic and imported product analysis.

The Permits and Business Assurance Program is designed to determine the eligibility of persons wishing to enter any of the businesses TTB regulates and to process applications for changes to the original permit. These activities may include a field investigation. The permit is necessary in order to conduct operations in the regulated industries.

The remainder of the Protect the Public resources were divided between the Trade Facilitation Program (6 percent) and the Outreach and Voluntary Compliance Program (12 percent).

# Systems and Controls

## Introduction

During FY 2012, TTB contracted with BPD ARC to handle its administrative, human resources, procurement, travel and, financial functions.

## Accounting Systems and Controls

The BPD ARC accounting system, known as Oracle Federal Financials, is certified by the Financial Systems Integration Office (FSIO) requirements and is in full compliance with Treasury reporting requirements; it also meets requirements under the Federal Financial Management Improvement Act (FFMIA).

The audit of the FY 2012 financial statements disclosed no instances of noncompliance on FFMIA matters, and showed that the Bureau's financial management systems are in compliance with 1) Federal financial management systems requirements, 2) applicable Federal accounting standards, and 3) the United States Government Standard General Ledger at the transaction level.

The Bureau successfully met the Department of the Treasury's reporting requirements and has maintained accurate and reliable financial information on TTB's program activities. The various administrative modules integrated with the TTB financial system have proven to accurately capture Bureau financial data and provide reliable information to management to inform decision making. Only two TTB databases operate outside the BPD ARC environment—the TTB property management system and the tax administration database, IRIS.

## Federal Managers' Financial Integrity Act of 1982 (FMFIA)

The FMFIA requires Federal agencies to conduct ongoing evaluations of the systems of internal accounting and administrative control. Annually, TTB must report to Treasury all material weaknesses found through these evaluations. Treasury submits a consolidated report on the Department's controls to the President.

The FMFIA also requires the heads of agencies to provide the President with yearly assurance that obligations and costs are in compliance with applicable laws; that funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and revenues and expenditures are properly recorded and accounted for.

To provide this report and assurance to the President, the Secretary of the Treasury depends upon information from component heads regarding their management controls. The FMFIA program places reliance on each office at TTB to maintain a cost-effective system of controls to provide reasonable assurance that Government resources are protected against fraud, waste, abuse, mismanagement, or misappropriation.

Responsibilities of the Bureau's executive staff include ensuring that programs and administrative support activities are managed efficiently and effectively. Managers must conform to specific management accountability and improvement policies when designing, planning, organizing, and carrying out their responsibilities in order to ensure the most efficient and effective operation of their programs.

These policies address:

- Delegation of authority and responsibility;
- Hierarchical reporting of emerging management problems;
- Personal integrity;
- Quality data;
- Separation of key duties and responsibilities;
- Periodic comparisons of actual with recorded accountability of resources;
- Routine assessment of programs with a high potential for risk;
- Systematic review strategy to assess the effectiveness of program operations; and
- Prompt management actions to correct significant problems or improve operations.

Since its inception, TTB has gradually developed its own Bureau-specific policies.

Management accountability systems must assure basic compliance with the objectives of the FMFIA and the management control standards set by the Government Accountability Office. In addition, any inspection, audit, evaluation, peer or program review process, self-assessment, or the equivalent, used by TTB management to keep informed about needs and opportunities for improvement must incorporate these same standards into its methodology.

Furthermore, the Bureau completed an annual risk assessment for improper payments on all of its programs and activities. This process disclosed low risk susceptibility for improper payments, and documented that sound internal management and controls were in place at the Bureau to cover its disbursements.

The Bureau continues to strengthen and improve the execution of its mission through the application of sound internal controls over financial reporting. In response to OMB Circular A-123, Management's Responsibility for Internal Controls, the Bureau, in concert with the Department, developed and implemented an extensive testing and assessment methodology that identified and documented internal controls over financial reporting on our revenue accounting activities.

This increased emphasis on management controls has had a positive impact on programs and enabled the Bureau to achieve the intended results. The process also ensures that the utilization of resources is consistent with mission priorities and that program and resources are being used without waste, fraud, or mismanagement. Also, in addition to the A-123 review, TTB conducted a series of office reviews during FY 2012 that included an extensive review of administrative and internal controls

## Financial Statement Highlights

The following overview of the TTB financial statements highlights certain aspects of the financial statements for the fiscal year ended September 30, 2012.

- The Balance Sheet shows the assets, liabilities, and net position as of a point in time, in this case, as of September 30, 2012.

  - The total assets were reported as $79.5 million at the close of the fiscal year. Of this amount, $34.4 million is classified as the fund balance with Treasury. That fund balance account is the undisbursed account balance with the Treasury, primarily resulting from undisbursed appropriations.
  - The total liabilities amount reported is $47.3 million, of which total intragovernmental liabilities amounts to $21.5 million. The other liabilities are classified by type, such as accrued tax refunds, payables, and other liabilities.
- The Statement of Net Cost shows the total net cost of operations at $103.7 million for the Bureau to administer its two budget activities.
  - The total net cost reported as program costs under the Collect the Revenue program was $51.0 million.
  - The total net cost reported as program costs under the Protect the Public program was $52.7 million.
- The Statement of Change in Net Position shows a total net position balance of $32.2 million, and that amount represents the unexpended appropriations from both prior periods and from the current operating cycle in addition to Net Position from Operations.
- The Statement of Budgetary Resources shows the budgetary resources received and the status of those resources. For TTB, the resources are primarily annual appropriations received from the in the amount of $99.8 million, in addition to spending authority from collections. The offsetting collections amount was $4.8 million. Of that amount, $3.1 million is from the recovery of costs for maintaining enforcement operations in Puerto Rico.
- The Statement of Custodial Activity shows the amount of revenue received during FY 2012 compared with FY 2011, along with tax refunds, drawback on Manufacturer of Nonbeverage Products claims, and cover-over payments. The amount displayed shows that the total Federal excise tax revenues collected from alcohol, tobacco, firearms, and ammunition amounted to $23.4 billion. Within this total, the Bureau processed tax refunds, drawback claims, and cover-over payments in the amount of $709.2 million.
  - **Drawback claims** of $289.3 million were processed based on claims filed from MNBPs. Under current law, a drawback claim is allowed when distilled spirits on which the tax has been paid were unfit for beverage purposes and used in the production of medicines, medicinal preparations, food products, flavors, flavoring extracts, or perfumes.
  - **Tax refunds** and other adjustments (e.g., interest) were processed in the amount of $30.3 million.
  - **Cover-over payments** were returned to Puerto Rico and the Virgin Islands in the amount of $385.7 million. Such taxes collected on rum imported in the United States are “covered over,” or paid into, the treasuries of Puerto Rico and the Virgin Islands.
  - **The disposition of the custodial revenue**, after refunds, claims, and cover-over payments, nets to $23.1 billion, and that amount was deposited to the U.S. Treasury to fund the Federal Government, with the exception of the Federal firearms and ammunition Federal excise taxes. Those revenues, in the amount of $514.6 million, were remitted to the Fish and Wildlife Restoration Fund under provisions of the Pittman Robertson Act of 1937.

## Notes to the Basic Financial Statements

The notes to the basic financial statements provide additional information that is essential to a full understanding of the financial information provided in the statements.

## Supplementary Information

In addition to the basic financial statements and accompanying notes, this report presents other supplementary information. For instance, TTB includes a table that outlines the tax collections for the past 10 years for each of the key revenue sources. Also, a table has been included to show the refunds, cover-over payments, and drawback payments for the past 10 years.

# Financial Statements, Accompanying Notes, and Supplemental Information

## Limitations of Financial Statements

The principal statements have been prepared to report the financial position and results of operations of the entity, pursuant to the requirements of 31 U.S.C. 3515(b). While the statements have been prepared from the books and records of the entity in accordance with GAAP for federal entities and the formats prescribed by the Office of Management and Budget (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. For fiscal years 2012 and 2011, all financial statements and note have been audited.

## Management Responsibilities

Bureau management is responsible for the fair presentation of information contained in the principal financial statements, in conformity with generally accepted accounting principles (GAAP), and the form and content for entity financial statements specified by OMB in Circular A-136.

Management is also responsible for the fair representation of TTB's performance measures in accordance with OMB requirements. The quality of the Bureau's internal control structure rests with management, as does the responsibility for identification of and compliance with pertinent laws and regulations.

## TTB in Relation to Treasury's Annual Financial Statements

The Department of the Treasury received an unqualified audit opinion on its FY 2012 financial statements. The financial activities of the Bureau are an integral part of the information reported by the Department of the Treasury.

This unqualified audit opinion means that the financial information presented by the Treasury, which includes TTB's financial activities, was presented fairly and in conformity with generally accepted accounting principles (GAAP) of the United States.

**KPMG LLP**
Suite 12000
1801 K Street, NW
Washington, DC 20006

## Independent Auditors' Report

Inspector General
United States Department of the Treasury

Administrator
Alcohol and Tobacco Tax and Trade Bureau:

We have audited the accompanying balance sheets of the Alcohol and Tobacco Tax and Trade Bureau as of September 30, 2012 and 2011, and the related statements of net cost, changes in net position, and custodial activity, and statements of budgetary resources (hereinafter referred to as "financial statements" ) for the years then ended. These financial statements are the responsibility of the Alcohol and Tobacco Tax and Trade Bureau's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended. Those standards and OMB Bulletin No. 07-04 require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Alcohol and Tobacco Tax and Trade Bureau's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Alcohol and Tobacco Tax and Trade Bureau as of September 30, 2012 and 2011, and its net costs, changes in net position, budgetary resources, and custodial activity for the years then ended in conformity with U.S. generally accepted accounting principles.

As discussed in Note 1.S. to the financial statements, the Alcohol and Tobacco Tax and Trade Bureau changed its presentation for reporting the statements of budgetary resources in fiscal year 2012, based on new reporting requirements under OMB Circular No. A-136, *Financial Reporting Requirements*. As a result, the Alcohol and Tobacco Tax and Trade Bureau's statement of budgetary resources for fiscal year 2011 has been changed to conform to the current year presentation.

U.S. generally accepted accounting principles require that the information in the Management's Discussion and Analysis and Required Supplementary Information sections be presented to supplement the financial statements. Such information, although not a part of the financial statements, is required by the Federal Accounting Standards Advisory Board who considers it to be an essential part of financial reporting for placing the financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the financial statements, and other knowledge we obtained during our audits of the financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Our audits were conducted for the purpose of forming an opinion on the financial statements as a whole. The Other Accompanying Information included in (1) pages i through vii, (2) *Part II: Program Performance Results*, (3) *Message from the Chief Financial Officer*, (4) pages 69 through 78 and pages 115 through 119 of *Part III: Financial Results, Position, Condition and Auditors' Reports*, and (5) *Part IV: Appendices* is presented for purposes of additional analysis and is not required as a part of the financial statements. This information has not been subjected to the auditing procedures applied in the audits of the financial statements, and accordingly, we do not express an opinion or provide any assurance on them.

In accordance with *Government Auditing Standards*, we have also issued our reports dated December 14, 2012, on our consideration of the Alcohol and Tobacco Tax and Trade Bureau's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and other matters. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in assessing the results of our audits.

KPMG LLP

December 14, 2012

**KPMG LLP**
Suite 12000
1801 K Street, NW
Washington, DC 20006

## Independent Auditors' Report on Internal Control Over Financial Reporting

Inspector General
United States Department of the Treasury

Administrator
Alcohol and Tobacco Tax and Trade Bureau:

We have audited the balance sheets of the Alcohol and Tobacco Tax and Trade Bureau as of September 30, 2012 and 2011 and the related statements of net cost, changes in net position, custodial activity, and statements of budgetary resources (hereinafter referred to as "financial statements") for the years then ended, and have issued our report thereon dated December 14, 2012.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended. Those standards and OMB Bulletin No. 07-04 require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The management of the Alcohol and Tobacco Tax and Trade Bureau is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our fiscal year 2012 audit, we considered the Alcohol and Tobacco Tax and Trade Bureau's internal control over financial reporting by obtaining an understanding of the design effectiveness of the Alcohol and Tobacco and Tax and Trade Bureau's internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Alcohol and Tobacco Tax and Trade Bureau's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Alcohol and Tobacco Tax and Trade Bureau's internal control over financial reporting. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*.

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. A material weakness is a deficiency, or a combination of deficiencies, in internal control 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.

Our consideration of internal control over financial reporting was for the limited purpose described in the third paragraph of this report and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses. In our fiscal year 2012 audit, we did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Exhibit I presents the status of the prior year material weakness.

This report is intended solely for the information and use of the Alcohol and Tobacco Tax and Trade Bureau's management, the Department of the Treasury Office of Inspector General, OMB, the U.S. Government Accountability Office, and the U.S. Congress and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

December 14, 2012

**EXHIBIT I**

**ALCOHOL AND TOBACCO TAX AND TRADE BUREAU**

Status of Prior Year Finding

September 30, 2012

| Fiscal Year 2011 Finding | Deficiency Type | Fiscal Year 2012 Status |
|---|---|---|
| **1) Improvements Are Needed In The Review Of The Allowance For Doubtful Accounts On Tax And Trade Receivables** | Material Weakness | Closed |

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## Independent Auditors' Report on Compliance and Other Matters

Inspector General
United States Department of the Treasury

Administrator
Alcohol and Tobacco Tax and Trade Bureau:

We have audited the balance sheets of the Alcohol and Tobacco Tax and Trade Bureau as of September 30, 2012 and 2011, and the related statements of net cost, changes in net position, custodial activity, and statements of budgetary resources (hereinafter referred to as "financial statements") for the years then ended, and have issued our report thereon dated December 14, 2012.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended. Those standards and OMB Bulletin No. 07-04 require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The management of the Alcohol and Tobacco Tax and Trade Bureau is responsible for complying with laws, regulations, and contracts applicable to the Alcohol and Tobacco Tax and Trade Bureau. As part of obtaining reasonable assurance about whether the Alcohol and Tobacco Tax and Trade Bureau's financial statements are free of material misstatement, we performed tests of the Alcohol and Tobacco Tax and Trade Bureau's compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of the financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 07-04, including the provisions referred to in Section 803(a) of the *Federal Financial Management Improvement Act of 1996* (FFMIA). We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws, regulations, and contracts applicable to the Alcohol and Tobacco Tax and Trade Bureau. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion.

The results of certain of our tests of compliance described in the preceding paragraph, exclusive of those referred to in FFMIA, disclosed no instances of noncompliance or other matters that are required to be reported herein under *Government Auditing Standards* or OMB Bulletin No. 07-04.

The results of our tests of FFMIA disclosed no instances in which the Alcohol and Tobacco Tax and Trade Bureau's financial management systems did not substantially comply with the (1) Federal financial management systems requirements, (2) applicable Federal accounting standards, and (3) the United States Government Standard General Ledger at the transaction level.

This report is intended solely for the information and use of the Alcohol and Tobacco Tax and Trade Bureau's management, the Department of the Treasury Office of Inspector General, OMB, the U.S. Government Accountability Office, and the U.S. Congress and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

December 14, 2012

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# ALCOHOL AND TOBACCO TAX AND TRADE BUREAU
## BALANCE SHEETS
## As of September 30, 2012 and 2011
## (In Thousands)

| | 2012 | 2011 |
|---|---|---|
| **ASSETS** | | |
| **Intragovernmental Assets:** | | |
| Fund Balance with Treasury (Note 2) | $ 34,431 | $ 37,866 |
| Accounts Receivable (Note 3) | 262 | 352 |
| Due from the General Fund (Notes 5 and 8) | 2,873 | 2,022 |
| Advances (Note 7) | 751 | 829 |
| **Total Intragovernmental Assets** | 38,317 | 41,069 |
| Accounts Receivable (Note 3) | 444 | 484 |
| Tax and Trade Receivables, Net (Notes 4 and 8) | 20,334 | 4,310 |
| Property, Plant and Equipment, Net (Note 6) | 20,353 | 20,451 |
| Advances | 44 | - |
| **TOTAL ASSETS** (Note 8) | $ 79,492 | $ 66,314 |
| **LIABILITIES** | | |
| **Intragovernmental Liabilities:** | | |
| Accounts Payable | $ 480 | $ 500 |
| Payroll Benefits | 651 | 641 |
| FECA Liabilities | 39 | 36 |
| Due to the General Fund (Notes 4 and 5) | 18,851 | 4,246 |
| Other Liabilities (Note 9) | 1,483 | 61 |
| **Total Intragovernmental Liabilities** | 21,504 | 5,484 |
| Accounts Payable | 2,573 | 5,843 |
| Payroll Benefits | 2,723 | 2,792 |
| FECA Actuarial Liability | 228 | 308 |
| Refunds | 2,873 | 2,025 |
| Unfunded Leave | 4,233 | 4,346 |
| Cash Bond Liabilities (Note 2) | 12,570 | 12,447 |
| Other Liabilities (Note 9) | 560 | 693 |
| **TOTAL LIABILITIES** | $ 47,264 | $ 33,938 |
| **NET POSITION** | | |
| Unexpended Appropriations | $ 16,377 | $ 16,559 |
| Cumulative Results of Operations | 15,851 | 15,817 |
| **TOTAL NET POSITION** | $ 32,228 | $ 32,376 |
| **TOTAL LIABILITIES AND NET POSITION** | $ 79,492 | $ 66,314 |

***The accompanying notes are an integral part of these statements.***

## ALCOHOL AND TOBACCO TAX AND TRADE BUREAU
## STATEMENTS OF NET COST
## For the Years Ended September 30, 2012 and 2011
## (In Thousands)

| | 2012 | 2011 |
|---|---|---|
| **COLLECT THE REVENUE** | | |
| **Program Costs** | | |
| Intragovernmental Gross Costs | $ 14,436 | $ 15,214 |
| Less: Intragovernmental Earned Revenue | (1,308) | (512) |
| Intragovernmental Net Costs | 13,128 | 14,702 |
| Gross Costs with the Public | 40,541 | 40,240 |
| Less: Earned Revenues from the Public | (2,655) | (2,941) |
| Net Costs with the Public | 37,886 | 37,299 |
| Total Net Program Cost | $ 51,014 | $ 52,001 |
| **PROTECT THE PUBLIC** | | |
| **Program Costs** | | |
| Intragovernmental Gross Costs | $ 13,988 | $ 14,495 |
| Less: Intragovernmental Earned Revenue | (197) | (27) |
| Intragovernmental Net Costs | 13,791 | 14,468 |
| Gross Costs with the Public | 39,285 | 38,339 |
| Less: Earned Revenues from the Public | (401) | (156) |
| Net Costs with the Public | 38,884 | 38,183 |
| Total Net Program Cost | $ 52,675 | $ 52,651 |
| **NET COST OF OPERATIONS** (Note 13) | $ 103,689 | $ 104,652 |

*The accompanying notes are an integral part of these statements.*

**ALCOHOL AND TOBACCO TAX AND TRADE BUREAU**
**STATEMENTS OF CHANGES IN NET POSITION**
**For the Years Ended September 30, 2012 and 2011**
**(In Thousands)**

| | 2012 | 2011 |
|---|---|---|
| **Cumulative Results of Operations** | | |
| Beginning Balances | $ 15,817 | $ 14,704 |
| **Budgetary Financing Sources** | | |
| Appropriations Used | 99,591 | 100,938 |
| **Other Financing Sources** | | |
| Transfers-in without reimbursement | 91 | 231 |
| Imputed Financing from Costs Absorbed by Others (Note 12) | 4,041 | 4,596 |
| **Total Financing Sources** | 103,723 | 105,765 |
| **Net Cost of Operations** (Note 13) | (103,689) | (104,652) |
| **Net Change** | 34 | 1,113 |
| **Cumulative Results of Operations** | $ 15,851 | $ 15,817 |
| **UNEXPENDED APPROPRIATIONS** | | |
| Beginning Balances | $ 16,559 | $ 17,416 |
| **Budgetary Financing Sources** | | |
| Appropriations Received | 99,878 | 101,000 |
| Other Adjustments | (469) | (919) |
| Appropriations Used | (99,591) | (100,938) |
| **Total Budgetary Financing Sources** | (182) | (857) |
| **Net Position of Unexpended Appropriations** | $ 16,377 | $ 16,559 |
| **TOTAL NET POSITION** | $ 32,228 | $ 32,376 |

***The accompanying notes are an integral part of these statements.***

**ALCOHOL AND TOBACCO TAX AND TRADE BUREAU**
**STATEMENTS OF BUDGETARY RESOURCES**
**For the Years Ended September 30, 2012 and 2011**
**(In Thousands)**

| | 2012 | 2011 |
|---|---|---|
| **BUDGETARY RESOURCES** (Note 14) | | |
| Unobligated Balance, Beginning of Period | $ 3,518 | $ 4,845 |
| Recoveries of Prior Year Obligations | 1,268 | 1,501 |
| Budget Authority: | | |
| Appropriations Received | 99,878 | 101,000 |
| Spending Authority from Offsetting Collections, Earned: | | |
| Collected | 4,786 | 3,939 |
| Change in Receivable from Federal Sources | (134) | (72) |
| Change in Unfilled Customer Orders: | | |
| Without Advance from Federal Sources | 2,189 | 218 |
| Subtotal | 106,719 | 105,085 |
| Permanently Not Available | (468) | (920) |
| **TOTAL BUDGETARY RESOURCES** | 111,037 | 110,511 |
| **STATUS OF BUDGETARY RESOURCES** | | |
| Obligations Incurred (Note 15) | $ 107,921 | $ 106,993 |
| Unobligated Balance Apportioned | 398 | 1,758 |
| Unobligated Balance not Available | 2,718 | 1,760 |
| Total Unobligated Balance, End of Period | 3,116 | 3,518 |
| **TOTAL STATUS OF BUDGETARY RESOURCES** | $ 111,037 | $ 110,511 |

*The accompanying notes are an integral part of these statements.*

**ALCOHOL AND TOBACCO TAX AND TRADE BUREAU**
**STATEMENTS OF BUDGETARY RESOURCES**
**For the Years Ended September 30, 2012 and 2011**
**(In Thousands)**

| | 2012 | 2011 |
|---|---|---|
| **CHANGE IN OBLIGATED BALANCE** | | |
| Unpaid Obligations Brought Forward, Oct 1 | $ 22,762 | $ 22,141 |
| Uncollected Customer Payments from Federal Sources Brought Forward Oct 1 | (1,554) | (1,407) |
| Total Unpaid Obligated Balance Brought Forward, Net | 21,208 | 20,734 |
| Obligations Incurred, Net (Note 15) | 107,921 | 106,993 |
| Outlays, Gross | (107,620) | (104,872) |
| Recoveries of Prior Year Unpaid Obligations, Actual | (1,268) | (1,501) |
| Change in Uncollected Customer Payments from Federal Sources | (2,055) | (146) |
| **OBLIGATED BALANCE, END OF PERIOD** | $ 18,186 | $ 21,208 |
| Obligated Balances, Net, End of Period: | | |
| Unpaid Obligations | 21,795 | 22,762 |
| Uncollected Customer Payments from Federal Sources | (3,609) | (1,554) |
| **TOTAL UNPAID OBLIGATED BALANCE, NET, END OF PERIOD** | $ 18,186 | $ 21,208 |
| | | |
| **BUDGET AUTHORITY AND OUTLAYS, NET** | | |
| Budget Authority: | | |
| Budget Authority, Gross | $ 106,719 | $ 105,085 |
| Actual Offsetting Collections | (4,786) | (3,939) |
| Change in Uncollected Customer Payments from Federal Sources | (2,055) | (146) |
| **BUDGET AUTHORITY, NET** | $ 99,878 | $ 101,000 |
| Outlays: | | |
| Outlays, Gross | 107,620 | 104,872 |
| Offsetting Collections | (4,786) | (3,939) |
| Distributed Offsetting Receipts | (3) | (10) |
| **OUTLAYS, NET** | $ 102,831 | $ 100,923 |

***The accompanying notes are an integral part of these statements.***

## ALCOHOL AND TOBACCO TAX AND TRADE BUREAU
## STATEMENTS OF CUSTODIAL ACTIVITY
### For the Years Ended September 30, 2012 and 2011
### (In Thousands)

| | 2012 | 2011 |
|---|---|---|
| **SOURCES OF CUSTODIAL REVENUE** | | |
| **Revenue Received** | | |
| Excise Taxes (Note 16) | $ 23,378,944 | $ 23,457,049 |
| Interest, Fines and Penalties | 934 | 4,351 |
| Other Custodial Revenue | 3 | 10 |
| **Total Revenue Received** (Note 17) | 23,379,881 | 23,461,410 |
| Refunds and Drawbacks (Note 16) | (323,447) | (340,416) |
| **Net Revenue Received** | 23,056,434 | 23,120,994 |
| Accrual Adjustment | 15,176 | 7,117 |
| **Total Sources of Custodial Revenue** | $ 23,071,610 | $ 23,128,111 |
| **DISPOSITION OF CUSTODIAL REVENUE** | | |
| Amounts Provided to Non-Federal Entities (Note 16) | 385,710 | 461,632 |
| Amounts Provided to Fund the Federal Government (Note 17) | 22,670,724 | 22,659,362 |
| Accrual Adjustment | 15,176 | 7,117 |
| **Total Disposition of Custodial Revenue** | $ 23,071,610 | $ 23,128,111 |
| **NET CUSTODIAL REVENUE ACTIVITY** | $ - | $ - |

***The accompanying notes are an integral part of these statements.***

# Notes to the Financial Statements

## Note 1. Summary of Significant Accounting Policies

### *A. Reporting Entity*

The Alcohol and Tobacco Tax and Trade Bureau (TTB) was established on January 24, 2003, as a result of the Homeland Security Act of 2002. The Act transferred firearms, explosives, and arson functions of the Bureau of Alcohol, Tobacco and Firearms (ATF) to the Department of Justice and retained the tax collection and consumer protection provisions of the Internal Revenue Code (IRC) and Federal Alcohol Administration Act in TTB within the Department of the Treasury. While the agency has a new name, the history of TTB's regulatory responsibility dates back to the creation of the Department of the Treasury and the first Federal taxes levied on distilled spirits in 1791. TTB has two primary programs: Collect the Revenue and Protect the Public. Under the Collect the Revenue program, TTB collects alcohol, tobacco, firearms, and ammunition excise taxes, and under its Protect the Public program, TTB protects the consumer by ensuring that alcohol beverages are labeled, advertised, and marketed in accordance with the law, and facilitates trade in beverage and industrial alcohols.

### *B. Basis of Presentation*

The financial statements were prepared to report the significant assets, liabilities, and net cost of operations, changes in net position, budgetary resources, and custodial activities of TTB. The financial statements have been prepared from the books and records of TTB in conformity with generally accepted accounting principles (GAAP) in the United States, and form and content guidance for entity financial statements issued by the Office of Management and Budget (OMB) in OMB Circular A-136. TTB's accounting policies are summarized in this note. GAAP for Federal entities is prescribed by the Federal Accounting Standards Advisory Board (FASAB), which has been designated the official accounting standards-setting body for the Federal Government by the American Institute of Certified Public Accountants.

### *C. Basis of Accounting*

Transactions are recorded on a proprietary accrual and a budgetary basis of accounting. Under the accrual basis, revenues are recorded when earned and expenses are recorded when incurred, regardless of when cash is exchanged. However, under the budgetary basis, funds availability is recorded based upon legal considerations and constraints. As a result, certain line items on the proprietary statements may not equal similar lines on the budgetary financial statements.

### *D. Revenue and Financing Sources*

#### (1) Exchange Revenue

Exchange Revenues are inflows of resources to a Government entity that the entity has earned by providing something of value to the public or another Government entity at a price. The majority of the Exchange Revenues earned by the Bureau result from providing services to the Government of Puerto Rico, as well as other Treasury entities.

#### (2) Financing Sources

Financing sources provide inflows of resources during the reporting period and include appropriations used and imputed financing. Unexpended appropriations are recognized separately in determining net position, but are not financing sources until used. Imputed financing sources are the result of other Federal entities financing costs on behalf of TTB.

TTB receives the majority of the funding needed to support the Bureau through congressional appropriations. The appropriations received are annual and multi-year funding that may be used, within statutory limits, for operating and capital expenditures.

#### (3) Imputed Financing Sources

Imputed financing sources are the result of Federal entities financing costs on behalf of TTB. Those entities pay future benefits for health insurance, life insurance, and pension benefits for TTB employees.

### *E. Custodial Revenue*

For TTB, most custodial revenues result from collecting taxes on alcohol and tobacco products, which are transferred to the General Fund, and recognized as a nonexchange revenue on the Federal government’s consolidated financial statements. The excise taxes collected by TTB come from businesses, and the taxes are imposed and collected at the producer and importer levels of operations. Members of the regulated industries paying excise taxes are distilleries, breweries, bonded wineries, bonded wine cellars, manufacturers of cigarette tubes, manufacturers of tobacco products, and manufacturers and importers of firearms and ammunition. These taxes are recorded on the records on a modified cash basis of accounting. The Statement of Custodial Activity is presented on a net accrual basis.

### *F. Fund Balance with Treasury*

The Fund Balance with Treasury is the undisbursed account balance with the Treasury, primarily resulting from undisbursed appropriations. The balance is available within statutory limits to pay current liabilities and finance authorized purchase obligations. The Fund Balance also includes a non-entity balance, primarily the result of custodial activities related to collecting escrow payments designed to finance Offers-in-Compromise and cash bonds held in lieu of corporate surety bonds guaranteeing payment of taxes.

### *G. Accounts Receivable*

Intragovernmental accounts receivable consist of amounts due under reimbursable agreements with Federal entities for services provided by TTB. Public accounts receivable consist of taxes, penalties, and interest that have been assessed but unpaid at year end.

Receivables due from Federal agencies are considered to be fully collectible. An allowance for doubtful accounts is established for public receivables based on specific identification.

### *H. Property, Plant, and Equipment*

Property, plant, and equipment purchased with a cost greater than or equal to $25,000 per unit and a useful life of two years or more, is capitalized and depreciated. Normal repairs and maintenance are charged to expense as incurred.

TTB also capitalizes internal use of software when the unit cost or development costs are greater than or equal to $25,000. The same threshold also applies to enhancements that add significant functionality to the software. TTB will amortize this software based on its classification. The classifications are as follows: 1) Enterprise and other business software (five years), and 2) Personal productivity and desktop operating software (three years).

Additionally, TTB also capitalizes like assets purchased in bulk when the unit price is greater than or equal to $5,000 and less than $25,000, with the aggregated purchase amount greater than or equal to $250,000.

Assets are depreciated on a straight-line basis beginning the month the asset was put in to use.

### *I. Advances*

Advances are payments made to cover certain periodic expenses before those expenses are incurred. In accordance with Public Law 91-614, TTB participated in the Treasury's Working Capital Fund for which it receives services on a reimbursable basis. Payments from TTB to Treasury are made in advance and are authorized for services that have been deemed as more advantageous and more economical when provided centrally. The services provided include those for telecommunications, payroll/personnel systems, printing, and other centralized services. The amount reported represents the balance available at the end of the fiscal year after charges/expenses incurred by the fund are deducted.

### *J. Non-entity Assets*

Non-entity assets consist primarily of cash and receivables for excise taxes and fees that are to be distributed to the Treasury, other Federal agencies, and other governments. Non-entity assets are not considered a financing source (revenue) available to offset the operating expenses of TTB.

### *K. Liabilities*

Liabilities represent the amount of monies, or other resources, that are likely to be paid by TTB as the result of a transaction or event that has already occurred. However, no liability can be paid by TTB absent an appropriation. Liabilities for which an appropriation has not been enacted and for which there is uncertainty an appropriation will be enacted, are classified as a liability not covered by budgetary resources. Also, the Government, acting in its sovereign capacity, can abrogate liabilities of TTB that arise from other than contracts.

Intragovernmental liabilities consist of amounts payable to the Treasury for collections of excise tax, fees receivable, payments to other Federal agencies, and accrued Federal Employees' Compensation Act (FECA) charges. Liabilities also include amounts due to be refunded to taxpayers, as well as amounts held in escrow for Offers-in-Compromise and cash bonds held in guaranteeing payment of taxes.

### *L. Litigation Contingencies and Settlements*

Probable and estimable litigation and claims against TTB are recognized as a liability and expense for the full amount of the expected loss. Expected litigation and claim losses include settlements to be paid from the Treasury Judgment Fund (Judgment Fund) on behalf of TTB and settlements to be paid from Bureau appropriations. The Judgment Fund pays Bivens-type tort claims. Settlements paid from the Judgment Fund for TTB are recognized as an expense and imputed financing source.

### *M. Annual, Sick, and Other Leave*

Annual and compensatory leave earned by TTB employees, but not yet used, is reported as an accrued liability. The accrued balance is adjusted annually to current pay rates. Any portions of the accrued leave, for which funding is not available, are recorded as an unfunded liability. Sick and other leave are expensed as taken.

### *N. Interest on Late Payments*

Pursuant to the prompt payment Act, 31 # U.S.C. & 3901-3907, Federal agencies must pay interest on payments for goods or services made to business concerns after their due date. The due date is generally 30 days after receipt of a proper invoice or acceptance of the goods or services.

### *O. Retirement Plan*

Employees hired after December 31, 1983, are automatically covered by FERS and Social Security. For most employees hired after December 31, 1983, TTB also contributes the employers' matching share of Social Security. For the FERS basic benefit, employees contribute 0.8 percent of basic pay while TTB contributes 11.2 percent, for a total contribution rate of 12.0 percent in FY 2012, as well as FY 2011. The cost of providing a FERS basic benefit, as provided by the Office of Personnel Management (OPM), is equal to the amounts contributed by TTB and the employees.

All employees are eligible to contribute to the Thrift Savings Plan (TSP). For those employees participating in the FERS, a TSP account is automatically established and TTB makes a mandatory 1 percent contribution to this account. In addition, TTB makes matching contributions, ranging from 1 to 4 percent, for FERS-eligible employees who contribute to their TSP accounts. Matching contributions are not made to the TSP accounts established by CSRS employees.

TTB recognized the full cost of providing future pension and other retirement benefits (ORB) for current employees as required by Statement of Federal Financial Accounting Standards (SFFAS) No. 5. Full cost includes pension and ORB contributions paid out of Bureau appropriations and costs financed by OPM. Costs financed by OPM are reported in the accompanying financial statements as an imputed financing revenue source. Reporting amounts such as plan assets, accumulated plan benefits, or unfunded liabilities, if any, is the responsibility of OPM.

### *P. 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 and employees who have incurred a work-related injury or occupational disease. The future workers' compensation estimates were generated from an application of actuarial procedures developed to estimate the liability for FECA benefits. The actuarial liability estimates for FECA benefits include the expected liability for death, disability, medical, and miscellaneous costs for approved compensation cases. The liability is determined using the paid losses extrapolation method, which is calculated over the next 37-year period. This method utilizes historical benefit patterns related to a specific incurred period to predict ultimate payments related to that period.

Claims are paid for TTB employees by the Department of Labor (DOL) from the FECA fund, for which TTB reimburses DOL. The accrued liability represents claims paid by DOL for TTB employees, for which the fund has not been reimbursed. The actuarial liability is an estimate of future costs to be paid on claims made by TTB employees. The estimated future cost is not obligated against budgetary resources until the year in which the cost is billed to TTB.

### *Q. Use of Estimates*

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amount of assets and liabilities, as well as the disclosure of contingent liabilities at the date of the financial statements, and the amount of revenues and cost reported during the period. Actual results could differ from those estimates.

### *R. Tax Exempt Status*

As an agency of the Federal Government, TTB is exempt from all income taxes imposed by any governing body, whether it is a Federal, state, commonwealth, local, or foreign government.

### *S. Changes in Presentation*

In FY 2012, changes to the presentation of the Statements of Budgetary Resources were made, in accordance with guidance provided in OMB Circular A-136 and as such, activity and balances reported on the FY 2011 Statement of Budgetary Resources has been changed to conform to the presentation in the current year.

### *T. Subsequent Events*

Subsequent events and transaction occurring after September 30, 2012 through the date of the auditors’ opinion have been evaluated for potential recognition or disclosure in the financial statements. The date of the auditors’ opinion also represents the date that the financial statements were available for issue.

## Note 2. Fund Balance with Treasury

Fund Balance with Treasury as of September 30, 2012 and 2011 consisted of the following (in thousands):

| | 2012 | 2011 |
|---|---|---|
| Fund Balances: | | |
| General Funds | $21,302 | $24,726 |
| Other Funds | 13,129 | 13,140 |
| Total | $34,431 | $37,866 |
| Status of Fund Balances: | | |
| Unobligated Balance - Available | $ 398 | $ 1,758 |
| Unobligated Balance - Unavailable | 2,718 | 1,760 |
| Obligated Balance Not Yet Disbursed | 18,186 | 21,208 |
| Subtotal | 21,302 | 24,726 |
| Adjustment for Non-Budgetary Funds | 13,129 | 13,140 |
| Total Status of Fund Balances | $34,431 | $37,866 |

The other funds and non-budgetary fund balance primarily represents cash bonds, which are cash payments made to the Bureau by taxpayers, in lieu of obtaining corporate surety bonds, guaranteeing payment of taxes. It also includes Offers-in-Compromise (OIC). OICs are payments made to the Bureau, being held in escrow, to finance offers from taxpayers to settle their tax debt at less than the assessed amount.

The unobligated balance that is unavailable is the balance of prior years' expired appropriations.

## Note 3. Accounts Receivable

Accounts Receivable as of September 30, 2012 and 2011 consisted of the following (in thousands):

| | 2012 | 2011 |
|---|---|---|
| Intragovernmental Accounts Receivable: | | |
| Due from Treasury Executive Office of Asset Forfieture | $ 68 | $ 82 |
| Due from Community Financial Development Institutions Fund | 194 | 246 |
| Due from General Services Administration | - | 24 |
| Total Intragovernmental Accounts Receivable | $ 262 | $ 352 |
| | | |
| Due from the Government of Puerto Rico | $ 436 | $ 479 |
| Due from Employees | 8 | 5 |
| Total Accounts Receivable Due from the Public | $ 444 | $ 484 |

No allowance for doubtful accounts has been recognized, nor have any accounts been written off. All intragovernmental accounts receivable are considered fully collectible. Additionally, other non-Federal receivables consist of a receivable from the government of Puerto Rico, which is collected via an offset to cover-over payments the Bureau remits to Puerto Rico, and employee accounts receivable, which can be collected via salary offsets.

## Note 4. Tax and Trade Receivables, Net

Tax and Trade Receivables as of September 30, 2012 and 2011 consisted of the following (in thousands):

| | 2012 | 2011 |
|---|---|---|
| Tax and Trade Receivables | $ 59,965 | $ 24,201 |
| Interest Receivable | 5,019 | 4,292 |
| Penalties, Fines and Administrative Fees Receivable | 15,490 | 6,069 |
| Total Tax and Trade Receivables | 80,474 | 34,562 |
| Allowance for Doubtful Accounts | (60,140) | (30,252) |
| Total Tax and Trade Receivables, Net | $ 20,334 | $ 4,310 |

All tax and trade receivables are non-entity assets. An allowance for uncollectible amounts has been established based on: 1) an analysis of individual receivable balances and 2) the application of historical non-collection rates for similar types of receivables. Because current laws governing the collection period for these tax assessments, 26 U.S.C. 6502, stipulate taxes are collectible for 10 years from the date the taxes were assessed, a large amount of aged receivables that are not likely to be collected have been offset with an allowance, but not written off. This is an offsetting liability reported as Due to the General Fund.

The increase in gross receivables is largely related to new receivables with one taxpayer, approximating $36 million.

## Note 5. Due from the General Fund and Due to the General Fund

In addition to collecting taxes from the alcohol and tobacco industries, the Bureau also is responsible for paying refunds, when applicable, to those same industry members. Amounts due from the General Fund represent a receivable from appropriations to cover the Bureau's accrued refund liability to alcohol and tobacco excise taxpayers.

| | 2012 | 2011 |
|---|---|---|
| Due from the General Fund (in thousands) | $ 2,873 | $ 2,022 |

Amounts due to the General Fund primarily represent the balance of receivables related to Alcohol and Tobacco excise taxes. Receivables related to Firearms and Ammunition excise taxes are payable to the Department of Interior's Fish and Wildlife Restoration Fund, not the General Fund.

| | 2012 | 2011 |
|---|---|---|
| Due to the General Fund (in thousands) | $ 18,851 | $ 4,246 |

## Note 6. Property, Plant, and Equipment, Net (PP&E)

Property, Plant and Equipment as of September 30, 2012 and 2011 consisted of the following (in thousands):

| 2012 | Estimated Useful Life (Years) | Acquisition Value | Accumulated Depreciation | Net Book Value |
|---|---|---|---|---|
| Internal Use Software | 3 - 5 | $ 13,644 | $ 5,542 | $ 8,102 |
| Equipment | 4 - 6 | 11,064 | 6,792 | 4,272 |
| Leasehold Improvements | 2 - 5 | 1,134 | 825 | 309 |
| Building | 40 | 9,772 | 2,102 | 7,670 |
| Total PP&E | | $ 35,614 | $ 15,261 | $ 20,353 |

| 2011 | Estimated Useful Life (Years) | Acquisition Value | Accumulated Depreciation | Net Book Value |
|---|---|---|---|---|
| Internal Use Software | 3 - 5 | $ 13,625 | $ 4,770 | $ 8,855 |
| Equipment | 4 - 6 | 9,034 | 5,596 | 3,438 |
| Leasehold Improvements | 2 - 5 | 796 | 562 | 234 |
| Building | 40 | 9,772 | 1,848 | 7,924 |
| Total PP&E | | $ 33,227 | $ 12,776 | $ 20,451 |

Depreciation and amortization are calculated using the straight-line method.

The balance in the buildings account represents TTB's 13.2 percent equity interest in the National Laboratory Center facility in Beltsville, Maryland, which TTB co-owns with ATF.

## Note 7. Advances

Intragovernmental advances consist of the balances paid to Treasury's Working Capital Fund that have not yet been earned and billed by the fund. Advances with the public generally consist of prepaid services agreements for support or maintenance.

## Note 8. Non-entity Assets

Non-entity Assets as of September 30, 2012 and 2011 consisted of the following (in thousands):

| | 2012 | 2011 |
|---|---|---|
| Intragovernmental Non-entity Assets: | | |
| Fund Balance with Treasury | $ 13,129 | $ 13,140 |
| Due from the General Fund | 2,873 | 2,022 |
| Total Intragovernmental Non-entity Assets | 16,002 | 15,162 |
| Tax and Trade Receivables, Net | 20,334 | 4,310 |
| Total Non-Entity Assets | 36,336 | 19,472 |
| Total Entity Assets | 43,156 | 46,842 |
| Total Assets | $ 79,492 | $ 66,314 |

## Note 9. Other Liabilities

Other Liabilities as of September 30, 2012 and 2011 consisted of the following (in thousands):

| | 2012 | 2011 |
|---|---|---|
| Due to the Fish and Wildlife Fund | $ 1,483 | $ 61 |
| Other Intragovernmental Liabilities | 1,483 | 61 |
| Offers-in-Compromise not yet Accepted | 560 | 693 |
| Total Other Liabilities with the Public | 560 | 693 |
| Total Other Liabilities | $ 2,043 | $ 754 |

All Other Liabilities are considered current liabilities.

## Note 10. Liabilities Not Covered by Budgetary Resources

Liabilities not Covered by Budgetary Resources as of September 30, 2012 and 2011 consisted of the following (in thousands):

| | 2012 | 2011 |
|---|---|---|
| Accrued FECA Liability | $ 39 | $ 36 |
| Total Intragovernmental Liabilities not Covered by Budgetary Resources | 39 | 36 |
| FECA Actuarial Liability | 228 | 308 |
| Accrued Leave | 4,233 | 4,346 |
| Total Liabilities with the Public not Covered by Budgetary Resources | 4,461 | 4,654 |
| Total Liabilities not Covered By Budgetary Resouces | 4,500 | 4,690 |
| Total Liabilities Covered by Budgetary Resources | 42,764 | 29,248 |
| Total Liabilities | $ 47,264 | $ 33,938 |

## Note 11. Future Funding Requirements

Total liabilities not covered by budgetary resources generally do not equal the total financing sources yet to be provided on the Reconciliation of Net Cost of Operations to Budget. The amounts reported on the Balance Sheet are period ending balances, while the amounts reported on the Reconciliation of Net Cost of Operations to Budget are activity for the period.

Generally, liabilities not covered by budgetary resources require future funding and can be liquidated only with the enactment of future appropriations.

## Note 12. Imputed Financing

Imputed Financing as of September 30, 2012 and 2011 consisted of the following (in thousands):

| | 2012 | 2011 |
|---|---|---|
| Health Insurance | $ 2,440 | $ 2,613 |
| Life Insurance | 8 | 8 |
| Pension | 1,593 | 1,975 |
| Total Imputed Financing | $ 4,041 | $ 4,596 |

Imputed financing recognizes actual cost of future benefits to be paid by other Federal entities. These benefits include Federal Employees Health and Benefits Program (FEHB), Federal Employees Group Life Insurance Program (FEGLI), and pensions. Imputed financing also recognizes costs paid by the Judgment Fund. The Fund was established and funded by Congress under 31 U.S.C. 1304 to pay in whole or in part court judgments and settlement agreements negotiated by Treasury on behalf of agencies, as well as certain types of administrative awards. The Judgment Fund did not pay out any awards on TTB's behalf during fiscal years 2012 or 2011. TTB does not report CSRS assets, FERS assets, accumulated plan benefits, or unfunded liabilities, if any, applicable to retirement plans because the accounting for and reporting of such amounts is the responsibility of OPM. Based on cost factors provided by OPM, which vary by retirement plan, estimated future pension benefits for TTB employees, to be paid by OPM, totaled $1.6 million and $2.0 million for fiscal years 2012 and 2011 respectively. Similarly, OPM rather than TTB, reports liabilities for future payments to retired employees who participate in the FEHB and FEGLI programs. The FEHB cost factor applied to a weighted average number of employees enrolled in the FEHB program decreased in FY 2012 to $5,817 from $6,027 in FY 2011, producing $2.4 million and $2.6 million of imputed cost for employees' health benefits in each respective year. The cost factor, as provided by OPM, for employees enrolled in the FEGLI program, remained unchanged from FY 2011 to FY 2012, at .02 percent of employees' basic pay. The FEGLI amounts totaling $8,000 each are also included as an expense and imputed financing source in TTB financial statements for fiscal years 2012 and 2011, respectively.

## Note 13. Consolidated Gross Cost and Earned Revenue by Budget Functional Classification

Consolidated Gross Cost and Earned Revenue by Budget Function Classification as of September 30, 2012 and 2011 consisted of the following (in thousands):

Fiscal Year Ended September 30, 2012

| Activity | Budget Function Classification (BFC) | BFC Code | Gross Costs | Earned Revenue | Net Costs |
|---|---|---|---|---|---|
| Intragovernmental | Central Fiscal Operations | 803 | $ 28,424 | $ (1,505) | $ 26,919 |
| With the Public | Central Fiscal Operations | 803 | 79,826 | (3,056) | 76,770 |
| Consolidated | Central Fiscal Operations | 803 | $ 108,250 | $ (4,561) | $ 103,689 |

Fiscal Year Ended September 30, 2011

| Activity | Budget Function Classification (BFC) | BFC Code | Gross Costs | Earned Revenue | Net Costs |
|---|---|---|---|---|---|
| Intragovernmental | Central Fiscal Operations | 803 | $ 29,709 | $ (539) | $ 29,170 |
| With the Public | Central Fiscal Operations | 803 | 78,579 | (3,097) | 75,482 |
| Consolidated | Central Fiscal Operations | 803 | $ 108,288 | $ (3,636) | $ 104,652 |

## Note 14. Statement of Budgetary Resources vs. Budget of the United States Government

The following chart displays balances from the FY 2011 Statement of Budgetary Resources and actual fiscal year balances included in the FY 2013 President's Budget. There were no differences. The FY 2014 budget, which would include FY 2012 actuals, had not been published at the time of this report.

| **Fiscal Year Ended September 30, 2011 (In Millions / Unaudited)** | **Statement of Budgetary Resources** | **President's Budget** |
|---|---|---|
| Budgetary Resources Available for Obligation | $ 108 | $ 108 |
| Status of Budgetary Resources Available for Obligation: | | |
| Obligations Incurred | $ 107 | $ 107 |
| Unobligated Balance Carried Forward, End of Year | 2 | 2 |
| Total Status of Budgetary Resources Available for Obligation | $ 109 | $ 109 |
| Net Outlays | $ 101 | $ 101 |

Additionally, the FY 2013 President's Budget disclosed budget authority of $452 million for FY 2011, funding cover-over payments to Puerto Rico, which is not reported in the Statement of Budgetary Resources.

The cover-over payments and associated tax revenues are reported as custodial activity of the Bureau. The tax revenues are not available for use in the operation of the Bureau and are not reported on the Statement of Net Cost. Likewise, the resultant cover-over payments are not recognized as an operating expense of the Bureau. Consequently, to present the refunds as an expense of the Bureau on the Statement of Net Cost would be inconsistent with the reporting of the related Federal tax revenue and would materially distort the costs incurred by the Bureau in meeting its strategic objectives. Further, since this activity is not reported on the Statement of Net Cost, it would be contradictory to report the budget authority on the Statement of Budgetary Resources.

## Note 15. Apportionment Categories of Obligations Incurred

Obligations Incurred as of September 30, 2012 and 2011 consisted of the following (in thousands):

| Fiscal Year | Apportionment Category | Direct Obligations | Reimbursable Obligations | Total Obligations Incurred |
|---|---|---|---|---|
| 2012 | Category B | $ 100,769 | $ 7,152 | $ 107,921 |
| 2011 | Category B | $ 103,038 | $ 3,955 | $ 106,993 |

The amount of direct and reimbursable obligations against amounts apportioned under Category B is reported in the table above. Apportionment categories are determined by the apportionment categories reported on the Standard Form 132 *Apportionment and Reapportionment Schedule*. Category B represents annual apportionments.

| | 2012 | 2011 |
|---|---|---|
| Undelivered Orders End of Period | $16,185 | $13,813 |

## Note 16. Net Custodial Revenue Activity

- **Excise Taxes**

  As an agent of the Federal Government and as authorized by 26 U.S.C., TTB collects excise taxes from alcohol, tobacco, firearms, and ammunition industries. In addition, special occupational taxes are collected from certain alcohol and tobacco businesses. During FY 2012 and FY 2011, TTB collected $23.4 billion and $23.5 billion respectively in taxes, interest, and other custodial revenues.

  Substantially all of the taxes collected by TTB net of related refund disbursements are remitted to the Department of Treasury General Fund. The Department of Treasury further distributes this revenue to Federal agencies in accordance with various laws and regulations. The firearms and ammunition excise taxes are an exception. Those revenues are remitted to the Fish and Wildlife Restoration Fund under provisions of the Pittman-Robertson Act of 1937.

- **Refunds and Other Payments**

During FY 2012 and FY 2011, TTB issued $709 million and $802 million in refunds, cover-over payments, and drawback payments in the respective years.

**Tax Refunds**

Tax Refunds result when taxpayers file returns for payments made for a given tax period and the result of the return is an overpayment.

**Cover-over Payments**

Federal excise taxes are collected under the Internal Revenue Code of 1986, 26 U.S.C., on certain articles produced in Puerto Rico and the Virgin Islands, and imported into the United States. In accordance with 26 U.S.C. 7652, such taxes collected on rum imported into the United States are custodial revenues and “covered over,” or paid into, the treasuries of Puerto Rico and the Virgin Islands.

TTB maintains operations in Puerto Rico to enforce the provisions of chapter 51 in respect to items of Puerto Rican manufacture brought in to the United States. These operations include conducting annual revenue, application, and product integrity investigations of large alcohol and tobacco industry members. Except for application investigations, TTB investigates medium and small alcohol and tobacco producers in response to specific problems and risk indicators. Revenue inspections are used to verify that TTB is collecting all of the revenue that is rightfully due from the taxpayer. TTB staff in Puerto Rico also conducts qualification inspections of all distilled spirits producers/processors, wineries, wholesalers, importers, Manufacturer of Nonbeverage Products (MNBP) claimants, and Specially Denatured Alcohol permit applicants. All costs associated with the functioning and supporting of the Puerto Rico office, $3.1 and $3.0 million in FY 2012 and FY 2011 respectively, are offset against the cover-over payments made by the United States to Puerto Rico.

**Drawbacks**

Under current law, 26 U.S.C. 5134, MNBP permittees may be eligible to claim a refund of tax paid on distilled spirits used in their products. In the case of distilled spirits, on which the tax has been paid or determined, a drawback shall be allowed on each proof gallon at the rate of $1 less than the rate at which the distilled spirits tax had been paid or determined. The refund is due upon the claimant providing evidence that the distilled spirits on which the tax has been paid or determined were unfit for beverage purposes and were used in the manufacture or production of medicines, medicinal preparations, food products, flavors, flavoring extracts, or perfume.

Refunds, Drawbacks and Cover-over Payments as of September 30, 2012 and 2011 consisted of the following (in thousands):

| | 2012 | 2011 |
|---|---|---|
| Alcohol and Tobacco Excise Tax Refunds | $ 30,293 | $ 33,414 |
| Drawbacks on MNBP Claims | 289,330 | 306,584 |
| Interest and Other Payments | 3,824 | 418 |
| Refunds and Drawbacks | 323,447 | 340,416 |
| Cover-over Payments - Puerto Rico | 376,373 | 452,040 |
| Cover-over Payments - Virgin Islands | 9,337 | 9,592 |
| Amounts Provided to Non-federal Entities | 385,710 | 461,632 |
| Total Refunds, Drawbacks and Coverover Payments | $ 709,157 | $ 802,048 |

## Note 17. Custodial Revenue

Collection and Disposition of Custodial Revenue as of September 30, 2012 and 2011 consisted of the following (in thousands):

FY 2012 Collections and Refunds by Tax Year

| Revenue Type | 2012 | 2011 | 2010 | Pre-2010 | FY 2012 Total |
|---|---|---|---|---|---|
| Excise Taxes | $ 17,158,574 | $ 6,209,558 | $ 3,510 | $ 7,302 | $ 23,378,944 |
| Fines, Penalties, Interest and Other | 246 | 371 | 184 | 136 | 937 |
| Total Revenue Received | 17,158,820 | 6,209,929 | 3,694 | 7,438 | 23,379,881 |
| Less: Amounts Collected for Non-federal Entities | (385,710) | - | - | - | (385,710) |
| Total | $ 16,773,110 | $ 6,209,929 | $ 3,694 | $ 7,438 | $ 22,994,171 |
| Refund Type | | | | | |
| Excise Taxes | $ 159,021 | $ 155,721 | $ 1,011 | $ 7,107 | $ 322,860 |
| Fines, Penalties, Interest and Other | 587 | - | - | - | 587 |
| Total Refunds & Drawbacks | $ 159,608 | $ 155,721 | $ 1,011 | $ 7,107 | $ 323,447 |
| Amounts Provided to Fund the Federal Government | $ 16,613,502 | $ 6,054,208 | $ 2,683 | $ 331 | $ 22,670,724 |

FY 2011 Collections and Refunds by Tax Year

FY 2011 Collections and Refunds by Tax Year

| Revenue Type | 2011 | 2010 | 2009 | Pre-2009 | FY 2011 Total |
|---|---|---|---|---|---|
| Excise Taxes | $ 17,199,511 | $ 6,240,989 | $ 9,052 | $ 7,497 | $ 23,457,049 |
| Fines, Penalties, Interest and Other | 3,736 | 466 | 64 | 95 | 4,361 |
| Total Revenue Received | 17,203,247 | 6,241,455 | 9,116 | 7,592 | 23,461,410 |
| Less: Amounts Collected for Non-federal Entities | (461,632) | - | - | - | (461,632) |
| Total | $ 16,741,615 | $ 6,241,455 | $ 9,116 | $ 7,592 | $ 22,999,778 |
| Refund Type | | | | | |
| Excise Taxes | $ 165,693 | $ 162,377 | $ 11,744 | $ 429 | $ 340,243 |
| Fines, Penalties, Interest and Other | 173 | - | - | - | 173 |
| Total Refunds & Drawbacks | $ 165,866 | $ 162,377 | $ 11,744 | $ 429 | $ 340,416 |
| Amounts Provided to Fund the Federal Government | $ 16,575,749 | $ 6,079,078 | $ (2,628) | $ 7,163 | $ 22,659,362 |

## Note 18. Reconciliation of Net Cost of Operations to Budget

The Reconciliation of Net Cost of Operations to Budget explains the difference between the budgetary net obligations and the proprietary net cost of operations.

Reconciliation of Net Cost of Operations to Budget, as of September 30, 2012 and 2011 consisted of the following (in thousands):

| | 2012 | 2011 |
|---|---|---|
| **Resources Used to Finance Activities** | | |
| **Budgetary Resources Obligated** | | |
| Obligations Incurred | $ 107,921 | $ 106,993 |
| Less: Spending Authority from Offsetting Collections and Recoveries | (8,109) | (5,586) |
| Obligations Net of Offsetting Collections and Recoveries | 99,812 | 101,407 |
| Less: Offsetting Receipts | (3) | (10) |
| Net Obligations | 99,809 | 101,397 |
| **Other Resources** | | |
| Transfers-in without Reimbursement | 91 | 231 |
| Imputed Financing from Costs Absorbed by Others | 4,041 | 4,596 |
| Net Other Resources Used to Finance Activities | 4,132 | 4,827 |
| **Total Resources Used to Finance Activities** | $ 103,941 | $ 106,224 |

| | | |
|---|---|---|
| **Resources Used to Finance Items not Part of the Net Cost Of Operations** | | |
| Change in Budgetary Resources Obligated for Goods, Services and Benefits Ordered but not Yet Provided (+/-) | $ 181 | $ 523 |
| Resources that Fund Expenses Recognized in Prior Periods | 193 | 42 |
| Other Budgetary Offsetting Collections and Receipts that do not Affect Net Cost of Operations | 88 | 221 |
| Resources that Finance the Acquisition of Assets | 3,625 | 3,311 |
| Other Resources or Adjustments to Net Obligated Resources that do not Affect Net Cost of Operations (+/-) | (91) | (241) |
| **Total Resources Used to Finance Items not Part of the Net Cost of Operations** | $ 3,996 | $ 3,856 |
| **Total Resources Used to Finance the Net Cost of Operations** | $ 99,945 | $ 102,368 |
| **Components of the Net Cost of Operations Requiring or Generating Resources in Future Periods** | | |
| **Components Requiring or Generating Resources in Future Periods:** | | |
| Other (+/-) | - | 176 |
| **Total Components of Net Cost of Operations that will Require or Generate Resources in Future Periods** | $ - | $ 176 |
| **Components of the Net Cost of Operations not Requiring or Generating Resources** | | |
| Depreciation and Amortization | $ 3,744 | $ 2,108 |
| **Total Components of Net Cost of Operations that will not Require or Generate Resources** | $ 3,744 | $ 2,108 |
| **Total Components of Net Cost of Operations that will not Require or Generate Resources in the Current Period** | $ 3,744 | $ 2,284 |
| **NET COST OF OPERATIONS** | $ 103,689 | $ 104,652 |

## Note 19: Contingent Liabilities

As of September 30, 2012, TTB is not party to any legal matters where the estimated loss would be of a material amount.

# Required Supplementary Information (Unaudited)

## Budgetary Information

Budgetary information aggregated for the purposes of the Statement of Budgetary Resources should be disaggregated for each of an entity's major budget accounts (i.e., Appropriated Funds, Trust Funds, Revolving Funds, or other funds) and presented as Supplementary Information. However, for proprietary reporting, TTB only has appropriated funds. Consequently, a Combining Statement of Budgetary Resources disaggregated by fund type has not been presented.

## Excise Tax and Other Collections

**Required Supplementary Information**
**Excise Tax and Other Collections by Fiscal Year**
**Unaudited (In Thousands)**

| Fiscal Year | Alcohol | Tobacco | FAET | SOT | FST | Other | Total |
|---|---|---|---|---|---|---|---|
| 2003 | $ 6,910,631 | $ 7,380,807 | $ 193,414 | $ 103,781 | $ 1,628 | $ - | 14,590,261 |
| 2004 | 6,995,366 | 7,433,852 | 216,006 | 100,562 | - | 359 | 14,746,145 |
| 2005 | 7,074,076 | 7,409,608 | 225,818 | 10,190 | 9 | 141 | 14,719,842 |
| 2006 | 7,182,940 | 7,350,058 | 249,578 | 2,895 | 638 | 146 | 14,786,255 |
| 2007 | 7,232,138 | 7,194,081 | 287,835 | 2,808 | - | 32 | 14,716,894 |
| 2008 | 7,420,576 | 6,851,705 | 312,622 | 448 | - | 634 | 14,585,985 |
| 2009 | 7,424,292 | 11,548,504 | 452,693 | 272 | 1,192,375 | 970 | 20,619,106 |
| 2010 | 7,476,789 | 15,913,479 | 360,813 | 300 | 8,558 | 180 | 23,760,119 |
| 2011 | 7,594,330 | 15,515,073 | 344,262 | 268 | 5,220 | 2,257 | 23,461,410 |
| 2012 | 7,856,391 | 15,002,616 | 514,622 | 249 | 5,942 | 61 | 23,379,881 |
| Average | $ 7,316,753 | $10,159,978 | $ 315,766 | $ 22,177 | $ 121,437 | $ 478 | $17,936,590 |

FAET – Firearms and Ammunition Excise Tax
SOT – Special Occupational Tax
FST – Floor Stocks Tax

The sharp decrease in SOT tax collections was the result of a new law that became effective during fiscal year 2005 that suspended the collection of most of the taxes. The law became permanent in 2008.

TTB collects FAET taxes on behalf of the Department of Interior, U.S. Fish and Wildlife Service, and deposits the collections directly into the Fish and Wildlife Restoration Fund. During fiscal years 2012 and 2011, TTB incurred $1.7 million and $1.5 million respectively of direct and indirect costs associated with collecting the FAET taxes. The law currently does not provide for TTB to recover these costs. The cost of the program was communicated to the U.S. Fish and Wildlife Service so the agency could properly record an imputed cost in its financial records.

## Refunds, Cover-over Payments, and Drawback Payments

**Required Supplementary Information**
**Refunds, Cover-over Payments and Drawback Payments by Fiscal Year**
**Unaudited (In Thousands)**

| Fiscal Year | Cover-over Puerto Rico | Cover-over Virgin Islands | A&T Excise Tax | Drawbacks MNBP Claims | Interest and Other | Total |
|---|---|---|---|---|---|---|
| 2003 | $ 356,144 | $ 6,405 | $ 15,168 | $ 296,168 | $ 2,011 | $ 675,896 |
| 2004 | 335,293 | 6,244 | 15,409 | 355,605 | 1,216 | 713,767 |
| 2005 | 419,602 | 6,010 | 18,504 | 317,132 | 2,100 | 763,348 |
| 2006 | 358,664 | 6,491 | 17,524 | 337,632 | 699 | 721,010 |
| 2007 | 459,278 | 8,054 | 13,208 | 335,706 | 972 | 817,218 |
| 2008 | 373,418 | 7,615 | 14,125 | 283,462 | 2,938 | 681,558 |
| 2009 | 472,695 | 8,624 | 17,791 | 268,612 | 252 | 767,974 |
| 2010 | 378,186 | 8,871 | 28,232 | 297,596 | 315 | 713,200 |
| 2011 | 452,040 | 9,592 | 33,414 | 306,584 | 418 | 802,048 |
| 2012 | 376,373 | 9,337 | 30,293 | 289,330 | 3,824 | 709,157 |
| Average | $ 398,169 | $ 7,724 | $ 20,367 | $ 308,783 | $ 1,475 | $ 736,518 |

A&T – Alcohol and Tobacco
MNBP – Manufacturer of Nonbeverage Products
Note – During December 2010, the Puerto Rico cover-over rate was increased from $10.50 per proof gallon to $13.25 per proof gallon, with retroactive provisions, resulting in a substantial increase in the Puerto Rico cover-over payments in FY 2011. The increased rate expired December 31, 2011.

# Other Accompanying Information (Unaudited)

**Other Accompanying Information**
**Schedule of Spending**
**For the Years Ended September 30, 2012 and 2011**
**Unaudited (In Thousands)**

| | 2012 | 2011 |
|---|---|---|
| **What Money is Available to Spend** | | |
| Total Resources | $ 111,037 | $ 110,511 |
| Less: Amount Available but not Agreed to be Spent | (398) | (1,758) |
| Less: Amount Not Available to Be Spent | (2,718) | (1,760) |
| Total Amounts Agreed to be Spent | $ 107,921 | $ 106,993 |
| **How was the Money Spent** | | |
| Collect the Revenue | | |
| Object Class 11: Personnel Compensation | $ 23,722 | $ 24,149 |
| Object Class 12: Personnel Benefits | 6,730 | 6,652 |
| Object Class 21: Travel | 1,757 | 1,728 |
| Object Class 23: Rent, Utilities, and Telecommunications Services | 3,475 | 3,579 |
| Object Class 25: Contractual Services | 15,878 | 15,014 |
| Object Class 31: Equipment and Software | 3,255 | 2,891 |
| Other | 713 | 532 |
| Total Collect the Revenue | 55,530 | 54,545 |
| Protect the Public | | |
| Object Class 11: Personnel Compensation | 22,998 | 23,284 |
| Object Class 12: Personnel Benefits | 6,330 | 6,306 |
| Object Class 21: Travel | 634 | 899 |
| Object Class 23: Rent, Utilities, and Telecommunications Services | 3,273 | 3,268 |
| Object Class 25: Contractual Services | 14,734 | 12,822 |
| Object Class 31: Equipment and Software | 3,556 | 3,339 |
| Other | 565 | 409 |
| Total Protect the Public | 52,090 | 50,327 |
| Total Spending | 107,620 | 104,872 |
| Amounts Remaining to be Spent | 301 | 2,121 |
| Total Amounts Agreed to be Spent | $ 107,921 | $ 106,993 |

## Intragovernmental Assets

**Other Accompanying Information**
**Intragovernmental Assets**
**As of September 30, 2012**
**Unaudited (In Thousands)**

| Trading Partner | Agency Code | Fund Balance W/ Treasury | Accounts Receivable | Advances |
|---|---|---|---|---|
| Department of the Treasury | 20 | $ - | $ 262 | $ 751 |
| General Fund | 99 | 34,431 | 2,873 | - |
| Total | | $ 34,431 | $ 3,135 | $ 751 |

**Other Accompanying Information**
**Intragovernmental Assets**
**As of September 30, 2011**
**Unaudited (In Thousands)**

| Trading Partner | Agency Code | Fund Balance W/ Treasury | Accounts Receivable | Advances |
|---|---|---|---|---|
| Department of the Treasury | 20 | $ - | $ 352 | $ 829 |
| General Fund | 99 | 37,866 | 2,022 | - |
| Total | | $ 37,866 | $ 2,374 | $ 829 |

# Intragovernmental Liabilities

**Other Accompanying Information**
**Intragovernmental Liabilities**
**As of September 30, 2012**
**Unaudited (In Thousands)**

| Trading Partner | Agency Code | Accounts Payable | Accrued FECA | Custodial and Other Liabilities |
|---|---|---|---|---|
| Government Printing Office | 04 | $ 26 | $ - | $ - |
| Department of the Interior | 14 | - | - | 1,483 |
| Department of Justice | 15 | 330 | - | - |
| Department of Labor | 16 | - | 39 | - |
| Department of the Treasury | 20 | - | - | - |
| Office of Personnel Management | 24 | - | - | 480 |
| General Services Administration | 47 | 123 | - | - |
| Treasury General Fund | 99 | 1 | - | 18,851 |
| Total | | $ 480 | $ 39 | $ 20,814 |

**Other Accompanying Information**
**Intragovernmental Liabilities**
**As of September 30, 2011**
**Unaudited (In Thousands)**

| Trading Partner | Agency Code | Accounts Payable | Accrued FECA | Custodial and Other Liabilities |
|---|---|---|---|---|
| Government Printing Office | 04 | $ 154 | $ - | $ - |
| Department of the Interior | 14 | - | - | 61 |
| Department of Justice | 15 | 150 | - | - |
| Department of Labor | 16 | - | 36 | - |
| Department of the Treasury | 20 | 36 | - | - |
| Office of Personnel Management | 24 | - | - | 476 |
| General Services Administration | 47 | 158 | - | - |
| Treasury General Fund | 99 | 2 | - | 4,411 |
| Total | | $ 500 | $ 36 | $ 4,948 |

## Intragovernmental Earned Revenue

**Other Accompanying Information**
**Intragovernmental Earned Revenue**
**For the Fiscal Years Ended September 30, 2012 and 2011**
**Unaudited (In Thousands)**

| Trading Partner | Agency Code | 2012 | 2011 |
|---|---|---|---|
| Department of Treasury | 20 | $ 1,500 | $ 514 |
| Department of Justice | 15 | 5 | - |
| GSA | 47 | - | 25 |
| Total | | $ 1,505 | $ 539 |

| Budget Function Classification (BFC) | BFC Code | 2012 | 2011 |
|---|---|---|---|
| Central Fiscal Operations | 803 | $ 1,505 | $ 539 |
| Total | | $ 1,505 | $ 539 |

## Intragovernmental Gross Cost

**Other Accompanying Information**
**Intragovernmental Gross Cost**
**For the Fiscal Years Ended September 30, 2012 and 2011**
**Unaudited (In Thousands)**

| Trading Partner | Agency Code | 2012 | 2011 |
|---|---|---|---|
| Library of Congress | 03 | $ 68 | $ 69 |
| Government Printing Office | 04 | 160 | 257 |
| Department of Interior | 14 | 75 | - |
| Department of Justice | 15 | 742 | 651 |
| Department of Labor | 16 | 19 | 16 |
| United States Postal Services | 18 | 54 | 44 |
| Department of State | 19 | 1 | 1 |
| Department of the Treasury | 20 | 5,247 | 6,172 |
| Office of Personnel Management | 24 | 12,480 | 12,914 |
| General Services Administration | 47 | 6,020 | 6,213 |
| Environmental Protection Agency | 68 | 20 | 8 |
| Department of Homeland Security | 70 | 450 | 362 |
| Department of Health and Human Services | 75 | 49 | 2 |
| National Archives Records Administration | 88 | 42 | 30 |
| Department of Defense | 97 | 100 | 95 |
| General Fund | 99 | 2,897 | 2,875 |
| Total | | $ 28,424 | $ 29,709 |

During fiscal years 2012 and 2011, TTB incurred costs with other Federal agencies totaling approximately $28.4 million and $29.7 million, in each year respectively. The majority of those costs were associated with the five entities detailed below.

- **Department of Justice:** TTB paid ATF $742,000 and $651,000 in fiscal years 2012 and 2011 respectively for shared lab space and shared building services.
- **Department of the Treasury:** The Bureau received services from Treasury's Working Capital Fund, as well as administrative services from the Bureau of Public Debt's Administrative Resource Center, in fiscal years 2012 and 2011 in the amounts of $5.2 million and $6.2 million respectively.
- **Office of Personnel Management:** TTB incurred $12.5 million and $12.9 million in costs for employee benefits for fiscal years 2012 and 2011 respectively.
- **General Services Administration:** TTB paid $6.0 million and $6.2 million to GSA for rent and information technology services in fiscal years 2012 and 2011 respectively.
- **General Fund:** The Bureau paid $2.9 million in each of the respective years for employee benefits and lockbox fees.

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# Part IV
## Appendices

### Principal Officers of TTB

**Administrator** .......... John Manfreda

**Deputy Administrator** .......... Mary Ryan

**Equal Employment Opportunity and Diversity Advancement** .......... Altivia Jackson

**Assistant Administrator, Field Operations** .......... Tom Crone

**Assistant Administrator, Headquarters Operations** .......... Theresa McCarthy

**Assistant Administrator, Management/CFO** .......... Cheri Mitchell

**Assistant Administrator, Information Resources/CIO** .......... Robert Hughes

**Executive Liaison for Industry and State Matters** .......... Susan Evans

**Chief Counsel** .......... John Lom (Acting)

For additional information, contact:

Alcohol and Tobacco Tax and Trade Bureau

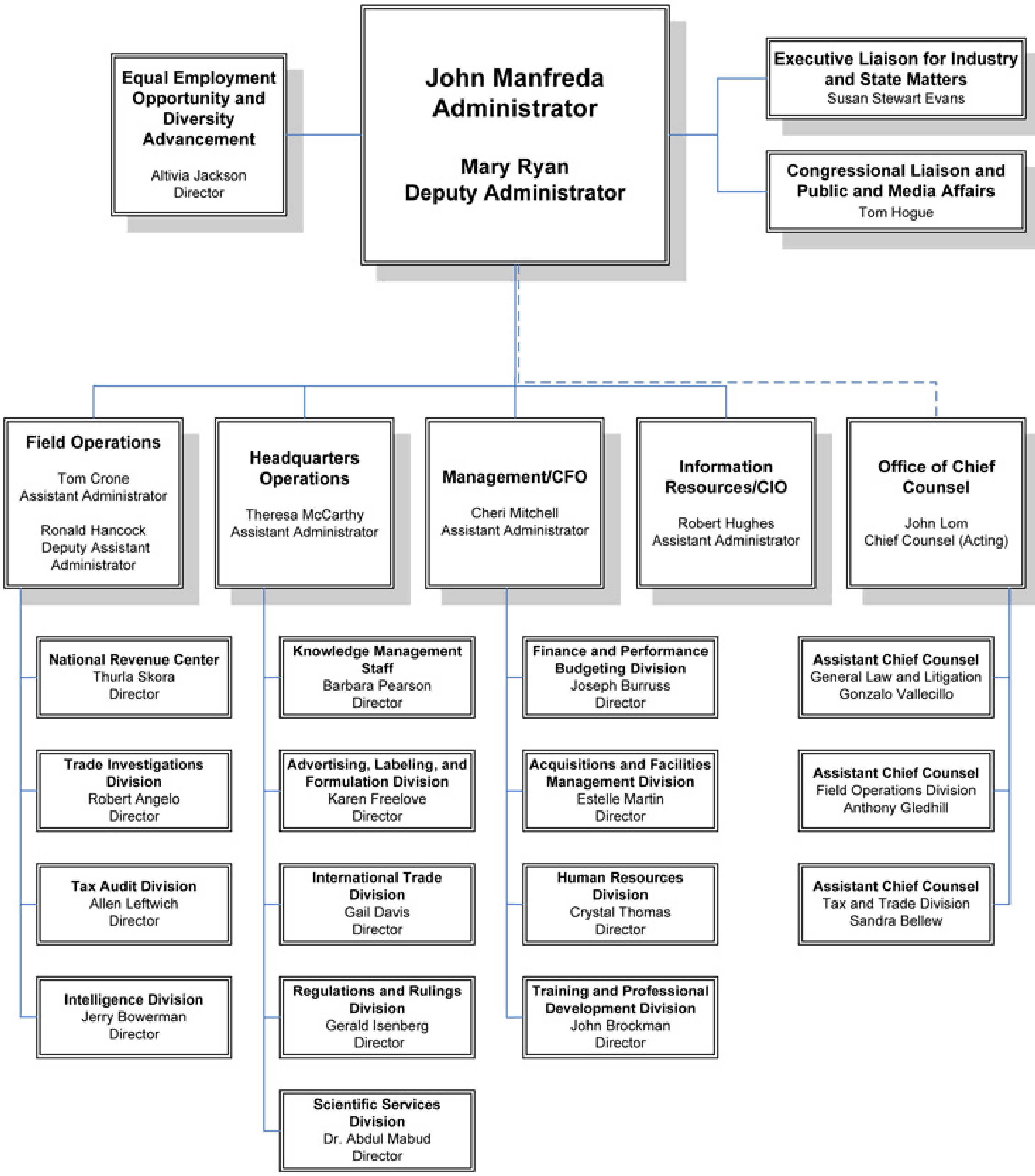
1310 G Street, NW, Box 12

Washington, DC 20005

(202) 453-2000

**http://www.ttb.gov**

# TTB Organization Chart



# Connecting the Treasury and TTB Strategic Plans

| TREASURY GOALS | TTB STRATEGIC GOALS | TTB OBJECTIVES |
|---|---|---|
| **TREASURY STRATEGIC GOAL:**<br>Enhance U.S. Competitiveness and Promote International Financial Stability and Balanced Global Growth<br><br>**AGENCY PRIORITY GOAL:**<br>Increase Electronic Transactions with the Public to Improve Service, Prevent Fraud, and Reduce Costs | **PROTECT THE PUBLIC (PTP):**<br><br>Alcohol and tobacco industry operators meet permit qualifications, and alcohol beverage products comply with federal production, labeling, and marketing requirements | **PTP 1. BUSINESS INTEGRITY:**<br>Assure that only qualified persons and business entities operate within the industries TTB regulates<br><br>**PTP 2. PRODUCT INTEGRITY:**<br>Assure that alcohol beverage products comply with Federal production, labeling, and advertising requirements<br><br>**PTP 3. MARKET INTEGRITY:**<br>Assure fair trade practices throughout the alcohol beverage marketplace |

**Note:** *TTB revised its goals and objectives in FY 2010, and is operating under these goals until the publication of its revised strategic plan in FY 2013. The current TTB strategic plan covers the period of FY 2007 – 2012.*

| TREASURY GOALS | TTB STRATEGIC GOALS | TTB OBJECTIVES |
|---|---|---|
| **TREASURY STRATEGIC GOAL:** Pursue Comprehensive Tax and Fiscal Reform<br><br>**AGENCY PRIORITY GOAL:** Increase Voluntary Tax Compliance | **COLLECT THE REVENUE (CTR):**<br><br>Enforce the tax code to ensure proper Federal tax payment on alcohol, tobacco, firearms, and ammunition products | **CTR 1. TAX VERIFICATION AND VALIDATION:** Assure voluntary compliance in the timely and accurate remittance of tax payments<br><br>**CTR 2. CIVIL AND CRIMINAL ENFORCEMENT:** Detect and address noncompliance, excise tax evasion, and other criminal violations of the Internal Revenue Code in the industries TTB regulates |

| TREASURY GOALS | TTB STRATEGIC GOALS | TTB OBJECTIVES |
|---|---|---|
| **TREASURY STRATEGIC GOAL:**<br>Manage the Government's Finances in a Fiscally Responsible Manner<br><br>**AGENCY PRIORITY GOAL:**<br>Increase Electronic Transactions with the Public to Improve Service, Prevent Fraud, and Reduce Costs | **MANAGEMENT AND ORGANIZATIONAL EXCELLENCE (MGT):**<br><br>Maximize performance, efficiency, and program results through effective resource and human capital management | **MGT 1. HUMAN CAPITAL MANAGEMENT:** Maintain a qualified, engaged, and satisfied workforce<br><br>**MGT 2. TECHNOLOGY SOLUTIONS:** Deliver effective, streamlined, and flexible IT solutions that add value and support program performance<br><br>**MGT 3. FINANCE AND PERFORMANCE RESULTS:** Facilitate strategic management and financial accountability through the delivery of timely and reliable financial and performance information |

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